Foundations of Commerce

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Preface

Audience and Purpose

This eTextbook is geared toward college students taking their first business course. It is not intended to replicate a traditional textbook or to provide a comprehensive treatment of the included topics; instead, the aim is to provide a streamlined, engaging, and interactive introduction to topics students will explore more deeply in future coursework, with the goal of introducing them to foundational concepts in business and helping them understand the "bigger picture" of the business world.

Open Education Resource

This eTextbook is an open education resource (OER) that substantially integrates, remixes, updates, and builds on a number of existing open-access textbooks and materials, which are attributed at the end of each chapter. I created many of the figures and H5P interactive components included in this eTextbook, selected high-quality videos to incorporate into most chapters, and chose many of the images used throughout the eTextbook. I also curated a collection of supplemental resources for students to learn more, included at the end of each chapter.

Third-party, copyrighted materials such as videos are incorporated into this eTextbook using the embed functionality offered by the respective hosting platforms (YouTube, in most cases) and are not encompassed by the creative commons licenses applied to other components of this OER.

Creative common licenses vary throughout the text. Chapter-level licenses are noted at the end of each chapter and licenses for H5P components and figures are noted individually.

Format

Because this eTextbook incorporates a number of interactive components, it is intended to be used online rather than in PDF or hardcopy format. I recommend using a laptop computer, desktop computer, or tablet to access this eTextbook, rather than a smaller device such as a mobile phone.

While a PDF version of this eTextbook is available for download, this download does not include the interactive content that is essential to this resource, and the PDF version may reflect minor formatting issues.

Acknowledgements

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Version Note

This version was finalized and published in May 2024 and will not be updated further. For the most up-to-date version, visit Foundations of Business (https://viva.pressbooks.pub/foundationsofbusiness/).

PART I
INTRODUCTION

1. Introduction to Business

Example 1.1: Apple

In 1976 Steve Jobs and Steve Wozniak created their first computer, the Apple I.[1] They invested a mere $1,300 and set up business in Jobs' garage. Almost four decades later, their business—Apple Inc.—has become one of the world's most influential and successful companies. Jobs and Wozniak were successful **entrepreneurs**: those who take the risks and reap the rewards associated with starting a new business enterprise.

Why has Apple flourished while so many other young companies fail? How did it grow from a garage start-up to a company generating revenues of $394 billion in 2022?[2] How was it able to transform itself from a nearly bankrupt firm to a multinational corporation with locations all around the world? You might conclude that it was the company's products, such as the Apple I and II, the Macintosh, or more recently its wildly popular iPod, iPhone, and iPad. Or, you could decide that it was its dedicated employees, management's wiliness to take calculated risks, or just plain luck—that Apple simply was in the right place at the right time.

Figure 1.1: Steve Jobs shows off the iPhone 4 at the 2010 Worldwide Developers Conference.

Before drawing any conclusions about what made Apple what it is today and what will propel it into a successful future, you might like to learn more about Steve Jobs, the company's cofounder and former CEO. Jobs was instrumental in the original design of the Apple I and, after being ousted from his position with the company, returned to save the firm from destruction and lead it onto its current path.

Growing up, Jobs had an interest in computers. He attended lectures at Hewlett-Packard after school and worked for the company during the summer months. He took a job at Atari after graduating from high school and saved his money to make a pilgrimage to India in search of spiritual enlightenment. Following his India trip, he attended Steve Wozniak's "Homebrew Computer Club" meetings, where the idea for building a personal computer surfaced.[3] "Many colleagues describe Jobs as a brilliant man who could be a great motivator and positively charming. At the same time his drive for perfection was so strong that employees who did not meet his demands [were] faced with blistering verbal attacks."[4] Not everyone at Apple appreciated Jobs' brilliance and ability to motivate.

Nor did they all go along with his willingness to do whatever it took to produce an innovative, attractive, high- quality product. So at age thirty, Jobs found himself ousted from Apple by John Sculley, whom Jobs himself had hired as president of the company several years earlier. It seems that Sculley wanted to cut costs and thought it would be easier to do so without Jobs around. Jobs sold $20 million of his stock and went on a two-month vacation to figure out what he would do for the rest of his life. His solution: start a new personal computer company called NextStep. In 1993, he was invited back to Apple (a good thing, because neither his new company nor Apple was doing well).

Steve Jobs was definitely not known for humility, but he was a visionary and had a right to be proud of his accomplishments. Some have commented that "Apple's most successful days occurred with Steve Jobs at the helm."[5]

Jobs did what many successful CEOs and managers do: he learned, adjusted, and improvised.[6] Perhaps the most important statement that can be made about him is this: He never gave up on the company that once turned its back on him. With Jobs being one of the most admired CEOs of all time, Tim Cook, Apple's current CEO, had big shoes to fill when he took over from Jobs in 2011. Despite doubt from many, Apple has released popular products under Cook's leadership, such as the Apple Watch and AirPods, with Apple becoming the first company to achieve a market-cap of more than $3 trillion, which it reached at the end of June 2023.[7]

Introduction to Business

Today is an interesting time to study business. Advances in technology are bringing rapid changes in the ways businesses produce and deliver goods and services. The Internet; other improvements in communication, such as smartphones, video conferencing, and social networking; and artificial intelligence (AI) now affect the way we do business. Companies are expanding international operations, and the workforce is more diverse than ever. Corporations are being held responsible for the behavior of their executives, and more people share the opinion that companies should be good corporate citizens. Because of the role they played in the worst financial crisis since the Great Depression, businesses today face increasing scrutiny and negative public sentiment.[8]

Economic turmoil that began in the housing and mortgage industries as a result of troubled subprime mortgages quickly spread to the rest of the economy. In 2008, credit markets froze up and banks stopped making loans. Lawmakers tried to get money flowing again by passing a $700 billion Wall Street bailout, however now-cautious banks became reluctant to extend credit. Without money or credit, consumer confidence in the economy dropped and consumers cut back on spending. Unemployment rose as troubled companies shed the most jobs in five years, and 760,000 Americans marched to the unemployment lines.[9] The stock market reacted to the financial crisis and its stock prices dropped by 44 percent while millions of Americans watched in shock as their savings and retirement accounts took a nosedive. In the fall of 2008, even Apple, a company that had enjoyed strong sales growth over the previous five years, began to cut production of its popular iPhone[10] and experienced a 50 percent drop in its stock price.[11] Apple eventually recovered and continued to grow, reaching an all-time high stock price of $194.48 in June 2023.[12]

Getting Down to Business

A **business** is an organization that provides goods or services to consumers for the purpose of making a profit. Be careful not to confuse the terms *revenue* and *profit*. **Revenue** represents the funds an enterprise receives in exchange for its goods or services. **Profit** is what's left (hopefully) after all the bills are paid. When Steve Jobs and Steve Wozniak launched the Apple I, they created the Apple Computer in Jobs' family garage in the hope of making a profit.

Before we go on, let's make a couple of important distinctions concerning the terms in our definitions. First, whereas Apple produces and sells **goods** (Mac, iPhone, iPod, iPad, Apple Watch), many businesses provide **services**. Your bank is a service company, as is your Internet provider. Hotels, airlines, law firms, movie theaters, and hospitals are also service companies. Many companies provide both goods and services. For example, your local car dealership sells goods (cars) and also provides services (automobile repairs). Second, some organizations are not set up to make profits. Many are established to provide social or educational services. Such **not-for-profit** (or *nonprofit*) organizations include the United Way of America, Habitat for Humanity, the Boys and Girls Clubs, the Sierra Club, the American Red Cross, and many colleges and universities. Most of these organizations, however, function in much the same way as a business. They establish goals and work to meet them in an effective, efficient manner. Thus, most business principles also apply to nonprofits.

One of the most fundamental principles of business is **risk**, or the potential to lose time and money or otherwise not be able to accomplish an organization's goals. Without enough blood donors, for example, the American Red Cross faces the risk of not meeting the demand for blood by victims of disaster. Businesses such as Microsoft face the risk of falling short of their revenue and profit goals. When a company such as Microsoft uses its resources intelligently, it can often increase sales, hold costs down, and earn a profit. Not all companies earn profits, but that is the risk of being in business. In U.S. business today, there is generally a direct relationship between risks and profit: the greater the risks, the greater the potential for profit (or loss). Companies that take too conservative a stance may lose out to more nimble competitors who react quickly to the changing business environment.

Business Participants and Activities

Let's begin our discussion of business by identifying the main participants of business and the functions that most businesses perform. Then we'll consider the external factors that influence a business' activities.

Participants

Every business must have one or more *owners* whose primary role is to invest money in the business. When a business is being started, it's generally the owners who polish the business idea and bring together the resources (money and people) needed to turn the idea into a business. The owners also hire *employees* to work for the company and help it reach its goals. Owners and employees depend on a third group of participants—*customers*. Ultimately, the goal of any business is to satisfy the needs of its customers in order to generate a profit for the owners.

Stakeholders

Consider your favorite restaurant. It may be an outlet or franchise of a national chain or a local "mom and pop" without affiliation to a larger entity. Whether national or local, every business has **stakeholders**—those with a legitimate interest in the success or failure of the business and the policies it adopts. Stakeholders include customers, vendors, employees, landlords, bankers, and others (Figure 1.2). All have a keen interest in how the business operates, in most cases for obvious reasons. If the business fails, employees will need new jobs, vendors will need new customers, and banks may have to write off loans they made to the business. Stakeholders do not always see things the same way— their interests sometimes conflict with each other. For example, lenders are more likely to appreciate high profit margins that ensure the loans they made will be repaid, while customers would probably appreciate the lowest possible prices. Pleasing stakeholders can be a real balancing act for any company.

Figure 1.2: Stakeholders.

Functional Areas of Business

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

Management

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

Operations

All companies must convert resources (labor, materials, money, information, and so forth) into goods or services. Some companies, such as Apple, convert resources into *tangible* products—Macs, iPhones, Apple Watch, etc. Others, such as hospitals, convert resources into *intangible* products—e.g., health care. The business function that designs and oversees the transformation of resources into goods or services is called **operations management**, or simply operations.

Marketing

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

Accounting

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

Finance

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

External Forces That Influence Business Activities

Apple, Microsoft, and other businesses don't operate in a vacuum; they're influenced by a number of external factors. These include the economy, government, consumer trends, technological developments, public pressure to act as good corporate citizens, and other factors. Collectively, these forces constitute what is known as the **macro environment**—essentially the big picture world external to a company over which the business exerts very little if any control.

An example of an industry that is affected by all these factors is the fast-food industry. Companies such as Taco Bell, McDonald's, Chick-fil-A and others all compete in this industry. A strong economy means people have more money to eat out. Food standards are monitored by a government agency, the Food and Drug Administration. Preferences for certain types of foods are influenced by consumer trends, for example, fast food companies are being pressured to make their menus healthier. Finally, a number of decisions made by companies in the industry result from their desire to be good corporate citizens. For example, several fast-food chains have responded to environmental concerns by eliminating Styrofoam containers.[13]

Chapter Review

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Optional Resources to Learn More

Books

The Visual MBA by Jason Barron https://www.thevisualmbabook.com/

Podcasts

Planet Money https://www.npr.org/podcasts/510289/planet-money

Marketplace https://www.marketplace.org/shows/marketplace/

Websites

Morning Brew https://www.morningbrew.com/daily

Harvard Working Knowledge https://hbswk.hbs.edu/

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Figure 1.2: Hoopes, C. (2023). *Stakeholders.* Licensed with CC BY-NC-SA 4.0.

Notes

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2. Securities Markets

What are Securities Markets?

Securities markets play an important role in the modern business world, and a basic understanding of markets, especially the stock market (Video 2.1), will help you better understand business news and current events.

Watch Video 2.1: *How Does the Stock Market Work?* for an overview of the stock market. Closed captioning is available. Click HERE to read a transcript.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=1210#oembed-1

Stocks, bonds, and other *securities* trade in securities markets. These markets streamline the purchase and sales activities of investors by allowing transactions to be made quickly and at a fair price. **Securities** are investment certificates that represent either **equity** (ownership in the issuing organization) or **debt** (a loan to the issuer). Corporations and governments raise capital to finance operations and expansion by selling securities to investors, who in turn take on a certain amount of risk with the hope of receiving a profit from their investment.

Individual investors invest their own money to achieve their personal financial goals. **Institutional investors** are investment professionals who are paid to manage other people's money. Most of these professional money managers work for financial institutions, such as banks, mutual funds, insurance companies, and pension funds, and they aim to meet the investment goals of their clients. Institutional investors control very large sums of money and are a major force in the securities markets.

What Is a Public Company?

The term **public company** can be defined in various ways. There are two commonly understood ways in which a company is considered public: first, the company's securities trade on public markets; and second, the company discloses certain business and financial information regularly to the public.

Companies are subject to public reporting requirements if they:

- Sell securities in a public offering, such as an **initial public offering (IPO)** (Video 2.2)
- Allow their investor base to reach a certain size, which triggers public reporting obligations
- Voluntarily register with the **Securities and Exchange Commission (SEC)**

Watch Video 2.2: *What is an IPO?* to learn more about what it means to "go public" through an IPO. Closed captioning is available. Click HERE to read a transcript.

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Public companies must keep their shareholders informed on a regular basis by filing periodic reports and other materials with the SEC. The SEC makes these documents publicly available without charge on its EDGAR website.

Following are reports that may be filed by U.S.-based public companies; click the name of each report type in the interactive list below to learn more:

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Types of Markets

Securities markets can be divided into primary and secondary markets. The **primary market** is where *new* securities are sold to the public, usually with the help of investment bankers. In the primary market, the issuer of the security gets the proceeds from the transaction. A security is sold in the primary market just once—when the corporation or government first issues it.

Later transactions take place in the **secondary market**, where *old* (already issued) securities are bought and sold, or traded, among investors. The issuers generally are not involved in these transactions. The vast majority of securities transactions take place in secondary markets, which include broker markets, dealer markets, the over-the-counter market, and the commodities exchanges.

The Role of Investment Bankers and Stockbrokers

Two types of investment specialists play key roles in the functioning of the securities markets. **Investment bankers** help companies raise long-term financing. These firms act as intermediaries, buying securities from corporations and governments and reselling them to the public. This process, called **underwriting**, is the main activity of the investment banker, which acquires the security for an agreed-upon price and hopes to be able to resell it at a higher price to make a profit. Investment bankers advise clients on the pricing and structure of new securities offerings, as well as on mergers, acquisitions, and other types of financing. Well-known investment banking firms include Goldman Sachs, Morgan Stanley, JP Morgan, Bank of America Merrill Lynch, and Citigroup.

A **stockbroker** is a person who is licensed to buy and sell securities on behalf of clients. Also called *account executives,* these investment professionals work for brokerage firms and execute the orders customers place for stocks, bonds, mutual funds, and other securities. Investors are wise to seek a broker who understands their investment goals and can help them pursue their objectives.

Brokerage firms are paid commissions for executing clients' transactions. Although brokers can charge whatever they want, most firms have fixed commission schedules for small transactions. These commissions usually depend on the value of the transaction and the number of shares involved.

Secondary Markets

When we think of stock markets, we are typically referring to secondary markets, which handle most of the securities trading activity. The two segments of the secondary markets are *broker markets* and *dealer markets*. The primary difference between broker and dealer markets is the way each executes securities trades. Securities trades can also take place in alternative market systems and on foreign securities exchanges.

Broker Markets

The **broker market** consists of national and regional securities exchanges that bring buyers and sellers together through brokers on a centralized trading floor. In the broker market, the buyer purchases the securities from the seller through the broker.

The oldest and most prestigious broker market is the **New York Stock Exchange** (NYSE), which has existed since 1792. Often called the Big Board, it is located on Wall Street in downtown New York City.[1] As of early 2023, the NYSE listed the shares of 2,385 companies, including 578 foreign companies, and had a total market capitalization of $24.6 trillion in mid-2022.[2] Major companies such as IBM, Coca-Cola, AT&T, Procter & Gamble, Ford Motor Co., and Chevron list their shares on the NYSE. Companies that list on the NYSE must meet stringent listing requirements and annual maintenance requirements.

Until relatively recently, all NYSE transactions occurred on the vast NYSE trading floor. Each of the companies traded at the NYSE is assigned to a trading post on the floor. When an exchange member receives an order to buy or sell a particular stock, the order is transmitted to a floor broker at the company's trading post. The floor brokers then compete with other brokers on the trading floor to get the best price for their customers.

In response to competitive pressures from electronic exchanges, the NYSE created a hybrid market that combines features of the floor auction market and automated trading. Its customers now have a choice of how they execute trades.

Dealer Markets

Unlike broker markets, **dealer markets** do not operate on centralized trading floors but instead use sophisticated telecommunications networks that link dealers throughout the United States. Buyers and sellers do not trade securities directly, as they do in broker markets. They work through securities dealers called *market makers*, who make markets in one or more securities and offer to buy or sell securities at stated prices. A security transaction in the dealer market has two parts: the selling investor sells his or her securities to one dealer, and the buyer purchases the securities from another dealer (or in some cases, the same dealer).

The largest dealer market is the **National Association of Securities Dealers Automated Quotation system**, commonly referred to as NASDAQ. The first electronic-based stock market, the NASDAQ is a sophisticated telecommunications network that links dealers throughout the United States. The NASDAQ lists more companies than the NYSE, but the NYSE still leads in total market capitalization. The NASDAQ's sophisticated electronic communication system provides faster transaction speeds than traditional floor markets.

The securities of many well-known companies trade on the NASDAQ. Examples include Amazon, Apple, Costco, Comcast, JetBlue, Microsoft, and Starbucks. The stocks of most commercial banks and insurance companies also trade in this market, as do most government and corporate bonds. As of early 2023, 3,629 companies were listed on the NASDAQ, including 864 foreign companies.[3]

Bonds

Bonds can be bought and sold in the securities markets. However, the price of a bond changes over its life as market interest rates fluctuate. When the market interest rate drops below the fixed interest rate on a bond, it becomes more valuable, and the price rises. If interest rates rise, the bond's price will fall. *Corporate bonds,* as the name implies, are issued by corporations. They usually have a **par value** of $1,000. Corporations can also issue **mortgage bonds**, bonds secured by property such as land, buildings, or equipment.

In addition to regular corporate debt issues, investors can buy *high-yield*, or **junk bonds**—high-risk, high-return bonds often used by companies whose credit characteristics would not otherwise allow them access to the debt markets. They generally earn 3 percent or more above the returns on high-quality corporate bonds. Corporate bonds may also be issued with an option for the bondholder to convert them into common stock. These **convertible bonds** generally allow the bondholder to exchange each bond for a specified number of shares of common stock.

U.S. Government Securities and Municipal Bonds

Both the federal government and local government agencies also issue bonds. The U.S. Treasury sells three major types of federal debt securities: Treasury bills, Treasury notes, and Treasury bonds. All three are viewed as default-risk-free because they are backed by the U.S. government. Treasury bills mature in less than a year and are issued with a minimum par value of $1,000. Treasury notes have maturities of 10 years or less, and Treasury bonds have maturities as long as 25 years or more. Both notes and bonds are sold in denominations of $1,000 and $5,000. The interest earned on government securities is subject to federal income tax but is free from state and local income taxes.

Municipal bonds are issued by states, cities, counties, and other state and local government agencies. These bonds typically have a par value of $5,000 and are either general obligation or revenue bonds. *General obligation bonds* are backed by the full faith and credit (and taxing power) of the issuing government. *Revenue bonds*, on the other hand, are repaid only from income generated by the specific project being financed. Examples of revenue bond projects include toll highways and bridges, power plants, and parking structures. Because the issuer of revenue bonds has no legal obligation to back the bonds if the project's revenues are inadequate, they are considered more risky and therefore have higher interest rates than general obligation bonds.

Municipal bonds are attractive to investors because interest earned on them is exempt from federal income tax. For the same reason, the coupon interest rate for a municipal bond is lower than for a similar-quality corporate bond. In addition, interest earned on municipal bonds issued by governments within the taxpayer's home state is exempt from state income tax as well. In contrast, all interest earned on corporate bonds is fully taxable.

Bond Ratings

Bonds vary in quality, depending on the financial strength of the issuer. Because the claims of bondholders come before those of stockholders, bonds are generally considered less risky than stocks. However, some bonds are in fact quite risky. Companies can default—fail to make scheduled interest or principal payments—on their bonds. Investors can use **bond ratings**, letter grades assigned to bond issues to indicate their quality or level of risk. Ratings for corporate bonds are easy to find. The two largest and best-known rating agencies are Moody's and Standard & Poor's (S&P). Table 2.1 lists the letter grades assigned by Moody's and S&P. A bond's rating may change if a company's financial condition changes.

Table 2.1: Bond Ratings

Moody's Ratings	S & P Ratings	Description
Aaa	AAA	**Prime-quality investment bonds:** Highest rating assigned; indicates extremely strong capacity to pay.
Aa, A	AA, A	**High-grade investment bonds:** Also considered very safe bonds, although not quite as safe as Aaa/AAA issues; Aa/AA bonds are safer (have less risk of default) than single As.
Baa	BBB	**Medium-grade investment bonds:** Lowest of investment-grade issues; seen as lacking protection against adverse economic conditions.
Ba B	BB B	**Junk bonds:** Provide little protection against default; viewed as highly speculative.
Caa Ca C	CCC CC C D	**Poor-quality bonds:** Either in default or very close to it.

Mutual Funds and ETFs

In addition to stocks and bonds, investors can buy mutual funds, a very popular investment category, or exchange-traded funds (ETFs).

Mutual Funds

Suppose that you have $1,000 to invest but don't know which stocks or bonds to buy, when to buy them, or when to sell them. By investing in a mutual fund, you can buy shares in a large, professionally managed portfolio, or group, of stocks and bonds. A **mutual fund** is a financial-service company that pools its investors' funds to buy a selection of securities—marketable securities, stocks, bonds, or a combination of securities—that meet its stated investment goals. Each mutual fund focuses on one of a wide variety of possible investment goals, such as growth or income. Many large financial-service companies, such as Fidelity and Vanguard, sell a wide variety of mutual funds, each with a different investment goal. Investors can pick and choose funds that match their particular interests. Some specialized funds invest in a particular type of company or asset: in one industry such as health care or technology, in a geographical region such as Asia, or in an asset such as precious metals.

Mutual funds appeal to investors for three main reasons:

1. They are a good way to hold a diversified, and thus less risky, portfolio. Investors with only $500 or $1,000 to invest cannot diversify much on their own. Buying shares in a mutual fund lets them own part of a portfolio that may contain 100 or more securities.
2. Mutual funds are professionally managed.
3. Mutual funds may offer higher returns than individual investors could achieve on their own.

Exchange-Traded Funds

Another type of investment, the **exchange-traded fund (ETF)**, has become very popular with investors. ETFs are similar to mutual funds (Video 2.3) because they hold a broad basket of stocks with a common theme, giving investors instant diversification. ETFs trade on stock exchanges, so their prices change throughout the day, whereas mutual fund share prices, called net asset values (NAVs), are calculated once a day, at the end of trading. ETFs tend to have low expense ratios, but because they trade as stocks, investors may pay commissions to buy and sell ETF shares.

Watch Video 2.3: *Mutual Funds vs. ETFs* to learn more about these two popular securities, how they are similar, and how they differ. Closed captioning is available. Click HERE to read a transcript.

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Regulation of Securities Markets

Both state and federal governments regulate the securities markets. The states were the first to pass laws aimed at preventing securities fraud. But most securities transactions occur across state lines, so federal securities laws are more effective. In addition to legislation, the industry has self-regulatory groups and measures.

Securities Legislation

Congress passed the Securities Act of 1933 in response to the 1929 stock market crash and subsequent problems during the Great Depression. It protects investors by requiring full disclosure of information about new securities issues. The issuer must file a *registration statement* with the Securities Exchange Commission (SEC), which must be approved by the SEC before the security can be sold.

The *Securities Exchange Act of 1934* formally gave the SEC power to regulate securities exchanges. The act was amended in 1964 to give the SEC authority over the dealer markets as well. The amendment included rules for operating the stock exchanges and granted the SEC control over all participants (exchange members, brokers, dealers) and the securities traded in these markets.

The 1934 act also banned **insider trading**, the use of information that is not available to the general public to make profits on securities transactions. Because of lax enforcement, however, several big insider trading scandals occurred during the late 1980s. The *Insider Trading and Fraud Act of 1988* greatly increased the penalties for illegal insider trading and gave the SEC more power to investigate and prosecute claims of illegal actions. The meaning of *insider* was expanded beyond a company's directors, employees, and their relatives to include anyone who gets private information about a company.

Other important legislation includes the *Investment Company Act of 1940,* which gives the SEC the right to regulate the practices of investment companies (such as mutual funds managed by financial institutions), and the *Investment Advisers Act of 1940,* which requires investment advisers to disclose information about their background. The *Securities Investor Protection Corporation (SIPC)* was established in 1970 to protect customers if a brokerage firm fails, by insuring each customer's account for up to $500,000.

In response to corporate scandals that hurt thousands of investors, the SEC passed new regulations designed to restore public trust in the securities industry. It issued *Regulation FD* (for "fair disclosure") in October 2000. Regulation FD requires public companies to share information with all investors at the same time, leveling the information playing field. The *Sarbanes-Oxley Act of 2002* has given the SEC more power when it comes to regulating how securities are offered, sold, and marketed.

Self-Regulation

The investment community also regulates itself, developing and enforcing ethical standards to reduce the potential for abuses in the financial marketplace. The Financial Industry Regulatory Authority (FINRA) oversees thousands of brokerage firms and more than 624,000 registered brokers.[4] It develops rules and regulations, provides a dispute resolution forum, and conducts regulatory reviews of member activities for the protection and benefit of investors.

In response to "Black Monday"—October 19, 1987, when the Dow Jones Industrial Average plunged 508 points and the trading activity severely overloaded the exchange's computers—the securities markets instituted corrective measures to prevent a repeat of the crisis. Now, under certain conditions, **circuit breakers** stop trading for a 15-minute cooling-off period to limit the amount the market can drop in one day. Under revised rules approved in 2012 by the SEC, market-wide circuit breakers kick in when the S&P 500 Index drops 7 percent (level 1), 13 percent (level 2), and 20 percent (level 3) from the prior day's closing numbers.[5]

Global Trading and Foreign Exchanges

Improved communications and the elimination of many legal barriers are helping the securities markets go global. The number of securities listed on exchanges in more than one country is growing. Foreign securities are now traded in the United States. Likewise, foreign investors can easily buy U.S. securities.

Stock markets also exist in foreign countries: more than 60 countries operate their own securities exchanges. NASDAQ ranks second to the NYSE, followed by the London Stock Exchange (LSE) and the Tokyo Stock Exchange. Other important foreign stock exchanges include Euronext (which merged with the NYSE but operates separately) and those in Toronto, Frankfurt, Hong Kong, Zurich, Australia, Paris, and Taiwan.[6]

Why should U.S. investors pay attention to international stock markets? Because the world's economies are increasingly interdependent, businesses must look beyond their own national borders to find materials to make their goods and markets for foreign goods and services. The same is true for investors, who may find that they can earn higher returns in international markets.

Chapter Review

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Optional Resources to Learn More

Articles

"Market Capitalization: How Is It Calculated and What Does It Tell Investors?" https://www.investopedia.com/terms/m/marketcapitalization.asp

Videos

"The Stock Market" https://youtu.be/ZCFkWDdmXG8

Websites

Corporate Finance Institute https://corporatefinanceinstitute.com/resources/

How Stock Markets Work https://www.investor.gov/introduction-investing/investing-basics/how-stock-markets-work

Investopedia https://www.investopedia.com/financial-term-dictionary-4769738

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Video 2.2: CNBC. (2018, May 3). *What is an IPO?* [Video]. YouTube. https://youtu.be/l4HMCr5roAM

Video 2.3: Wall Street Journal. (2016, February 8). *Mutual funds vs. ETFs: Which is right for you?* [Video]. YouTube. https://youtu.be/Es3vXJ7GoV8

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PART II

ORGANIZATIONS

3. Entrepreneurship

What is an Entrepreneur?

An **entrepreneur** is someone who identifies and acts on an idea or problem that no one else has identified or acted on in quite the same way. According to some perspectives on entrepreneurship, this combination of recognizing an opportunity to bring something new to the world and acting on that opportunity is what distinguishes an entrepreneur from a small business owner.[1] A small business owner is someone who owns or starts a business that already has an existing model, whereas an entrepreneur is someone who creates something new. This new creation can be a new process or product, a business that identifies a new or unique target market, or a combination of ideas that creates a new approach or method, for example.

Figure 3.1: Issues of Entrepreneur magazine.

Taking a broader perspective, others acknowledge that a small business owner may also be an entrepreneur; in other words, being an entrepreneur and a small business owner are not mutually exclusive. Someone may start a venture that is not a completely new idea, but that introduces a product or service to a new region or market. Where does a franchise fall in this discussion? Again, there is not complete agreement, with some claiming that a franchisee and entrepreneur cannot be the same, and others arguing that a franchise is, indeed, an entrepreneurial venture. According to an article in Forbes, "In the for-profit world, an entrepreneur is someone who creates and runs a new business where one did not exist before. And, no, the McDonald's franchisee didn't create McDonald's. But he certainly created a McDonald's where there never was one before. Franchisees are entrepreneurs."[2] The point is that small business owners and franchisees are considered by some to be entrepreneurs.

Entrepreneurs have many different talents and focus on a variety of different areas, taking advantage of many opportunities for entrepreneurial ventures. An entrepreneurial venture is the creation of any business, organization, project, or operation of interest that includes a level of risk in acting on an opportunity that has not previously been established. For some entrepreneurs, this could be a for-profit venture; for other entrepreneurs, this could be a venture focused on social needs and take the form of a nonprofit endeavor.

***Example 3.1**: Brooklyn Bowl*

Peter Shapiro, an influential concert promoter, takes a unique approach to his work. His courage to implement his creativity into his work, love for music, ability to take risks, and use of strategic partnerships have enabled him to successfully establish his business. He has established six music venues, put on tours with groups such as the Grateful Dead, and created a magazine, music festival, and a live streaming platform, all while maintaining (and arguably because of) his passion for music and creative energy.[3]

Entrepreneurial Opportunity

Aspiring entrepreneurs can come up with ideas all day long, but not every idea is necessarily a good idea. For an idea to be worth pursuing, we must first determine whether the idea translates into an *entrepreneurial opportunity*. **Entrepreneurial opportunity** is the point at which identifiable consumer demand meets the feasibility of satisfying the requested product or service. In the field of entrepreneurship, specific criteria need to be met to move from an idea into an opportunity. It begins with developing the right mindset—a mindset where the aspiring entrepreneur sharpens their senses to consumer needs and wants, and conducts research to determine whether the idea can become a successful new venture.

In some cases, opportunities are found through a deliberate search, especially when developing new technologies. In other instances, opportunities emerge serendipitously, through chance. But in most cases, an entrepreneurial opportunity comes about from recognizing a problem and making a deliberate attempt to solve that problem. The problem may be difficult and complex, such as landing a person on Mars, or it may be a much less complicated problem such as making a less expensive and more comfortable mattress, as companies like Casper and Purple did.

Product-Market Fit

In the 1989 film *Field of Dreams*, Kevin Costner plays an Iowa farmer who hears a voice that tells him , “If you build it, he will come.” Inspired by this vision, Costner’s character turns his cornfield into a baseball field (of dreams), and eventually the ghosts of deceased baseball players such as Shoeless Joe Jackson appear on the field as younger versions of themselves. The movie coined the popular axiom that “if you build it, they will come,” just as the players appeared after the field of dreams was built. Although it’s a fun saying for film buffs and sports fans, this approach is one you will want to avoid in entrepreneurship. In fact, the entrepreneurial graveyard is littered with ghosts of startups that never gained traction with customers, never to be heard from again. (Seventy-five percent of venture-backed startups fail, according to one study.[4]) Thus, you don’t want to blindly build a product and hope that customers will come. Juicero is one example of product that conducted little-to-no customer discovery before launch. A cold press juicer made by this San Francisco startup cost $699 at launch. The juicer squeezed packs of cut up fruits and vegetables, but customers found they could just as easily squeeze the juice out of the packs by hand and avoid the hefty price of the juicer.

Customer acquisition and customer retention are not easy processes by any means. You have to work to gain a customer and work even harder to get her to return. One study by the data analysis firm CBInsights of why 101 startups failed found that 42 percent of them joined the “entrepreneurial afterlife” because there was “no market need,” which suggests a customer (or lack thereof) problem.[5]

***Example 3.2**: Spot Hero*

Mark Lawrence was a banker until he was laid off during the the 2008 financial crisis. During his time as a banker, he regularly experienced a frustrating but common problem: finding parking (particularly in Chicago, where, at one point, he owed over $5,000 in parking tickets). In 2011, Lawrence and his co-founders established SpotHero to enable those who own private parking spots to rent them out online.

After a few years of struggling, the company finally landed a key partnership with a parking garage, which gave them the momentum they needed to be able to expand their business. SpotHero then grew rapidly by showing garage and parking lot owners the benefits of moving into the digital realm. As of May 2023, SpotHero had raised $118 million in funding and was operating in New York, Milwaukee, Boston, Baltimore, and Washington D.C., with plans to continue expanding throughout North America. Mark Lawrence is a classic example of an entrepreneur identifying a problem, creating a solution, and implementing it to great success.[6]

Current trends in entrepreneurial thinking reflect a customer-centric approach. From the start, entrepreneurs infuse their insights into the planning process through a process called “customer discovery.” The entrepreneurial journey should begin with finding what the serial entrepreneur, author, and educator Steve Blank, one of the founders of modern entrepreneurship, calls the problem/solution fit.[7]In a complementary approach, the Mosaic/Netscape founder Marc Andreessen discussed the need to achieve **product-market fit**.[8] In other words, don’t just build a baseball field and expect players to show up. This is an oversimplification, but if we extend the Field of Dreams analogy before blindly believing in the magic, you would want to talk to prospective players and fans to see if a field is needed, what type of field (corn-to-baseball?), why that field is needed, how that field would be used, and what features of the field would be most useful—before you go to bat.[9]

Business Plan

A **business plan** is a formal document used for the long-range planning of a company’s operation. It typically includes background information, financial information, and a summary of the business. Investors nearly always request a formal business plan because it is an integral part of their evaluation of whether to invest in a company. A business plan is likely to describe the business and industry, market strategies, sales potential, and competitive analysis, as well as the company’s long-term goals and objectives. The business plan usually projects financial data over a three-year period and is typically required by banks or other investors to secure funding. The business plan is a roadmap for the company to follow over multiple years.

Entrepreneurial Finance

Funds are the necessary capital to get a business, or idea, off the ground (Video 3.1). But funding cannot make up for a lack of experience, poor management, or a product with no viable market. Nonetheless, securing funding is one of the first steps, and a very real requirement, for starting a business.

Watch Video 3.1: *Where do Entrepreneurs Get Their Money?* to learn more about entrepreneurial financing. Closed captioning is available. Click HERE to read a transcript.

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Let's begin by exploring the financial needs and funding considerations for a simple organization. Imagine that you and your college roommate have decided to start your own band. In the past, you have always played in a school band where the school provided the instruments. Thus, you will need to start by purchasing or leasing your own equipment. You and your roommate begin to identify the basic necessities—guitars, drums, microphones, amplifiers, and so on. In your excitement, you begin browsing for these items online, adding to your shopping cart as you select equipment. It doesn't take you long to realize that even the most basic set of equipment could cost several thousand dollars. Do you have this much money available to make the purchase right now? Do you have other funding resources, such as loans or credit? Should you consider leasing most or all of the instruments and equipment? Would family or friends want to invest in your venture? What are the benefits and risks associated with these funding options?

This same basic inquiry and analysis should be completed as part of every business plan. First, you must determine the basic requirements for starting the business. What kinds of equipment will you need? How much labor and what type of skills? What facilities or locations would you require to make this business a reality? Second, how much do these items cost? If you do not possess an amount of money equal to the total anticipated cost, you will need to determine how to fund the excess amount.

Once a new business plan has been developed or a potential acquisition has been identified, it's time to start thinking about **financing**, which is the process of raising money for an intended purpose. In this case, the purpose is to launch a new business. Typically, those who can provide financing want to be assured that they could, at least potentially, be repaid in a short period of time, which requires a way that investors and business owners can communicate how that financing would happen.

Entrepreneurial Funding across the Company Lifecycle

An entrepreneur may pursue one or more different types of funding. Identifying the lifecycle stage of the business venture can help entrepreneurs decide which funding opportunities are most appropriate for their situation.

Seed Stage

From inception through successful operations, a business's funding grows generally through three stages: seed stage, early stage, and maturity (Figure 3.1). A **seed-stage** company is the earliest point in its lifecycle. It is based on a founder's idea for a new product or service. Nurtured correctly, it will eventually grow into an operational business, much as an acorn can grow into a mighty oak—hence the name "seed" stage. Typically, ventures at this stage are not yet generating revenue, and the founders haven't yet converted their idea into a saleable product. The personal savings of the founder, plus perhaps a few small investments from family members, usually constitute the initial funding of companies at the seed stage. Before an outsider will invest in a business, they will typically expect an entrepreneur to have exhausted what is referred to as F&F financing—friends and family financing—to reduce risk and instill confidence in the business's potential success.

Figure 3.2: Funding sources across different phases of the company lifecycle.

After investments from close personal sources, the business idea may begin to build traction and attract the attention of an angel investor. **Angel investors** are wealthy, private individuals seeking investment options with a greater potential return than is traditionally expected on publicly traded stocks, albeit with much greater risk. For that reason, they must be investors accredited by the federal Securities and Exchange Commission (SEC) and they must meet a net worth or income test. Nonaccredited investors are allowed in certain limited circumstances to invest in security-based crowdfunding for startup companies. Among the investment opportunities angel investors look at are startup and early stage companies. Angel investors and funds have grown rapidly in the past ten years, and angel groups exist in every state.

Early Stage

An **early stage** company has begun development of its product. It may be a technical proof of concept that still requires adjustments before it is customer ready. It may also be a first-generation model of the product that is securing some sales but requires modifications for large-scale production and manufacturing. At this stage, the company's investors may now include a few outsider investors, including venture capitalists.

A **venture capitalist** is an individual or investment firm that specializes in funding early stage companies. Venture capitalists differ from angel investors in two ways. First, a venture capital firm typically operates as a full-time active investment business, whereas an angel investor may be a retired executive or business owner with significant savings to invest. Additionally, venture capital firms operate at a higher level of sophistication, often specializing in certain industries and with the ability to leverage industry expertise to invest with more know-how. Typically, venture capitalists will invest higher amounts than angel investors, although this trend may be shifting as larger angel groups and "super angels" begin to invest in venture rounds.

Private equity investment is a rapidly growing sector and generally invests later than venture capitalists. Private equity investors either take a public company private or invest in private companies (hence the term "private equity"). The ultimate goals of private equity investors are generally taking a private company public through an initial public offering (IPO) or by adding debt or equity to the company's balance sheet, and helping it improve sales and/or profits in order to sell it to a larger company in its sector.

Mature Stage

Companies in the **mature stage** have reached commercial viability. They are operating in the manner described in the business plan: providing value to customers, generating sales, and collecting customer payments in a timely manner. Companies at this stage should be self-sufficient, requiring little to no outside investment to maintain current operations. For a product company, this means manufacturing a product at scale, that is, in very large volumes. For a software company or app provider, this means generating sales of the software or subscriptions under an SaaS model (Software as a Service) and possibly securing advertising revenue from access to the user base.

Companies at the mature stage have different financing needs from those in the previous two stages, where the focus was on building the product and creating a sales/manufacturing infrastructure. Mature companies have reached a consistent level of sales but may seek to expand into new markets or regions. Typically, this requires significant investment because the proposed expansion can often mirror the present level of operations. That is to say, an expansion at this level may result in doubling the size of the business. To access this amount of capital, mature companies may consider selling a portion of the company, either to a private equity group or through an IPO.

An **initial public offering (IPO)** occurs the first time a company offers ownership shares for sale on a public stock exchange, such as the New York Stock Exchange. Before a company executes an IPO, it is considered to be privately held, usually by its founders and other private investors. Once the shares are available to the general public through a stock exchange, the company is considered to be publicly held. This process typically involves an investment banking firm that will guide the company. Investment bankers will solicit institutional investors, such as State Street or Goldman Sachs, which will in turn sell those shares to individual investors. The investment banking firm typically takes a percentage of the funds raised as its fee. The benefit of an IPO is that the company gains access to a massive audience of potential investors. The downside is that the owners give up more ownership in the business and are also subject to many costly regulatory requirements.

The IPO process is highly regulated by the SEC, which requires companies to provide comprehensive information up front to potential investors before completing the IPO. These publicly traded companies must also publish quarterly financial statements, which are required to be audited by an independent accounting firm. Although there are benefits to an IPO for later-stage companies, it can be very costly both at the start and on an ongoing basis. Another risk is that if the company does not meet investors' expectations, the value of the company can decline, which can hinder its future growth options.

Thus, a business's lifecycle stage greatly influences its funding strategies and so does its industry. Different types of industries have different financing needs and opportunities. For example, if you were interested in opening a pizzeria, you would need a physical location, pizza ovens, and furniture so customers could dine there. These requirements translate into monthly rent on a restaurant location and the purchase of physical assets: ovens and furniture. This type of business requires a significantly higher investment in physical equipment than would a service business, such as a website development firm. A website developer could work from home and potentially begin a business with very little investment in physical resources but with a significant investment of their own time. Essentially, the web developer's initial funding requirement would simply be several months' worth of living expenses until the business is self-sufficient.

Once we understand where a business is in its lifecycle and which industry it operates in, we can get a sense of its funding requirements. Business owners can acquire funding through different avenues, each with its own advantages and disadvantages.

Types of Financing

Although many types of individuals and organizations can provide funds to a business, these funds typically fall into two main categories: debt and equity financing (Table 3.1). Entrepreneurs should consider the advantages and disadvantages of each type as they determine which sources to pursue in support of their venture's immediate and long-term goals.

Table 3.1: Debt vs. Equity Financing

	Debt Financing	Equity Financing
Ownership	Lender does not own stake in company	Lender owns stake in company
Cash	Requires early and regular cash outflow	No immediate cash outflow

Debt Financing

Debt financing is the process of borrowing funds from another party. Ultimately, this money must be repaid to the lender, usually with interest (the fee for borrowing someone else's money). Debt financing may be secured from many sources: banks, credit cards, or family and friends, to name a few. The maturity date of the debt (when it must be repaid in full), the payment amounts and schedule over the period from securement to maturity, and the interest rate can vary widely among loans and sources. You should weigh all of these elements when considering financing.

The advantage of debt financing is that the debtor pays back a specific amount. When repaid, the creditor releases all claims to its ownership in the business. The disadvantage is that repayment of the loan typically begins immediately or after a short grace period, so the startup is faced with a fairly quick cash outflow requirement, which can be challenging.

One source of debt financing for entrepreneurs is the Small Business Administration (SBA), a government agency founded as part of the Small Business Act of 1963, whose mission is to “aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns.”[10] The SBA partners with lending institutions such as banks and credit unions to guarantee loans for small businesses. The SBA typically guarantees up to 85 percent of the amount loaned. Whereas banks are traditionally wary of lending to new businesses because they are unproven, the SBA guarantee takes on some of the risk that the bank would normally be exposed to, providing more incentive to the lending institution to finance an entrepreneurial venture.

Equity Financing

In terms of investment opportunities, equity investments are those that involve purchasing an ownership stake in a company, usually through shares of stock in a corporation. Unlike debts that will be repaid and thus provide closure to the investment, **equity financing** is financing provided in exchange for part ownership in the business. Like debt financing, equity financing can come from many different sources, including friends and family, or more sophisticated investors. You may have seen this type of financing on the TV show *Shark Tank*. Contestants on the series pitch a new business idea in order to raise money to start or expand their business. If the “sharks” (investors) want to invest in the idea, they will make an offer in exchange for an ownership stake. For example, they might offer to give the entrepreneur $200,000 for a return of 40 percent ownership of the business.

The advantage of equity financing is that there is no immediate cash flow requirement to repay the funds, as there is with debt financing. The drawback of equity financing is that the investor in our example is entitled to 40 percent of the profits for all future years unless the business owner repurchases the ownership interest, typically at a much higher **valuation**—an estimate of worth, usually described in relation to the price an investor would pay to acquire the entire company.

Some financing sources are neither debt nor equity, such as gifts from family members, funds from crowdfunding websites such as Kickstarter, and grants from governments, trusts, or individuals.

Chapter Review

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"So You Want to Be an Entrepreneur?" https://hbr.org/2020/07/so-you-want-to-be-an-entrepreneur

"Why Startups Fail" https://www.wilburlabs.com/blueprints/why-startups-fail

Books

How I Built This by Guy Raz https://www.guyraz.com/howibuiltthisbook

Podcasts

How I Built This https://wondery.com/shows/how-i-built-this/

Videos

"Go Be an Entrepreneur" https://youtu.be/FOFm8fPP2Kc

Websites

Kauffman Founders School https://www.entrepreneurship.org/learning-paths

Stanford eCorner https://ecorner.stanford.edu/

Startup Grind https://medium.com/startup-grind

Y Combinator Startup School https://www.startupschool.org/

Resources for Innovators https://venturewell.org/resources/

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Figure 3.2: Hoopes, C. (2023). *Funding Sources*. Image of stacked coins from Freepik. Licensed with CC BY-NC-SA 4.0.

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4. Business Models

What is a Business Model?

In standard business usage, a **business model** is a plan for how a venture will be funded; how the venture creates value for its stakeholders, including customers; how the venture's offerings are made and distributed to the end users; and how income will be generated through this process. The business model refers more to the design of the business, whereas a **business plan** is a more of a planning document used for such aspects of the business as financing and operations.

Each business model is unique to the company it describes. A typical business model addresses the desirability, feasibility, and viability of a company, product, or service. At a bare minimum, a business model needs to address revenue streams (e.g., a revenue model), a value proposition, and customer segments. Put more simply, you want to address what your idea is, who will use it, why they will use it, and how you will make money from it.

Business Model Canvas

According to Alexander Osterwalder and Yves Pigneur, the authors of *Business Model Generation*, a business model "describes the rationale of how an organization creates, delivers and captures value."[1]

A **business model canvas** is a display that allows users to map out different components of a business models (Videos 4.1 and 4.2). While the business model canvas is often used and discussed in the context of entrepreneurship and starting a business, the business model canvas can be applied in a number of other ways, including strategic planning, understanding competition, understanding customers, and making investment decisions.[2]

Watch Video 4.1: *Getting from Business Idea to Business Model* to learn about the business model canvas. Closed captioning is available. Click HERE to read a transcript.

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Watch Video 4.2: *Visualizing your Business Model* to learn more about the business model canvas. Closed captioning is available. Click HERE to read a transcript.

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As developed by Osterwalder and Pigneur, the business model canvas has nine components. Click on each information icon in the interactive business model canvas below to learn more about each component:

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Value propositions: A company creates value, or benefits, for customers by solving a problem or satisfying a need. The value proposition is the reason that customers choose one option over another when deciding what to buy. Although certainly not an exhaustive list, customers may value: newness, performance, customization, design, brand, price, cost reduction, risk reduction, accessibility, and convenience.

The value proposition block of the business model canvas answers questions such as:

- What do we provide our customers?
- What problem are we solving?
- What are we offering to each customer segment?

Customer segments: Without customers, businesses cannot survive. Businesses must identify and understand their customers, and they can group these customers into segments with common characteristics. For example, a business model that focuses on a **mass market** is focused on a large group of customers with generally similar problems and needs, while a business model that focuses on a **niche market** is focused on a specific, specialized customer segment with problems or needs that differ from other customer segments.

The customer segments block of the business model canvas answers questions such as:

- Who are our customers?
- For whom are we creating value?

Channels: Channels bring the value proposition to the customers through communication, distribution, and sales. Companies can reach their customer segments through a mix of channels, both direct (e.g., through sales force and web sales) and indirect (e.g., through partner stores), to raise awareness, allow for purchase and delivery, provide customer support, and support other important functions of the business.

The channels block of the business model canvas answers questions such as:

- How will we reach our customer segments?
- How are our channels integrated?
- Which channels are the most efficient?

Customer relationships: Companies need to maintain relationships with their customers to acquire and retain customers and boost sales. Strong customer relationships can significantly impact overall customer experience. There are many categories of customer relationships including personal assistance, self-service, automated service, user communities, and cocreation.

The customer relationships block of the business model canvas answers questions such as:

- What type of relationship does each customer segment want?
- How costly are the relationships?
- How do we integrate them with the rest of our business model?

Revenue streams: Revenue streams can be generated through asset sales (e.g., selling a physical product), usage fees, subscription fees, licensing, brokerage fees, advertising, and temporarily selling the use of a particular asset (e.g., lending, renting, or leasing). Revenue pricing mechanisms vary from fixed (e.g., predefined prices based on static variables) to dynamic (e.g., price changes based on market conditions).

The revenue streams block of the business model canvas answers questions such as:

- What are customers willing to pay?
- What and how do they currently pay?
- How much does each revenue stream contribute to overall revenue?

Key resources: Any business needs resources—physical, financial, intellectual, and/or human—to function. These resources enable the company to provide their products or services to their customers.

The key resources block of the business model canvas answers questions such as:

- What key resources do our value proposition(s), channels, customer relationships, and revenue streams require?

Key activities: Key activities are the critical tasks that a company does to succeed and operate successfully. Different companies focus on different activities in categories such as production, problem-solving, and platform/network.

The key activities block of the business model canvas answers questions such as:

- What key activities do our value proposition(s), channels, customer relationships, and revenue streams require?

Key partnerships: Companies build partnerships to optimize their business, reduce risk, or gain resources. There are four main types of partnerships: strategic alliances between noncompetitors, coopetition (strategic alliances between competitors), joint ventures, and buyer-supplier relationships.

The key partnerships block of the business model canvas answers questions such as:

- Who are our key partners and suppliers?
- Which key resources are from which partner?

- What key activities are done by partners?

Cost structure: All businesses incur costs through operation, whether **fixed** or **variable**. They may also face **economies of scale** and **scope**. Companies consider their cost structures in two strategies: *cost-driven*, where all costs are reduced wherever possible, and *value-driven*, where the focus is on greater value creation.

The cost structure block of the business model canvas answers questions such as:

- What are the most important costs in our business model?
- Which key activities and key resources are the most expensive?

The Business Model "Theater"

The nine components of the business model canvas can be grouped to represent two distinct aspects of a business: the "front stage," or the customer-facing side of the business, as well as the "back stage," or business-facing side (Video 4.3). Both the customer-facing and business-facing sides of a business model need to align in order for a company to be profitable and to best position itself for success in the broader competitive environment.

Watch Video 4.3: *The Business Model Theatre* to better understand how the components of the business model canvas can be grouped to represent the two key aspects, or "sides," of any business. Closed captioning is available. Click HERE to read a transcript.

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Chapter Review

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Optional Resources to Learn More

Articles

"A Better Way to Think About Your Business Model" https://hbr.org/2013/05/a-better-way-to-think-about-yo

Books

Business Model Generation https://www.strategyzer.com/books/business-model-generation

Design a Better Business https://designabetterbusiness.com/

Videos

"The Business Model Canvas" https://www.youtube.com/watch?v=IP0cUBWTgpY

Websites

Business Model Analyst https://businessmodelanalyst.com/business-model-canvas

The Business Model Canvas Building Blocks https://web.archive.org/web/20230514005959/https://www.strategyzer.com/business-model-canvas/building-blocks

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Video 4.1: Strategyzer. (2013, September 20). *Getting from business idea to business model* [Video]. YouTube. https://youtu.be/wwShFsSFb-Y

Video 4.2: Strategyzer. (2013, September 20). *Visualizing your business model* [Video]. YouTube. https://youtu.be/wlKP-BaC0jA

Video 4.3: Strategyzer. (2014, July 28). *The business model theater* [Video]. YouTube. https://youtu.be/LLKqthJOdN8

Notes

1. Osterwalder, A., & Pigneur, Y. (2010). *Business model generation: A handbook for visionaries, game changers, and challengers*. Wiley.
2. Garner, B. (2015, March 23). *14 ways to apply the business model canvas*. https://www.strategyzer.com/blog/posts/2015/3/23/14-ways-to-apply-the-business-model-canvas

5. Strategy

What is Strategy?

Strategic management, **strategy** for short, is essentially about choice — in terms of what an organization will do and won't do to achieve specific goals and objectives. Strategy is also about making choices that provide the organization with some measure of a sustainable competitive advantage (Video 5.1). The concept of strategy is relevant to all types of organizations, from large, public companies to nonprofits.

Watch Video 5.1: *What is a Business Model?* to better understand strategy, including how it relates to and differs from the concept of business models. Closed captioning is available. Click HERE to read a transcript.

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Generating Advantage

There are countless variations in the competitive strategies that companies employ, mainly because each company's strategic approach entails custom-designed actions to fit its own circumstances and industry environment. The custom-tailored nature of each company's strategy is also the result of management's efforts to uniquely position the company in its market.

Competitive strategies that provide distinctive industry positioning and competitive advantage in the marketplace involve choosing between a target market that is either broad or narrow, and whether the company should pursue a competitive advantage linked to low costs or product differentiation. These two factors give rise to four primary competitive strategy options: *cost leadership*, *focused low cost*, *broad differentiation*, and *focused differentiation*. [1] These four strategies are also referred to as **generic strategies**, because they can be applied to any size or form of business (Video 5.2). A fifth strategy, *best-cost provider*, is a hybrid option that combines elements of both cost leadership and differentiation. Each of these five strategies will be described in the sections that follow.

Watch Video 5.2: *Generic Strategies* to learn about the four generic strategies. Closed captioning is available. Click HERE to read a transcript.

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Cost Leadership

Cost leadership, also referred to as *low-cost provider*, is a low-cost market strategy. Firms pursuing this type of strategy must be particularly efficient in engineering tasks, production operations, and physical distribution; they must also be able to minimize costs in marketing and research and development (R&D). A low-cost leader can gain significant market share enabling it to procure a more powerful position relative to both suppliers and competitors. A firm employing this strategy uses product price as its primary competitive edge, minimizing its cost to enable it to provide an acceptable product at the lowest possible price while still maintaining a positive margin. This strategy is particularly effective for organizations in industries where there is limited possibility of product differentiation and where buyers are very price sensitive as with commodities and similar products or services.

Focused Low Cost

A **focused low-cost** strategy is a low-cost, narrowly-focused market strategy. Firms employing this strategy may focus on a particular buyer segment or a particular geographic segment and must locate a niche market that wants or needs an efficient product and is willing to forgo extras to pay a lower price for the product. A company's costs can be reduced by providing little or no service, providing a low-cost method of distribution, or producing a no-frills product.

Challenges in Pursuing a Low-Cost Strategy

Perhaps the biggest challenge of a low-cost provider strategy is getting carried away with overly aggressive price cutting and ending up with lower, rather than higher, profitability. A low-cost, low-price advantage results in superior profitability only if (1) prices are cut by less than the size of the cost advantage or (2) the added volume is large enough to bring in a bigger total profit despite lower margins per unit sold. Thus, a company with a 5 percent cost advantage cannot cut prices 20 percent, end up with a volume gain of only 10 percent, and still expect to earn higher profits!

A second challenge is relying on an approach to reduce costs that can be easily copied by rivals. If rivals find it relatively easy or inexpensive to imitate the leader's low-cost methods, then the leader's advantage will be too short-lived to yield a valuable edge in the marketplace. Thus, cost leaders must maintain their investment in state-of-the-art equipment or face the possible entry of more cost-effective competitors. Furthermore, major changes in technology may drastically change production processes so that previous investments in production technology are no longer advantageous.

A third challenge is becoming too fixated on cost reduction. Low costs cannot be pursued so zealously that a firm's offering ends up being too features-poor to gain the interest of buyers. Furthermore, a company driving hard to push its costs down has to guard against misreading or ignoring increased buyer preferences for added features or declining buyer price sensitivity. Even if these mistakes are avoided, a low-cost competitive approach still carries risk. Cost-saving technological breakthroughs or process improvements by rival firms can nullify a low-cost leader's hard-won position.

Differentiation

A **differentiation** strategy involves offering a unique product; because this type of strategy involves a unique product, price is not the most significant factor. In fact, consumers may be willing to pay a high price for a product that they perceive as different. The product difference may be based on product design, method of distribution, or any aspect of the product (other than price) that is significant to the consumer. A company choosing this strategy must develop and maintain a product perceived as different enough from the competitors' products to warrant the asking price.

Differentiation does not allow a firm to ignore costs; it makes a firm's products less susceptible to cost pressures from competitors because customers see the product as unique and are willing to pay extra to have the product with the desirable features. Differentiation can be achieved through real product features or through advertising that causes the customer to perceive that the product is unique.

Several studies have shown that a differentiation strategy is more likely to generate higher profits than a cost-leadership strategy, because differentiation creates stronger entry barriers. However, a cost-leadership strategy is more likely to generate increases in market share.

Focused Differentiation

A **focused differentiation** strategy is the marketing of a differentiated product to a narrow market. This strategy is viable for a company that can convince consumers that its narrow focus allows it to provide better goods and services than its competitors.

Challenges in Pursuing a Differentiation Strategy

Differentiation strategies can fail for any of several reasons. A differentiation strategy keyed to product or service attributes that are easily and quickly copied is always suspect. Rapid imitation means that no rival achieves meaningful differentiation, because whatever new feature one firm introduces that strikes the fancy of buyers is almost immediately added by rivals. This is why a firm must search out sources of uniqueness that are time-consuming or burdensome for rivals to match if it hopes to use differentiation to win a sustainable competitive edge over rivals.

Differentiation strategies can also falter when buyers see little value in the unique attributes of a company's product. Thus even if a company sets the attributes of its brand apart from its rivals' brands, its strategy can fail because of trying to differentiate on the basis of something that does not deliver adequate value to buyers. Any time many potential buyers look at a company's differentiated product offering and conclude "so what," the company's differentiation strategy is in deep trouble; buyers will likely decide the product is not worth the extra price and sales will be disappointingly low.

Overspending on efforts to differentiate is a strategy flaw that can erode profitability. Company efforts to achieve differentiation nearly always raise costs. The trick to profitable differentiation is either to keep the costs of achieving differentiation below the price premium the differentiating attributes can command in the marketplace or to offset thinner profit margins by selling enough additional units to increase total profits. If a company goes overboard in pursuing costly differentiation, it could be saddled with unacceptably thin profit margins or even losses. The need to contain differentiation costs is why many companies add little touches of differentiation that add to buyer satisfaction but are inexpensive to institute.

The Risks of a Market Niche Strategy

Focusing, either in terms of a cost leadership or differentiation strategy, carries several risks. The first major risk is the chance that competitors will find effective ways to match the focused firm's capabilities in serving the target niche. In the lodging business, large chains such as Marriott and Hilton have launched multi-brand strategies that allow them to compete effectively in several lodging segments simultaneously. Marriott has flagship hotels with a full complement of services and amenities that allow it to attract travelers and vacationers going to major resorts; it has J.W. Marriott and Ritz-Carlton hotels that provide deluxe comfort and service to business and leisure travelers; it has Courtyard by Marriott and SpringHill Suites brands for business travelers looking for moderately priced lodging; it has Marriott Residence Inns and TownePlace Suites designed as a "home away from home" for travelers staying five or more nights; and it has more than 650 Fairfield Inn locations that cater to travelers looking for quality lodging at an "affordable" price.

Similarly, Hilton has a lineup of brands (Waldorf Astoria, Conrad Hotels, Doubletree Hotels, Embassy Suites Hotels, Hampton Inns, Hilton Hotels, Hilton Garden Inns, and Homewood Suites) that enable it to compete in multiple segments and compete head-to-head against lodging chains that operate only in a single segment. Multi-brand strategies are attractive to large companies such as Marriott and Hilton precisely because they enable a company to enter a market niche and siphon business away from companies that employ a focus strategy.

A second risk of employing a focus strategy is the potential for the preferences and needs of niche members to shift over time toward the product attributes desired by the majority of buyers. An erosion of the differences across buyer segments lowers entry barriers into a focused market niche and provides an open invitation for rivals in adjacent segments to begin competing for the focuser's customers. A third risk is that the segment may become so attractive it is soon inundated with competitors, intensifying rivalry and splintering segment profits.

Best-cost Provider Strategy

Can forms of competitive advantage be combined? That is, can a firm straddle strategies so that it is simultaneously the low-cost leader and a differentiator? Some strategy experts have asserted that a successful strategy requires a firm to stake out a market position aggressively and that different strategies involve distinctly different approaches to competing and operating the business. Some research suggests that a combination strategy — also known as a **best-cost provider** strategy — is a recipe for below-average profitability compared to the industry, and that such a strategy indicates that the firm's managers have not made necessary choices about the business and its strategy.

An organization pursuing a differentiation strategy seeks competitive advantage by offering products or services that are unique from those offered by rivals, either through design, brand image, technology, features, or customer service. Alternatively, an organization pursuing a cost-leadership strategy attempts to gain competitive advantage based on being the overall low-cost provider of a product or service. To be "all things to all people" can mean becoming "stuck in the middle" with no distinct competitive advantage. The difference between being "stuck in the middle" and successfully pursuing a combination, or best-cost provider, strategy merits discussion, as some firms have been able to succeed using combination strategies, such as by being a cost leader while maintaining a differentiated product.

Some industries may actually call for such combination strategies. Trends suggest that highly complex environments do not have the luxury of choosing exclusively one strategy over another. The hospital industry may represent such an environment, as hospitals must compete on a variety of fronts. Combination (i.e., more complicated) strategies are both feasible and necessary to compete successfully. For instance, reimbursement to diagnosis-related groups, and the continual lowering of reimbursement ceilings have forced hospitals to compete on the basis of cost. At the same time, many of them jockey for position with differentiation based on such features as technology and birthing rooms. Thus, many hospitals may need to adopt some form of hybrid strategy to compete successfully.[2]

Best-cost provider strategies are a hybrid of low-cost provider and differentiation strategies that aim at satisfying buyer expectations on key quality, feature, performance, or service attributes and beating customer expectations on price. Companies pursuing best-cost strategies aim squarely at the mass of value-conscious buyers looking for a good-to-very-good product or service at an economical price. The essence of a best-cost provider strategy is giving customers more value for the money by satisfying buyer desires for appealing product attributes in terms of features, performance, quality, service, or related characteristics and charging a lower price for these attributes compared to rivals with similar caliber product offerings. Alternatively, the firm could provide a superior product at a comparable price. Either approach yields a comparable best-cost product.

When a Best-Cost Provider Strategy Works Best

A best-cost provider strategy works best in markets where product differentiation is the norm and attractively large numbers of value-conscious buyers can be induced to purchase midrange products rather than the basic products of low-cost producers or the expensive products of top-of-the-line differentiators. A best-cost provider usually needs to position itself in the middle of the market with either a medium-quality product at a below-average price or a high-quality product at an average or slightly higher-than-average price. Best-cost provider strategies also work well in recessionary times when great masses of buyers become value-conscious and are attracted to economically priced products and services with especially appealing attributes.

Challenges in Pursuing a Best-Cost Provider Strategy

A company's biggest vulnerability in employing a best-cost provider strategy is not having the requisite core competencies and efficiencies in managing value chain activities to support the addition of differentiating features without significantly increasing costs. A company with a modest degree of differentiation and no real cost advantage will most likely find itself squeezed between the firms using low-cost strategies and those using differentiation strategies. Low-cost providers may be able to siphon customers away with the appeal of a lower price (despite having marginally less appealing product attributes). High-end differentiators may be able to steal customers away with the appeal of appreciably better product attributes (even though their products carry a somewhat higher price tag). Thus, a successful best-cost provider must offer buyers significantly better product attributes to justify a price above what low-cost leaders are charging. Likewise, it has to achieve significantly lower costs in providing upscale features so that it can outcompete high-end differentiators on the basis of a significantly lower price.

Generic Strategies Summary

Before moving on to the next section, click on each information icon in the interactive matrix below to review each of the five strategy options described above:

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Facets of Strategy

The **strategy diamond** was developed as a framework for checking and communicating a strategy.[3] A strategy consists of an integrated set of choices, but it isn't a catchall for every important choice a manager or organization faces.

The following sections will introduce the three traditional strategy facets of *arenas*, *differentiators*, and *economic logic*, as well as the facets of *vehicles* and *staging and pacing*. The first three facets of the strategy diamond—arenas, differentiators, and economic logic—are labeled as traditional in the sense that they address three longstanding hallmarks of strategizing. Specifically, strategy matches up market needs and opportunities (located in arenas) with unique features of the firm (shown by its differentiators) to yield positive performance (economic logic).

Click on each information icon in the interactive strategy diamond below to learn more about each component:

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Arenas

Strategy questions about **arenas** tell managers and employees where the firm will be active and with how much emphasis.

- Which product categories?
- Which channels?
- Which market segments?
- Which geographic areas?
- Which core technologies?
- Which value-creation strategies?

Beyond geographic-market and product-market arenas, an organization can also make choices about the value-chain arenas in its strategy. To emphasize the choice part of this value-chain arena, Nike's competitor New Balance manufactures nearly all the athletic shoes that it sells in the United States. Thus, these two sports-shoe companies compete in similar geographic- and product-market arenas but differ greatly in terms of their choice of value-chain arenas.

Differentiators

Differentiators are the things that are unique to the firm such that they give it a competitive advantage in its current and future arenas. Differentiators are concerned with the question, how will the firm win?

- Image?
- Customization?
- Price?
- Styling?
- Product reliability?
- Speed to market?

A differentiator could be asset based, that is, it could be something related to an organization's *tangible* or *intangible assets*. A **tangible asset** has a value and physically exists. Land, machines, equipment, automobiles, and even currencies, are examples of tangible assets. For instance, the oceanfront land on California's Monterey Peninsula, where the Pebble Beach Golf Course and Resort is located, is a differentiator for it in the premium golf-course market. An **intangible asset** is a nonphysical resource that provides gainful advantages in the marketplace. Brands, copyrights, software, logos, patents, goodwill, and other intangible factors afford name recognition for products and services. Differentiators can also be found in capabilities, that is, how the organization does something. Walmart, for instance, is very good at keeping its costs low.

Economic Logic

Economic logic explains how the firm makes money above its cost of capital.

- Lowest costs through scale advantages?
- Lowest costs through scope and replication advantages?
- Premium prices due to unmatchable service?
- Premium prices due to proprietary product features?

While economic logic can include environmental and social profits (benefits reaped by society), the strategy must earn enough financial profits to keep investors (owners, taxpayers, governments, and so on) willing to continue to fund the organization's costs of doing business. A firm performs well (i.e., has a strong, positive economic logic) when its differentiators are well-aligned with its chosen arenas.

Vehicles

You can see why the first three facets of the strategy diamond—arenas, differentiators, and economic logic—might be considered the traditional facets of strategizing in that they cover the basics: (1) external environment, (2) internal organizational characteristics, and (3) some fit between them that has positive performance consequences. The fourth facet of the strategy diamond is called **vehicles**. If arenas and differentiators show where an organization wants to go, then vehicles communicate how the strategy will get it there.

- Internal development?
- Joint ventures?
- Licensing/franchising?
- Alliances?
- Acquisitions?

Specifically, vehicles refer to how an organization might pursue a new arena through internal means, through help from a new partner or some other outside source, or even through acquisition. In the context of vehicles, this is where an organization determines whether it is going to grow organically, through acquisition, or a combination of both. **Organic growth** is the growth rate of a company excluding any growth from takeovers, acquisitions, or mergers. **Acquisitive growth**, in contrast, refers precisely to any growth from takeovers, acquisitions, or mergers.

Vehicles are considered part of the strategy because there are different skills and competencies associated with different vehicles. For instance, acquisitions fuel rapid growth, but they are challenging to negotiate and put into place. Similarly, alliances are a great way to spread the risk and let each partner focus on what it does best. But at the same time, to grow through alliances also means that an organization must be really good at managing relationships in which it is dependent on another organization over which it does not have direct control.

Staging and Pacing

Staging and pacing constitute the fifth and final facet of the strategy diamond and reflect the sequence and speed of strategic moves. This powerful facet of strategizing helps an organization think about timing and next steps, instead of creating a strategy that is a static, monolithic plan. The staging and pacing facet also helps to reconcile the designed and emergent portions of an organization's strategy.

Chapter Review

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Optional Resources to Learn More

Articles

“Building a Winning Business Model Portfolio” https://sloanreview.mit.edu/article/building-a-winning-business-model-portfolio/

Videos

“What Is Strategy? It’s a Lot Simpler Than You Think” https://www.youtube.com/watch?v=o7Ik1OB4TaE

Websites

Learn Strategy https://learnstrategy.byu.edu/

Understanding Competition and Strategy https://www.isc.hbs.edu/strategy/Pages/default.aspx

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Video 5.1: Harvard Business Review (2019, July 2). *The explainer: What is a business model?* [Video]. YouTube. https://www.youtube.com/watch?v=_C-vGu2mL38

Video 5.2: Kryscynski, D. (2012, November 8). *Generic strategies* [Video]. YouTube. https://www.youtube.com/watch?v=V14kuqYEsxE

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1. Porter, M. E. (1985). *Competitive advantage: creating and sustaining superior performance*. New York: FreePress.
2. Walters, B. A., & Bhuian, S. (2004). Complexity absorption and performance: A structural analysis of acute-care hospitals. *Journal of Management*, 30, 97–121.
3. Hambrick, D. C., & Fredrickson, J. W. (2001). Are you sure you have a strategy? *Academy of Management Executive*, 19(4), 51–62.

6. Organizational Structure

Levels of Management: How Managers Are Organized

A typical organization has several *layers of management*. Think of these layers as forming a pyramid, with top managers occupying the narrow space at the peak, frontline managers the broad base, and middle managers the levels in between. As you move up the pyramid, management positions get more demanding, but they carry more authority and responsibility (along with more power, prestige, and pay). Top managers spend most of their time in planning and decision making, while frontline managers focus on day-to-day operations. For obvious reasons, there are far more people with positions at the base of the pyramid than there are at the other two levels.

In the interactive pyramid below, click each information icon to learn more about each level of management:

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Let's now look at each management level in more detail.

Top Managers

Top managers are responsible for the health and performance of the organization. They set the objectives, or performance targets, designed to direct all the activities that must be performed if the company is going to fulfill its mission. Top-level executives routinely scan the external environment for opportunities and threats, and they redirect company efforts when needed. They spend a considerable portion of their time planning and making major decisions. They represent the company in important dealings with other businesses and government agencies, and they promote it to the public. Job titles at this level typically include chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO), president, and vice president.

Middle Managers

Middle managers are in the center of the management hierarchy: they report to top management and oversee the activities of frontline managers. They're responsible for developing and implementing activities and allocating the resources needed to achieve the objectives set by top management. Common job titles include operations manager, division manager, plant manager, and branch manager.

Frontline Managers

Frontline managers supervise employees and coordinate their activities to make sure that the work performed throughout the company is consistent with the plans of both top and middle management. It's at this level that most people acquire their first managerial experience. The job titles vary considerably but include such designations as manager, group leader, office manager, foreman, and supervisor.

Structure: How Companies Get the Job Done

Building an organizational structure engages managers in two key activities: *job specialization* (dividing tasks into jobs) and *departmentalization* (grouping jobs into units). **Organizational structure** outlines the various roles within an organization, which positions report to which, and how an organization will departmentalize its work. Take note than an organizational structure is an arrangement of positions that's most appropriate for a company at a specific point in time. Given the rapidly changing environment in which businesses operate, a structure that works today might be outdated tomorrow. That's why you hear so often about companies **restructuring**—altering existing organizational structures to become more competitive once conditions have changed. Let's now look at how the processes of specialization and departmentalization are accomplished.

Specialization

Organizing activities into clusters of related tasks that can be handled by certain individuals or groups is called **specialization**. This aspect of designing an organizational structure is twofold:

1. *Identify the activities that need to be performed* in order to achieve organizational goals.
2. *Break down these activities into tasks* that can be performed by individuals or groups of employees.

Specialization has several advantages. First and foremost, it leads to efficiency. Imagine a situation in which each department was responsible for paying its own invoices; a person handling this function a few times a week would likely be far less efficient than someone whose job was to pay all the bills. In addition to increasing efficiency, specialization results in jobs that are easier to learn and roles that are clearer to employees. But the approach has disadvantages, too. Doing the same thing over and over sometimes leads to boredom and may eventually leave employees dissatisfied with their jobs. Before long, companies may notice decreased performance and increased absenteeism and **turnover** (the rate at which workers who leave an organization and must be replaced).

Departmentalization

The next step in designing an organizational structure is **departmentalization**—grouping specialized jobs into meaningful units. Depending on the organization and the size of the work units, they may be called divisions, departments, or just plain groups. Traditional groupings of jobs result in different organizational structures, and for the sake of simplicity, we'll focus on two types—functional and divisional organizations.

Functional Organizations

A **functional organization** groups together people who have comparable skills and perform similar tasks. This form of organization is fairly typical for small to medium-size companies, which group their people by business functions: accountants are grouped together, as are people in finance, marketing and sales, human resources, production, and research and development. Each unit is headed by an individual with expertise in the unit's particular function. Examples of typical functions in a business enterprise include human resources, operations, marketing, and finance.

There are a number of advantages to the functional approach. The structure is simple to understand and enables the staff to specialize in particular areas; everyone in the marketing group would probably have similar interests and expertise. But homogeneity also has drawbacks: it can hinder communication and decision making between units and even promote interdepartmental conflict. The marketing department, for example, might butt heads with the accounting department because marketers want to spend as much as possible on advertising, while accountants want to control costs.

> Business schools often organize according to functions found in a business (with majors or concentrations in functional areas such as finance, accounting, marketing, operations, human resources, etc.).

Divisional Organizations

Large companies often find it unruly to operate as one large unit under a functional organizational structure. Sheer size can make it difficult for managers to oversee operations and serve customers. To rectify this problem, many large companies are structured as **divisional organizations**. Divisions can be formed according to products, customers, processes, or geography.

Divisions are similar in many respects to stand-alone companies, except that certain common tasks, like legal work, tends to be centralized at the headquarters level. Each division functions relatively autonomously because it contains most of the functional expertise (production, marketing, accounting, finance, human resources) needed to meet its objectives. The challenge is to find the most appropriate way of structuring operations to achieve overall company goals.

There are pluses and minuses associated with divisional organization. On the one hand, divisional structure usually enhances the ability to respond to changes in a firm's environment. If, on the other hand, services must be duplicated across units, costs will be higher. In addition, some companies have found that units tend to focus on their own needs and goals at the expense of the organization as a whole.

Product Divisions

Product division means that a company is structured according to its product lines. General Motors, for example, has four product-based divisions: Buick, Cadillac, Chevrolet, and GMC.[1] Each division has its own research and development group, its own manufacturing operations, and its own marketing team. This allows individuals in the division to focus all their efforts on the products produced by their division. A downside is that it results in higher costs as corporate support services (such as accounting and human resources) are duplicated in each of the four divisions.

Customer Divisions

Some companies prefer a **customer division** structure because it enables them to better serve their various categories of customers. For example, prior to announcing a split in 2021, Johnson & Johnson's 200 or so operating companies were grouped into three customer-based business segments: consumer business (personal-care and hygiene products sold to the general public), pharmaceuticals (prescription drugs sold to pharmacies), and professional business (medical devices and diagnostics products used by physicians, optometrists, hospitals, laboratories, and clinics).[2]

Geographical Divisions

Geographical division enables companies that operate in several locations to be responsive to customers at a local level. Adidas, for example, is organized according to the regions of the world in which it operates (Figure 6.1). They have eight different regions, and each one reports its performance separately in their annual reports.[3]

Figure 6.1: Adidas' geographical divisions.

The Organizational Chart

Once an organization has set its structure, it can represent that structure in an **organizational chart**: a diagram delineating the interrelationships of positions within the organization.

Let's look at the chart of an organization that relies on a divisional structure based on goods or services produced—say, a theme park. The top layers of this company's organization chart might look like the one in Figure 6.2A. We see that the president has two direct reports—a vice president in charge of rides and a vice president in charge of concessions. What about a bank that's structured according to its customer base? The bank's organization chart would begin like the one in Figure 6.2B. Once again, the company's top manager has two direct reports, in this case a VP of retail-customer accounts and a VP of commercial-customer accounts.

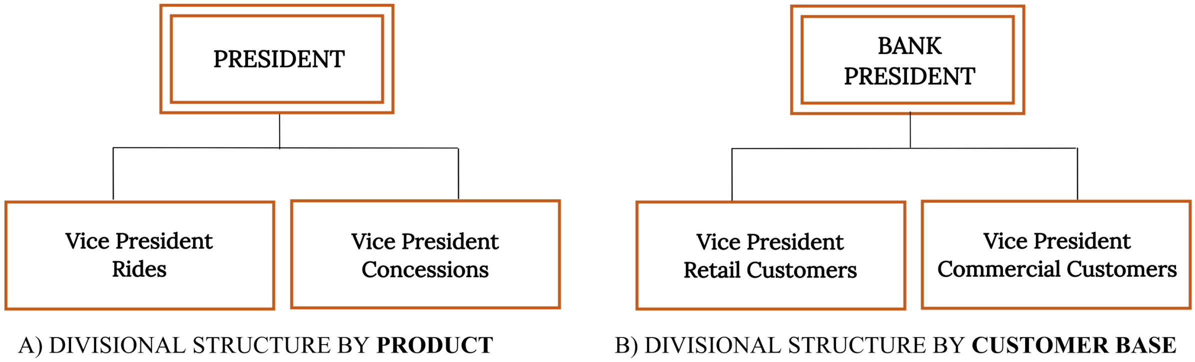

Figure 6.2: Organizational charts for divisional structures.

Over time, companies revise their organizational structures to accommodate growth and changes in the external environment. It's not uncommon, for example, for a firm to adopt a functional structure in its early years. Then, as it becomes bigger and more complex, it might move to a divisional structure—perhaps to accommodate new products or to become more responsive to certain customers or geographical areas. Some companies might ultimately rely on a combination of functional and divisional structures. This could be a good approach for a credit card company that issues cards in both the United States and Europe. An outline of this firm's organization chart might look like the one in Figure 6.3.

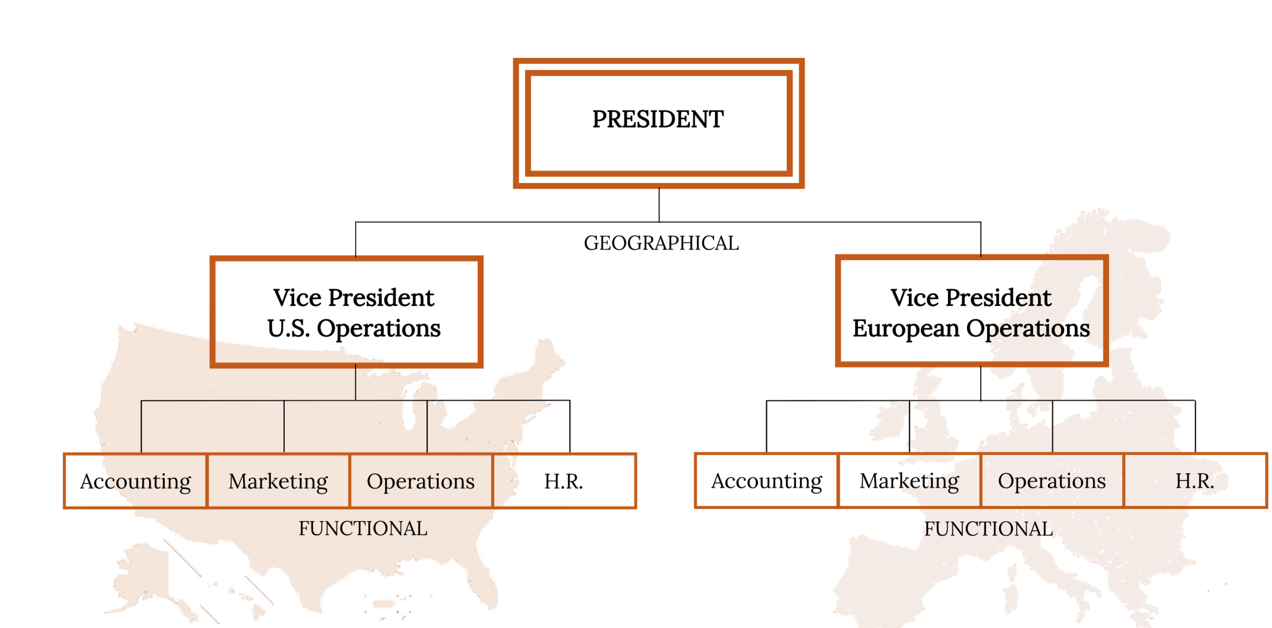

Figure 6.3: Organizational charts for divisional structure with functional components.

Chain of Command

The vertical connecting lines in the organization chart show the firm's **chain of command**: the authority relationships among people working at different levels of the organization. That is to say, they show who reports to whom. When you're examining an organization chart, you'll probably want to know whether each person reports to one or more supervisors: to what extent, in other words, is there **unity of command**? To understand why unity of command is an important organizational feature, think about it from a personal standpoint. Would you want to report to more than one boss? What happens if you get conflicting directions? Whose directions would you follow?

There are, however, conditions under which an organization and its employees can benefit by violating the unity-of-command principle. Under a **matrix structure**, for example, employees from various functional areas (product design, manufacturing, finance, marketing, human resources, etc.) form teams to combine their skills in working on a specific project or product. This matrix organization chart might look like the one in Figure 6.4.

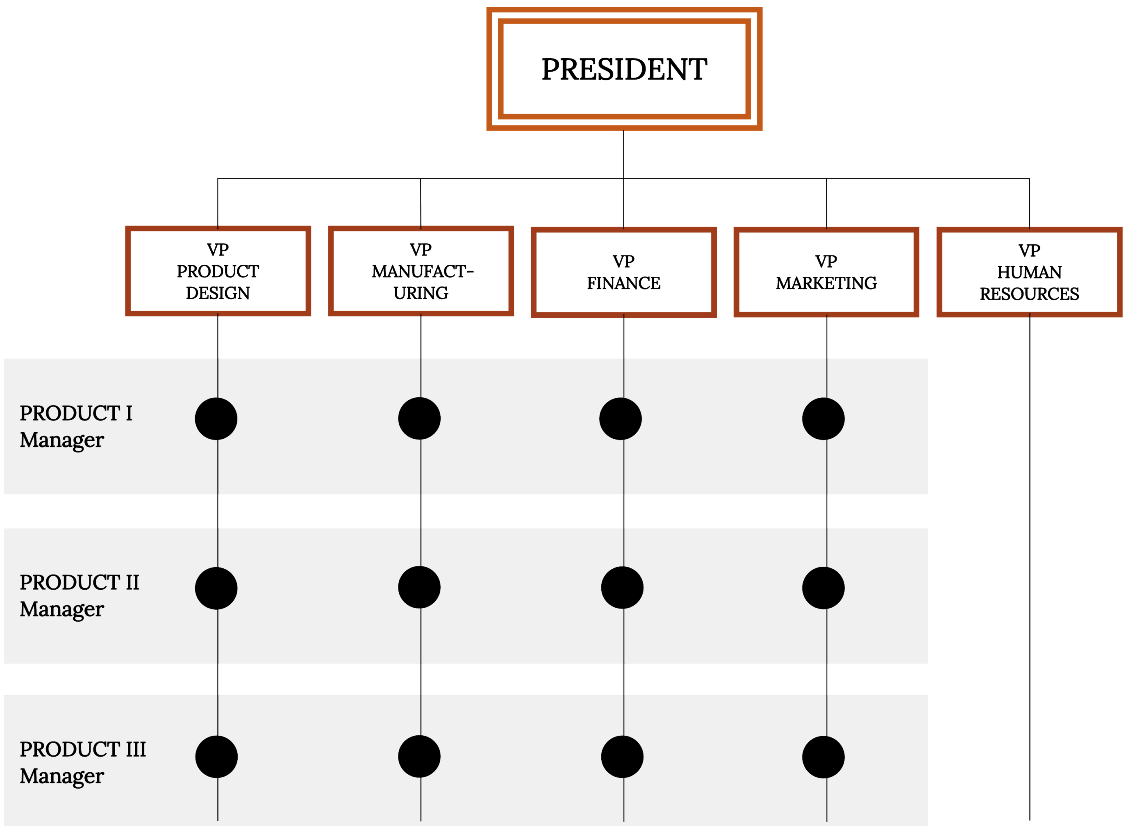

Figure 6.4: Matrix structure.

Nike sometimes uses this type of arrangement. To design new products, the company may create product teams made up of designers, marketers, and other specialists with expertise in particular sports categories—say, running shoes or basketball shoes. Each team member would be evaluated by both the team manager and the head of his or her functional department.

Span of Control

Another thing to notice about a firm's chain of command is the number of layers between the top managerial position and the lowest managerial level. As a rule, new organizations have only a few layers of management—an organizational structure that's often called **flat.**

As a company grows, however, it tends to add more layers between the top and the bottom; that is, it gets **taller**. Added layers of management can slow down communication and decision making, causing the organization to become less efficient and productive. That's one reason why many of today's organizations are restructuring to become flatter.

There are trade-offs between the advantages and disadvantages of flat and tall organizations. Companies determine which trade-offs to make according to a principle called **span of control**, which measures the number of people reporting to a particular manager. If, for example, you remove layers of management to make your organization flatter, you end up increasing the number of people reporting to a particular supervisor.

So what's better—a **narrow span of control** (with few direct reports) or a **wide span of control** (with many direct reports)? The answer to this question depends on a number of factors, including frequency and type of interaction, proximity of subordinates, competence of both supervisor and subordinates, and the nature of the work being supervised. For example, you'd expect a much wider span of control at a nonprofit call center than in a hospital emergency room.

Delegating Authority

Given the tendency toward flatter organizations and wider spans of control, how do managers handle increased workloads? They must learn how to handle **delegation**—the process of entrusting work to subordinates. Unfortunately, many managers are reluctant to delegate. As a result, they not only overburden themselves with tasks that could be handled by others, but they also deny subordinates the opportunity to learn and develop new skills.

Centralization and Decentralization

If and when a company expands, it has to decide whether most decisions should still be made by individuals at the top or delegated to lower-level employees. The first option, in which most decision making is concentrated at the top, is called **centralization**. The second option, which spreads decision making throughout the organization, is called **decentralization**.

Centralization has the advantage of consistency in decision-making. Since in a centralized model, key decisions are made by the same top managers, those decisions tend to be more uniform than if decisions were made by a variety of different people at lower levels in the organization. In most cases, decisions can also be made more quickly provided that top management does not try to control too many decisions. However, centralization has some important disadvantages. If top management makes virtually all key decisions, then lower-level managers will feel under-utilized and will not develop decision-making skills that would help them become promotable. An overly centralized model might also fail to consider information that only front-line employees have or might actually delay the decision-making process. Consider a case where the sales manager for an account is meeting with a customer representative who makes a request for a special sale price; the customer offers to buy 50 percent more product if the sales manager will reduce the price by 5 percent for one month. If the sales manager had to obtain approval from the head office, the opportunity might disappear before she could get approval—a competitor's sales manager might be the customer's next meeting.

An overly decentralized decision model has its risks as well. Imagine a case in which a company had adopted a geographically-based divisional structure and had greatly decentralized decision making. In order to expand its business, suppose one division decided to expand its territory into the geography of another division. If headquarters approval for such a move was not required, the divisions of the company might end up competing against each other, to the detriment of the organization as a whole. Companies that wish to maximize their potential must find the right balance between centralized and decentralized decision making.

The Organizational Life Cycle

Most organizations begin as very small systems that feature very loose structures. In a new venture, nearly every employee might contribute to many aspects of an organization's work. As the business grows, the workload increases, and more workers are needed. Naturally, as the organization hires more and more people, employees being to specialize. Over time, these areas of specialization mature through differentiation, the process of organizing employees into groups that focus on specific functions in the organization. Usually, differentiated tasks should be organized in a way that makes them complementary, where each employee contributes an essential activity that supports the work and outputs of others in the organization.

The patterns and structures that appear in an organization need to evolve over time as an organization grows or declines, often through four predictable phases (Figure 6.5). In the *entrepreneurship phase*, the organization is usually very small and agile, focusing on new products and markets. The founders typically focus on a variety of responsibilities, and they often share frequent and informal communication with all employees in the new company. Employees enjoy a very informal relationship, and the work assignments are very flexible. Usually, there is a loose, organic organizational structure in this phase.

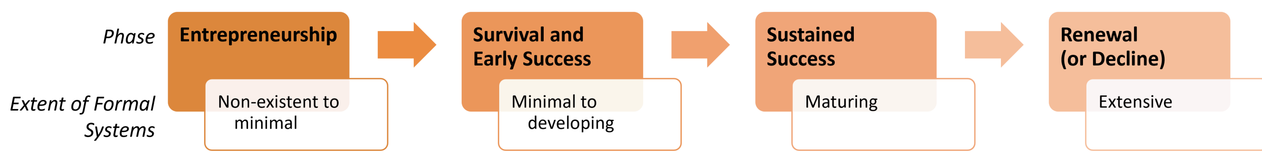

Figure 6.5: Formalization across the organizational life cycle.

The second phase, *survival and early success*, occurs as an organization begins to scale up and find continuing success. The organization develops more formal structures around more specialized job assignments. Incentives and work standards are adopted. The communication shifts to a more formal tone with the introduction of hierarchy with upper- and lower-level managers. It becomes impossible for every employee to have personal relationships with every other employee in the organization. At this stage, it becomes appropriate to introduce structures that support the standardization and formalization required to create effective coordination across the organization.

In a third phase, *sustained success* or *maturity*, the organization expands and the hierarchy deepens, now with multiple levels of employees. Lower-level managers are given greater responsibility, and managers for significant areas of responsibility may be identified. Top executives begin to rely almost exclusively on lower-level leaders to handle administrative issues so that they can focus on strategic decisions that affect the overall organization. At this stage, structures of the organization are strengthened.

A transition to the fourth phase, *renewal* or *decline*, occurs when an organization expands to the point that its operations are complex and need to operate somewhat autonomously. At times it becomes necessary for the organization to be reorganized or restructured to achieve higher levels of coordination between and among different groups or subunits. Managers may need to address fundamental questions about the overall direction and administration of the organization.

To summarize, the key insight about the organizational life cycle is that the needs of an organization will evolve over time. Different structures are needed at different stages as an organization develops. The needs of employees will also change. An understanding of the organizational life cycle provides a framework for thinking about changes that may be needed over time.

Chapter Review

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Notes

1. Associated Press (2010, October 7). General Motors rebuilds with 4 divisions. *Augusta Chronicle*. http://chronicle.augusta.com/life/autos/2010-10-07/general-motors-rebuilds-4-divisions#
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PART III

PEOPLE IN ORGANIZATIONS

7. Individual Behavior

Many factors influence how individuals behave and interact with others within organizations and in the context of work. Employees and managers are also susceptible to cognitive limitations and biases which can impact how they perceive the world around them, process information, and make decisions. This chapter will introduce you to some of the most common factors that impact individuals in the workplace.

Bounded Rationality

While we might like to think that we can make completely rational decisions, this is often unrealistic given the complex issues faced by employees and managers (Video 7.1). Even when we have gathered seemingly all possible information, we may not be able to make rational sense of all of it, or to accurately forecast or predict the outcomes of our choice.

Bounded rationality is the idea that for complex issues, we cannot be completely rational because we cannot fully grasp all the possible alternatives, nor can we understand all the implications of every possible alternative. Our brains have limitations in terms of the amount of information they can process. Similarly, even when individuals have the cognitive ability to process all the relevant information, they often must make decisions without first having time to collect all the relevant data—their information is incomplete.

Watch Video 7.1: *Cognitive Bias*. Closed captioning is available. Click HERE to read a transcript.

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Escalation of Commitment

Given the lack of complete information, individuals don't always make the right decision initially, and it may not be clear that a decision was a bad one until after some time has passed. For example, consider a manager who had to choose between two competing software packages that her organization will use on a daily basis to enhance efficiency. She initially chooses the product that was developed by the larger, more well-established company, reasoning that they will have greater financial resources to invest in ensuring that the technology is good. However, after some time it becomes clear that the competing software package is going to be far superior. While the smaller company's product could be integrated into the organization's existing systems at little additional expense, the larger company's product will require a much greater initial investment, as well as substantial ongoing costs for maintaining it. At this point, however, let's assume that the manager has already paid for the larger company's (inferior) software. Will she abandon the path that she's on, accept the loss on the money that's been invested so far, and switch to the better software? Or will she continue to invest time and money into trying to make the first product work?

Escalation of commitment is the tendency of decision makers to remain committed to poor decisions, even when doing so leads to negative outcomes. Once we commit to a decision, we may find it difficult to reevaluate that decision rationally. It can seem easier to "stay the course" than to admit (or to recognize) that a decision was poor. It's important to acknowledge that not all decisions are going to be good ones, in spite of our best efforts. Effective employees and managers recognize that progress down the wrong path isn't really progress, and they are willing to reevaluate decisions and change direction when appropriate.

Personal Biases

Our decision-making is also limited by our own biases. We tend to be more comfortable with ideas, concepts, things, and people that are familiar to us or similar to us. We tend to be less comfortable with that which is unfamiliar, new, and different. One of the most common biases that we have, as humans, is the tendency to like other people who we think are similar to us.[1] While these similarities can be observable (based on demographic characteristics such as race, gender, and age), they can also be a result of shared experiences (such as attending the same university) or shared interests (such as being in a book club together). This **similar-to-me bias** and preference for the familiar can lead to a variety of problems for managers and organizations: hiring less-qualified applicants because they are similar to the manager in some way, paying more attention to some employees' opinions and ignoring or discounting others, choosing a familiar technology over a new one that is superior, sticking with a supplier that is known over one that has better quality, and so on.

It can be incredibly difficult to overcome our biases because of the way our brains work. The brain excels at organizing information into categories, and it doesn't like to expend the effort to re-arrange once the categories are established. As a result, we tend to pay more attention to information that confirms our existing beliefs and less attention to information that is contrary to our beliefs, a shortcoming that is referred to as **confirmation bias** (Video 7.2).[2]

Watch Video 7.2: *Conformation Bias*. Closed captioning is available. Click HERE to read a transcript.

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In fact, we don't like our existing beliefs to be challenged. Such challenges feel like a threat, which tends to push our brains towards the reactive system and prevent us from being able to logically process the new information via the reflective system. It is hard to change people's minds about something if they are already confident in their convictions. So, for example, when a manager hires a new employee who they like and are convinced is going to be excellent, they will tend to pay attention to examples of excellent performance and ignore examples of poor performance (or attribute those events to things outside the employee's control). The manager will also tend to trust that employee and therefore accept their explanations for poor performance without verifying the truth or accuracy of those statements. The opposite is also true; if we dislike someone, we will pay attention to their negatives and ignore or discount their positives. We are less likely to trust them or believe what they say at face value. This is why politics tend to become very polarized and antagonistic within a two-party system. It can be very difficult to have accurate perceptions of those we like and those we dislike. The effective manager will try to evaluate situations from multiple perspectives and gather multiple opinions to offset this bias when making decisions.

Attribution Theory

A major influence on how people behave is the way they interpret the events around them. People who feel they have control over what happens to them are more likely to accept responsibility for their actions than those who feel control of events is out of their hands. The cognitive process by which people interpret the reasons or causes for their behavior is described by **attribution theory**.[3] Specifically, "attribution theory concerns the process by which an individual interprets events as being caused by a particular part of a relatively stable environment."[4]

Attribution theory is based largely on the work of Fritz Heider. Heider argues that behavior is determined by a combination of internal forces (e.g., abilities or effort) and external forces (e.g., task difficulty or luck), as well as that it is perceived determinants, rather than actual ones, that influence behavior. Hence, if employees perceive that their success is a function of their own abilities and efforts, they can be expected to behave differently than they would if they believed job success was due to chance.

The Attribution Process

The underlying assumption of attribution theory is that people are motivated to understand their environment and the causes of particular events. If individuals can understand these causes, they will then be in a better position to influence or control the sequence of future events. This process is diagrammed in Figure 7.1.

Specifically, attribution theory suggests that particular behavioral events (e.g., being promoted) are analyzed by individuals to determine their causes. This process may lead to the conclusion that the promotion resulted from the individual's own effort or, alternatively, from some other cause, such as luck. Based on such cognitive interpretations of events, individuals revise their cognitive structures and rethink their assumptions about causal relationships. For instance, an individual may infer that performance does indeed lead to promotion. Based on this new structure, the individual makes choices about future behavior. In some cases, the individual may decide to continue exerting high levels of effort in the hope that it will lead to further promotions. On the other hand, if an individual concludes that the promotion resulted primarily from chance and was largely unrelated to performance, a different cognitive structure might be created, and there might be little reason to continue exerting high levels of effort. In other words, the way in which we perceive and interpret events around us significantly affects our future behaviors.

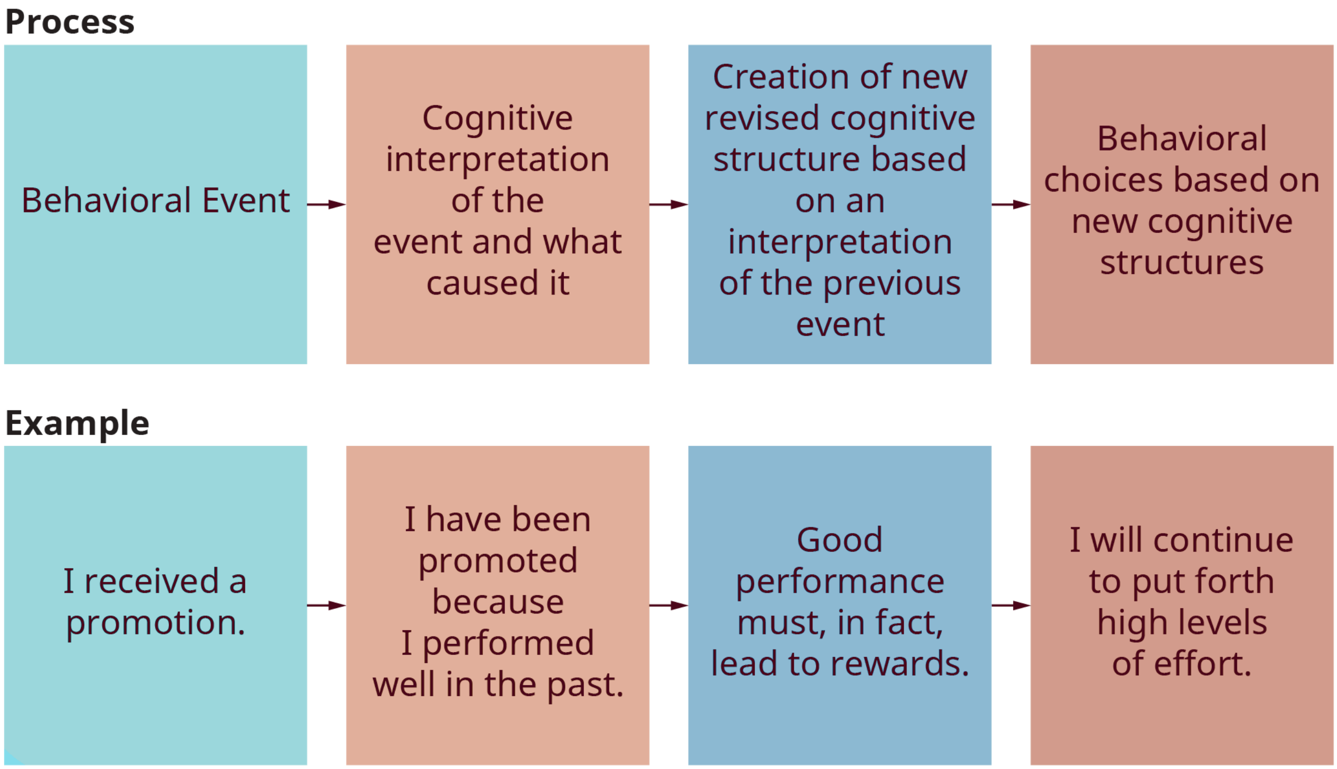

Figure 7.1: The general attribution process.

Attribution Bias

One final point should be made with respect to the attributional process. In making attributions concerning the causes of behavior, people tend to make certain errors of interpretation. Two such errors, or attribution biases, should be noted here. The first is called the **fundamental attribution error** (Video 7.3). This error is a tendency, when assessing *another* person's actions or behavior, to underestimate the effects of external or situational causes and to overestimate the effects of internal or personal causes. For example, if we observe a major problem within another department, we are more likely to blame people rather than events or situations.

Watch Video 7.3: *Fundamental Attribution Error*. Closed captioning is available. Click HERE to read a transcript.

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The second error in attribution processes is called the **self-serving bias** (Video 7.4). There is a tendency, not surprisingly, for individuals to attribute success on an event or project to their own actions while attributing failure to others. Hence, we often hear sales representatives saying, "*I* made the sale," but "*They* stole the sale from me" rather than "I lost it." Considered together, fundamental attribution error and self-serving bias help explain why employees looking at the same event often "see" substantially different things.

Watch Video 7.4: *Self-serving Bias*. Closed captioning is available. Click HERE to read a transcript.

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Stereotypes and Self-Fulfilling Prophecy

A **self-fulfilling prophecy** is an expectation held by a person that alters their behavior in a way that tends to make it true. For example, when we hold **stereotypes** about a person, we tend to treat the person according to our expectations. This treatment can influence the person to act according to our stereotypic expectations, thus confirming our stereotypic beliefs. Research by Rosenthal and Jacobson found that disadvantaged students whose teachers expected them to perform well had higher grades than disadvantaged students whose teachers expected them to do poorly.[5]

Consider this example of cause and effect in a self-fulfilling prophecy: If an employer expects a job applicant to be incompetent, the potential employer might treat the applicant negatively during the interview by engaging in less conversation, making little eye contact, and generally behaving coldly toward the applicant.[6] In turn, the job applicant will perceive that the potential employer dislikes him, and he will respond by giving shorter responses to interview questions, making less eye contact, and generally disengaging from the interview. After the interview, the employer will reflect on the applicant's behavior, which seemed cold and distant, and the employer will conclude, based on the applicant's poor performance during the interview, that the applicant was in fact incompetent. Do you think this job applicant is likely to be hired?

Another dynamic that can reinforce stereotypes is confirmation bias. When interacting with the target of our prejudice, we tend to pay attention to information that is consistent with our stereotypic expectations and ignore information that is inconsistent with our expectations. Furthermore, we tend to seek out information that supports our stereotypes or pre-existing beliefs and ignore information that is inconsistent with our stereotypes or pre-existing beliefs.[7] In the job interview example, the employer may not have noticed that the job applicant was friendly and engaging, and that he provided competent responses to the interview questions in the beginning of the interview. Instead, the employer focused on the job applicant's performance in the later part of the interview, after the applicant changed his demeanor and behavior to match the interviewer's negative treatment.

In-Groups and Out-Groups

We all belong to gender, race, age, and social economic groups. These groups provide a powerful source of identity and self-esteem and serve as our in-groups.[8] An **in-group** is a group that we identify with or see ourselves as belonging to. A group that we don't belong to, or an **out-group**, is a group that we view as fundamentally different from us (Video 7.5). Because we often feel a strong sense of belonging and emotional connection to our in-groups, we develop in-group bias: a preference for our own group over other groups. This in-group bias can result in prejudice and discrimination because the out-group is perceived as different and is less preferred than our in-group.

Watch Video 7.5: *In-group/Out-group*. Closed captioning is available. Click HERE to read a transcript.

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One function of prejudice is to help us feel good about ourselves and maintain a positive self-concept. This need to feel good about ourselves extends to our in-groups: we want to feel good and protect our in-groups. We seek to resolve threats individually and at the in-group level. This often happens by blaming an out-group for the problem. Scapegoating is the act of blaming an out-group when the in-group experiences frustration or is blocked from obtaining a goal.[9]

Despite the group dynamics that seem only to push groups toward conflict, there are forces that promote reconciliation between groups: the expression of empathy, the acknowledgment of past suffering on both sides, and the halt of destructive behaviors.

Job Satisfaction

Some people love their jobs, some people tolerate their jobs, and some people cannot stand their jobs. **Job satisfaction** describes the degree to which individuals enjoy their job. It was described by Edwin Locke as the state of feeling resulting from appraising one's job experiences.[10] Job satisfaction is impacted by many different factors associated with the work itself (Table 7.1), as well as our personality and the culture we come from and live in.[11]

Job satisfaction is typically measured after a change in an organization, such as a shift in the management model, to assess how the change affects employees. It may also be routinely measured by an organization to assess one of many factors expected to affect the organization's performance. In addition, polling companies like Gallup regularly measure job satisfaction on a national scale to gather broad information on the state of the economy and the workforce.[12]

Table 7.1: Factors Involved in Job Satisfaction and Dissatisfaction

Factor	Description
Autonomy	Individual responsibility, control over decisions
Work content	Variety, challenge, role clarity
Communication	Feedback
Financial rewards	Salary and benefits
Growth and development	Personal growth, training, education
Promotion	Career advancement opportunity
Coworkers	Professional relations or adequacy
Supervision and feedback	Support, recognition, fairness
Workload	Time pressure, tedium
Work demands	Extra work requirements, insecurity of position

Research has suggested that the work-content factor, which includes variety, difficulty level, and role clarity of the job, is the most strongly predictive factor of overall job satisfaction.[13] In contrast, there is only a weak correlation between pay level and job satisfaction.[14] Judge et al. suggest that individuals adjust or adapt to higher pay levels: higher pay no longer provides the satisfaction the individual may have initially felt when their salary increased.[15]

Measures of job satisfaction are somewhat correlated with job performance; in particular, they appear to relate to organizational citizenship or discretionary behaviors on the part of an employee that further the goals of the organization.[16] Job satisfaction is related to general life satisfaction, although there has been limited research on how the two influence each other or whether personality and cultural factors affect both job and general life satisfaction. One carefully controlled study suggested that the relationship is reciprocal: Job satisfaction affects life satisfaction positively, and vice versa.[17] Job satisfaction, specifically low job satisfaction, is also related to withdrawal behaviors, such as leaving a job or absenteeism.[18] The relationship with turnover itself, however, is weak.[19] Finally, it appears that job satisfaction is related to organizational performance, which suggests that implementing organizational changes to improve employee job satisfaction will improve organizational performance.[20]

Chapter Review

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Optional Resources to Learn More

Books

Thinking Fast and Slow by Daniel Kahneman https://us.macmillan.com/books/9780374533557/thinkingfastandslow

Videos

"Hidden Traps in Decision Making" https://youtu.be/gk1kqJMdv2o

Websites

Cognitive Biases (A list of the most relevant biases in behavioral economics) https://thedecisionlab.com/biases

Ethics Defined Glossary https://ethicsunwrapped.utexas.edu/ethics-defined

APA Dictionary of Psychology https://dictionary.apa.org/

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8. Motivation

What is Motivation?

People can be a firm's most important resource. They can also be the most challenging resource to manage well. Employees who are motivated and work hard to achieve personal and organizational goals can become a crucial competitive advantage for a firm. The key then is understanding *what* motivates individuals, and *how* an organization can create a workplace that allows people to perform to the best of their abilities.

Motivation is the set of forces that prompt a person to release energy in a certain direction. As such, motivation is essentially a need- and want-satisfying process. A **need** is best defined as the gap between what is and what is *required*. Similarly, a **want** is the gap between what is and what is *desired*. Unsatisfied needs and wants create a state of tension that motivates individuals to practice behavior that will result in the need being met or the want being fulfilled. That is, motivation is what pushes us to move from where we are to where we want to be, because expending that effort will result in some kind of reward.

Rewards can be divided into two basic categories: intrinsic and extrinsic. **Intrinsic rewards** come from within the individual—things like satisfaction, contentment, sense of accomplishment, confidence, and pride. By contrast, **extrinsic rewards** come from outside the individual and include things like pay raises, promotions, bonuses, prestigious assignments, and so forth. Figure 8.1 illustrates the motivation process.

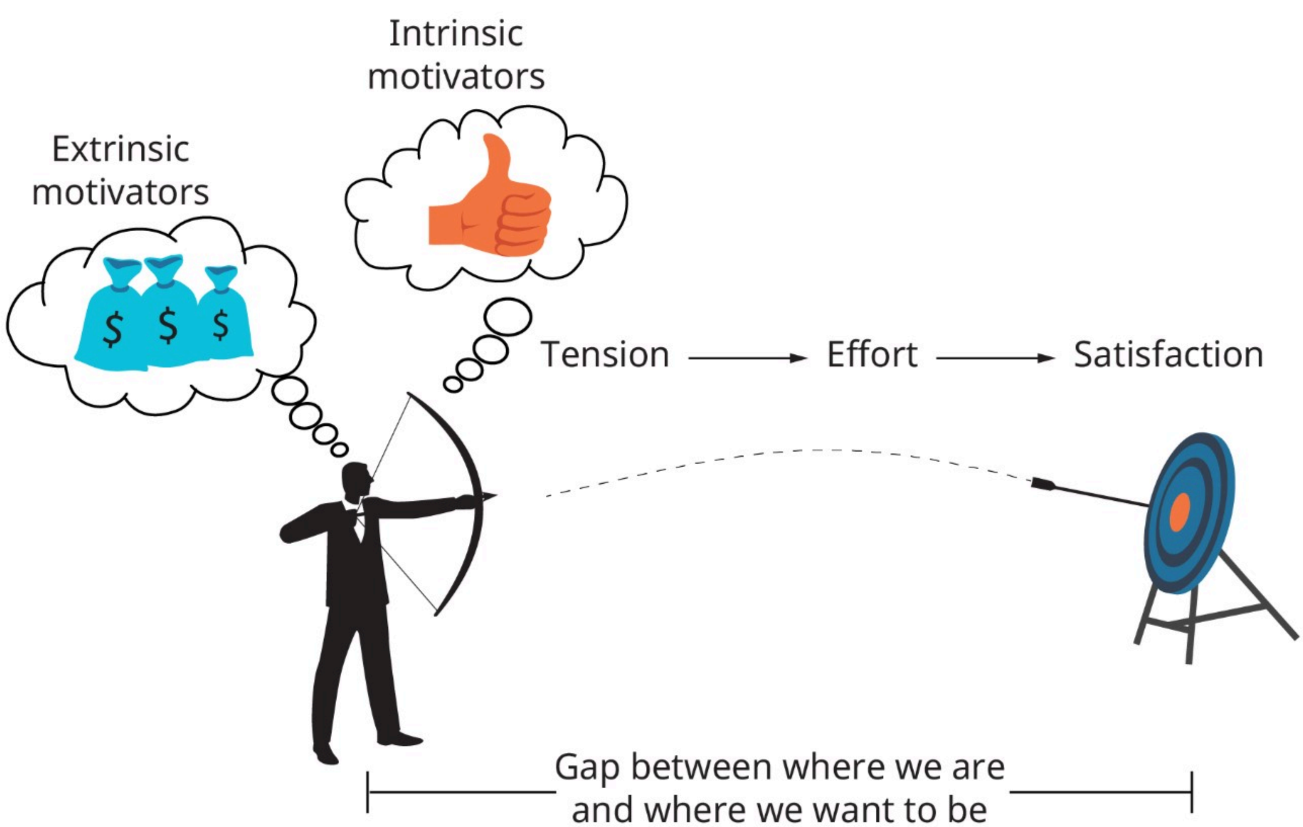

Figure 8.1: Model of motivation.

Figure 8.1: Model of motivation.Successful managers are able to marshal the forces to motivate employees to achieve organizational goals. And just as there are many types of gaps between where organizations are and where they want to be, there are many motivational theories from which managers can draw to inspire employees to bridge those gaps.

Expectancy Theory

One of the best-supported and most widely accepted theories of motivation is expectancy theory (Video 8.1), which focuses on the link between motivation and behavior.[1]

Watch Video 8.1: *Expectancy Theory*. Closed captioning is available. Click HERE to read a transcript.

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According to **expectancy theory**, the probability of an individual acting in a particular way depends on the strength of that individual's belief that the act will have a particular outcome and on whether the individual values that outcome. The degree to which an employee is motivated depends on three important relationships, shown in Figure 8.2.

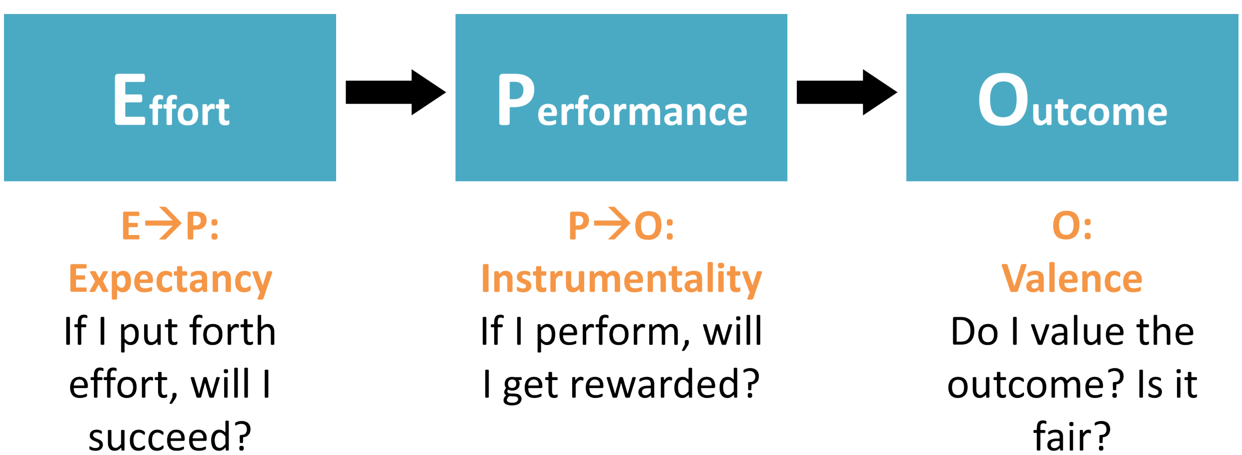

Figure 8.2: Expectancy theory.

1. The **expectancy** link, or the link between *effort and performance:* the strength of the individual's expectation that a certain amount of effort will lead to a certain level of performance.
2. The **instrumentality** link, or the link between *performance and outcome:* the strength of the expectation

that a certain level of performance will lead to a particular outcome.

3. The **valence**, or *outcome:* the degree to which the individual expects the anticipated outcome to satisfy personal needs or wants. Some outcomes have more valence, or value, for individuals than others do.

To apply expectancy theory to a real-world situation, let's analyze an automobile-insurance company with 100 agents who work from a call center. Assume that the firm pays a base salary of $3,000 a month, plus a $300 commission on each policy sold above ten policies a month. In terms of expectancy theory, under what conditions would an agent be motivated to sell more than ten policies a month?

1. The agent would have to believe that his or her efforts would result in policy sales (that, in other words, there's a positive link between effort and performance).
2. The agent would have to be confident that if he or she sold more than ten policies in a given month, there would indeed be a bonus (a positive link between performance and reward).
3. The bonus per policy—$300—would have to be of value to the agent.

Now let's alter the scenario slightly. Say that the company raises prices, thus making it harder to sell the policies. How will agents' motivation be affected? According to expectancy theory, motivation will suffer. Why? Because agents may be less confident that their efforts will lead to satisfactory performance. What if the company introduces a policy whereby agents get bonuses only if buyers don't cancel policies within 90 days? Now agents may be less confident that they'll get bonuses even if they do sell more than ten policies. Motivation will decrease because the link between performance and reward has been weakened. Finally, what will happen if bonuses are cut from $300 to $50? Obviously, the reward would be of less value to agents, and, again, motivation will suffer. The message of expectancy theory, then, is fairly clear: managers should offer rewards that employees value, set performance levels that they can reach, and ensure a strong link between performance and reward.

Equity Theory

Another contemporary explanation of motivation, **equity theory** (Video 8.2), is based on individuals' perceptions about how fairly they are treated compared with their coworkers.[2]

Watch Video 8.2: *Equity Theory*. Closed captioning is available. Click HERE to read a transcript.

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Equity means justice or fairness, and in the workplace it refers to employees' perceived fairness of the way they are treated and the rewards they earn. For example, imagine that after graduation you were offered a job that paid $65,000 a year and had great benefits. You'd probably be ecstatic, even more so if you discovered that the coworker in the next cubicle was making $53,000 for the same job. But what if that same colleague were instead making $72,000 for the same job? You'd probably think it unfair, particularly if the coworker had the same qualifications and started at the same time as you did. Your determination of the fairness of the situation would depend on how you felt you compared to the other person, or **referent**.

Employees evaluate their own *outcomes* (e.g., salary, benefits) in relation to their *inputs* (e.g., number of hours worked, education, and training) and then compare the outcomes-to-inputs ratio to one of the following:

- Someone in a similar position
- Someone holding a different position in the same organization
- Someone with a similar occupation
- Someone who shares certain characteristics (such as age, education, or level of experience)
- Oneself at another point in time

When individuals perceive that the ratio of their contributions to rewards is comparable to that of others, they perceive that they're being treated fairly or *equitably*; when they perceive that the ratio is out of balance, they perceive *inequity*. Occasionally, people will perceive that they're being treated better than others. More often, however, they conclude that others are being treated better (and that they themselves are being treated worse).

What will an employee do if he or she perceives an inequity? The individual might try to bring the ratio into balance, by making one of the following choices:

- *Change their work habits* (exert less effort on the job)
- *Change their job benefits and income* (ask for a raise, steal from the employer)
- *Distort their perception of themselves* ("I always thought I was smart, but now I realize I'm a lot smarter than my coworkers.")
- *Distort their perceptions of others* ("Joe's position is really much less flexible than mine.")
- *Look at the situation from a different perspective* ("I don't make as much as the other department heads, but I make a lot more than most graphic artists.")
- *Leave the situation* (quit the job)

Managers can use equity theory to improve worker satisfaction. Knowing that every employee seeks equitable and fair treatment, managers can make an effort to understand an employee's perceptions of fairness and take steps to reduce concerns about inequity.

Organizational Justice

In recent years, equity theory has been extended into the broader concept of **organizational justice**, which encompasses three distinct forms of justice (Video 8.3 and Figure 8.3).[3]

> Watch Video 8.3: *Perceptions of Fairness, Justice and Trust* to learn more about organizational justice. Closed captioning is available. Click HERE to read a transcript.

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When employees receive rewards (or punishments), they evaluate them in terms of the fairness of the outcome. This is referred to as **distributive justice**. Employees also assess rewards in terms of how fair the processes used to distribute them are, called **procedural justice**. For example, during organizational downsizing, when employees lose their jobs, employees may ask whether the loss of work is fair (distributive justice). But they may also assess the fairness of the process used to decide *who* is laid off (procedural justice). For example, layoffs based on seniority may be perceived as more fair than layoffs based on supervisors' opinions. Finally, employees also assess whether they are treated with respect and dignity, which reflects a third form of organizational justice, known as **interactional justice.**

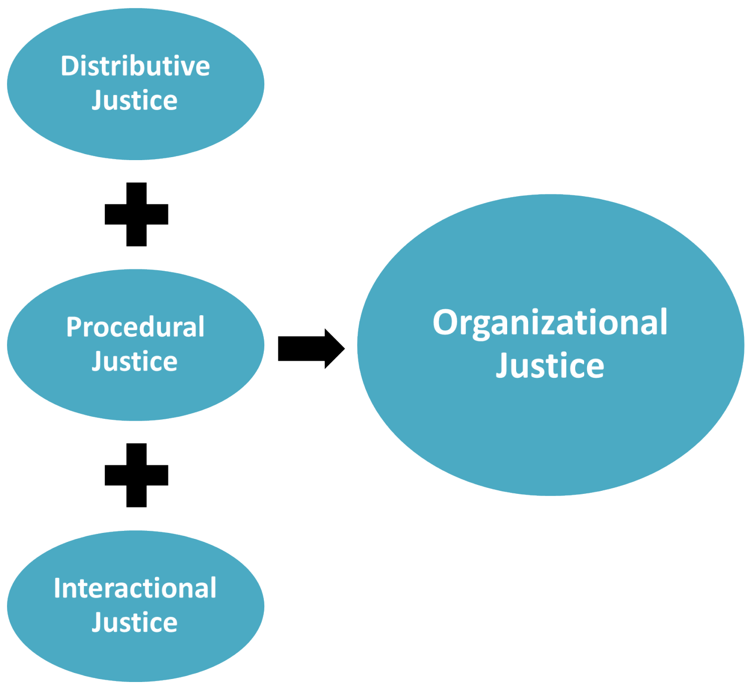

Figure 8.3: Organizational justice.

Goal-setting Theory

Goal-setting theory, or simply goal theory, is based on the premise that an individual's intention to work toward a goal is a primary source of motivation (Video 8.4). In addition, goal theory states that people will perform better if they have difficult, specific, accepted performance goals or objectives.[4]

Watch Video 8.4: *Goal Setting Theory*. Closed captioning is available. Click HERE to read a transcript.

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The first and most basic premise of goal theory is that people will attempt to achieve those goals that they *intend* to achieve. Thus, if we intend to do something (like get an A on an exam), we will exert effort to accomplish it. Without such goals, our effort at the task (studying) required to achieve the goal is less. Students whose goals are to get As generally study harder than students who don't have this goal. This doesn't mean that people without goals are unmotivated. It simply means that people with goals are more motivated. The intensity of their motivation is greater, and they are more directed.

The second basic premise is that *difficult* goals result in better performance than easy goals. This does not mean that difficult goals are always achieved, but our performance will usually be better when we intend to achieve harder goals. Your goal of an A in your economics course may not get you your A, but it may earn you a B+, which you wouldn't have gotten otherwise. Difficult goals cause us to exert more effort, and this almost always results in better performance.

Another premise of goal theory is that *specific* goals are better than vague goals. We often wonder what we need to do to be successful. Have you ever asked a professor "What do I need to do to get an A in this course?" If she responded "Do well on the exams," you weren't much better off for having asked. This is a vague response. Goal theory says that we perform better when we have specific goals. Had your professor told you to turn in *all* the problem sets, to pay close attention to the essay questions on exams, and to aim for scores in the 90s, you would have something concrete on which to build a strategy.

A key premise of goal theory is that people must *accept* the goal. Usually we set our own goals. But sometimes others set goals for us. Your professor telling you your goal is to "score at least a 90 percent on your exams" doesn't mean that you'll accept this goal. Maybe you don't feel you can achieve scores in the 90s. Or, you've heard that 90 isn't good enough for an A in the course. This happens in work organizations quite often. Supervisors give orders that something must be done by a certain time. The employees may fully understand what is wanted, yet if they feel the order is unreasonable or impossible, they may not exert much effort to accomplish it. Thus, it is important for people to accept the goal. They need to feel that it is also their goal. If they do not, goal theory predicts that they won't try as hard to achieve it.

Goal theory also states that people need to *commit* to a goal in addition to accepting it. Goal commitment is the degree to which we dedicate ourselves to achieving a goal. Goal commitment is about setting priorities. We can accept many goals (go to all classes, stay awake during classes, take lecture notes), but we often end up doing only some of them. In other words, some goals are more important than others. And we exert more effort for certain goals. This also happens frequently at work. A software analyst's major goal may be to write a new program. Her minor goal may be to maintain previously written programs. It is minor because maintaining old programs is boring, while writing new ones is fun. Goal theory predicts that her commitment, and thus her intensity, to the major goal will be greater.

Allowing people to participate in the goal-setting process often results in higher goal commitment. This has to do with ownership. And when people participate in the process, they tend to incorporate factors they think will make the goal more interesting, challenging, and attainable. Thus, it is advisable to allow people some input into the goal-setting process. Imposing goals on them from the outside usually results in less commitment (and acceptance).

Drawbacks of Goal-setting Theory

Goal theory can be a tremendous motivational tool, but several cautions are appropriate. First, setting goals in one area can lead people to neglect other areas. Second, goal setting sometimes has unintended consequences. For example, employees set easy goals so that they look good when they achieve them. Or it causes unhealthy competition between employees. Or an employee sabotages the work of others so that only she has goal achievement.

Some managers use goal setting in unethical ways. They may manipulate employees by setting impossible goals. This enables them to criticize employees even when the employees are doing superior work and, of course, causes much stress. Goal setting should never be abused. Perhaps the key caution about goal setting is that it often results in too much focus on quantified measures of performance. Qualitative aspects of a job or task may be neglected because they aren't easily measured. Managers must keep employees focused on the qualitative aspects of their jobs as well as the quantitative ones. Finally, setting individual goals in a teamwork environment can be counterproductive.[5] Where possible, it is preferable to have group goals in situations where employees depend on one another in the performance of their jobs.

Reinforcement Theory

Reinforcement theory says that behavior is a function of its consequences (Video 8.5). In other words, people do things because they know other things will follow. So, depending on what type of consequence follows, people will either practice a behavior or refrain from it.

Watch Video 8.5: *Reinforcement Theory*. Closed captioning is available. Click HERE to read a transcript.

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There are three basic types of consequences: positive, negative, and none. In general, we think of positive consequences as rewards, but a **reward** is anything that increases the particular behavior. In contrast, **punishment** is anything that decreases the behavior.

Motivating with the reinforcement theory can be tricky because consequences can operate differently for different people and in different situations. What is considered a punishment by one person may, in fact, be a reward for another. Nonetheless, managers can successfully use reinforcement theory to motivate workers to practice certain behaviors and avoid others. Often, managers use both rewards and punishment to achieve the desired results.

Reinforcement occurs when a consequence makes it more likely the response/behavior will be repeated in the future. There are two primary ways to make a response more likely to recur: positive reinforcement and negative reinforcement. In addition, there are two ways to make a response less likely to recur: punishment and extinction.

Making a Behavior More Likely

According to reinforcement theorists, managers can encourage employees to repeat a behavior if they provide a desirable consequence, or reward, after the behavior is performed. A **positive reinforcement** is a desirable consequence that satisfies an active need or that removes a barrier to need satisfaction (Figure 8.4). It can be as simple as a kind word or as major as a promotion. Companies that provide awards to employees who go the extra mile are utilizing positive reinforcement. It is important to note that there are wide variations in what people consider to be a positive reinforcer. Praise from a supervisor may be a powerful reinforcer for some workers, but not others.

	POSITIVE Consequence	NEGATIVE Consequence
Consequence APPLIED	**Positive Reinforcement:** Increases DESIRED behavior	**Punishment:** Decreases UNDESIRED behavior
Consequence REMOVED	**Extinction:** Decreases UNDESIRED behavior	**Negative Reinforcement:** Increases DESIRED behavior

Figure 8.4: Reinforcement theory.

Another technique for making a desired response more likely to be repeated is known as **negative reinforcement**. When a behavior causes something undesirable to be taken away, the behavior is more likely to be repeated in the future. Managers use negative reinforcement when they remove something unpleasant from an employee's work environment in the hope that this will encourage the desired behavior. For example, consider a scenario in which an employee doesn't like being continually reminded by his supervisor to work faster, so he works faster at stocking shelves to avoid being criticized.

Approach using negative reinforcement with extreme caution. Negative reinforcement is often confused with punishment. Punishment, unlike reinforcement (negative or positive), is intended to make a particular behavior go away (not be repeated). Negative reinforcement, like positive reinforcement, is intended to make a behavior more likely to be repeated in the future. In the previous example, the supervisor's reminders simultaneously punished one behavior (slow stocking) and reinforced another (faster stocking). The difference is often a fine one, but it becomes clearer when we identify the behaviors we are trying to encourage (reinforcement) or discourage (punishment).

Making a Behavior Less Likely

At times it is necessary to discourage a worker from repeating an undesirable behavior. The techniques managers use to make a behavior less likely to occur involve doing something that frustrates the individual's need satisfaction or that removes a currently satisfying circumstance.

Punishment is an aversive consequence that follows a behavior and makes it less likely to reoccur. Although punishment effectively tells a person what *not* to do and stops the undesired behavior, it does not, by itself, tell them what they *should* do. In addition, even when punishment works as intended, the worker being punished often develops negative feelings toward the person who does the punishing.

Finally, the principle of **extinction** suggests that undesired behavior will decline as a result of a lack of positive reinforcement. If a perpetually tardy employee consistently fails to receive supervisory praise and is not recommended for a pay raise, we would expect this nonreinforcement to lead to an "extinction" of the tardiness. The employee may realize, albeit subtly, that being late is not leading to desired outcomes, and she may try coming to work on time.

Recognition and Empowerment

All employees have unique needs that they seek to fulfill through their jobs. Organizations must devise a wide array of incentives to ensure that a broad spectrum of employee needs can be addressed in the work environment, thus increasing the likelihood of motivated employees.

Formal recognition of superior effort by individuals or groups in the workplace is one way to enhance employee motivation. Recognition serves as positive feedback and reinforcement, letting employees know what they have done well and that their contribution is valued by the organization. Recognition can take many forms, both formal and informal. Some companies use formal awards ceremonies to acknowledge and celebrate their employees' accomplishments. Others take advantage of informal interaction to congratulate employees on a job well done and offer encouragement for the future. Recognition can take the form of a monetary reward, a day off, a congratulatory e-mail, or a verbal "pat on the back."

Employee **empowerment**, sometimes called employee involvement or participative management, involves delegating decision-making authority to employees at all levels of the organization, trusting employees to make the right decision. Employees are given greater responsibility for planning, implementing, and evaluating the results of decisions. Empowerment is based on the premise that human resources, especially at lower levels in the firm, are an underutilized asset. Employees are capable of contributing much more of their skills and abilities to organizational success if they are allowed to participate in the decision-making process and are given access to the resources needed to implement their decisions.

Chapter Review

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"The Explainer: One More Time, How Do You Motivate Employees?" https://hbr.org/video/5487440968001/the-explainer-one-more-time-how-do-you-motivate-employees

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9. Leadership

In the context of business, *leadership* is the process of guiding and motivating others toward the achievement of organizational goals. A leader can be anyone in an organization—regardless of position—who is able to influence others to act or follow.

Example 9.1: *Warren Buffett*

Warren Buffett has become one of the wealthiest individuals in the world through his leadership of the holding company, Berkshire Hathaway Inc.

Figure 9.1: Warren Buffett.

As chairman, president, and CEO, Buffett is the obvious formal leader at Berkshire Hathaway, but his effective leadership is perhaps better demonstrated by the devoted following he has outside of the official structure of the company. Thousands of individuals read his annual shareholder letter and travel to hear him at Berkshire Hathaway's annual meetings.

One of the easily identifiable reasons for this is his unparalleled success as an investor. However, there are also a number of key features of his leadership style that have strongly contributed to his effectiveness and influence with his followers.

One interesting element of Buffett's approach is his "light touch" as a manager. One of his key tasks is to identify companies for purchase that he believes are well-managed and situated for success. As a rule, he buys only companies whose directors he trusts. Because he has confidence in them and their direction, he is happy to leave them to their work with as little interference as possible, which is a trait that appeals to many companies looking for a potential buyer.

Buffett is also a leader who presents a vision, stands firmly behind it, and inspires others to confidence and enthusiasm about that vision. His approach to investing is starkly different from that of many other investors. He emphasizes a deep understanding of companies and their industries, and urges the wisdom of buying proven companies and trusting in their long-term success. This approach contrasts sharply with an eager obsession to discover an unknown company that is about to explode in value and provide quick riches. Buffett's patient, steady approach to long-term investing has proven effective in the extreme, and many others have placed their confidence in Buffett's message and vision. As an important ingredient in this vision-casting, many have attested to Buffett's skill in presenting his approach with a great simplicity that enables his followers to understand the vision easily and deeply, inspiring further confidence.

Leadership vs. Management

What is the difference between *management* and *leadership*? Sometimes the terms are used almost interchangeably, but there can be important differences between them. **Leadership** is primarily about establishing a direction and influencing others to follow. **Management**, on the other hand, is more about successfully administering the many complex details involved in a business's operations. Leadership pursues change and challenges the status quo, whereas management seeks to provide stability within existing structures and processes.

Both management and leadership are necessary approaches, and they often overlap with one another. In most settings, the role of a manager includes both leadership and management functions. Leadership skills are needed to set the vision, and management skills are needed to implement a plan to achieve that vision. Recognizing the difference between leadership and management, however, can help individuals focus on developing their skills in both arenas. In many cases, successful outcomes are most likely when strong leadership is paired with effective management.

Leadership as a Process

Leadership is a complex and dynamic exchange relationship built over time between two or more people who are dependent on each another for goal attainment.[1] There are several key components to this relationship:

- Leader
- Follower
- The context, or situation
- The process itself
- Consequences, or outcomes

Across time, each component interacts with and influences the other components, and whatever consequences (such as leader-follower trust) are created influence future interactions. As any one of the components changes, so too will leadership.[2]

The Leader

Leaders are individuals who take charge of or guide the activities of others. They are often seen as the focus or orchestrater of group activity, the people who set the tone of the group so that it can move forward to attain its goals. Effective leadership helps individuals and groups achieve their goals by focusing on **maintenance needs**, or the need for individuals to fit and work together by having, for example, shared norms, as well as **task needs**, or the need for individuals and groups to make progress toward attaining the goal(s) that brought them together.

The Follower

The follower is not a passive participant in the leadership process. It is, after all, the follower who perceives the situation and comes to define the needs that the leader must fulfill. In addition, it is the follower who either rejects leadership or accepts acts of leadership by surrendering to the direction of the leader.

The follower's personality and readiness to follow determine the style of leadership that will be most effective. For example, followers who perform at high levels tend to cause their leaders to play a less directive role. Followers who are novices or poor performers, on the other hand, tend to cause their leaders to be more directive in their leadership style.[3]

The Context

Situations make demands on a group and its members, and not all situations are the same. *Context* refers to the situation that surrounds the leader and the followers. For example:

- Is the task structured or unstructured?
- Are the goals of the group clear or ambiguous?
- Is there agreement or disagreement about goals?
- Is there a body of knowledge that can guide task performance?
- Is the task boring? Frustrating? Intrinsically satisfying?
- Is the environment complex or simple, stable or unstable?

The above factors create different contexts within which leadership unfolds, and each factor places a different set of needs and demands on the leader and on the followers.

The Process

The leadership process is a complex, interactive, and dynamic working relationship between leader and followers. To the extent that leadership is the exercise of influence, part of the leadership process is captured by the surrender of power by the followers and the exercise of influence over the followers by the leader.[4] Thus, the leader influences the followers and the followers influence the leader, the context influences the leader and the followers, and both leader and followers influence the context.

The Consequences

A number of outcomes or consequences of the leadership process unfold between leader, follower, and situation. At the group level, two outcomes are important:

- Have the group's maintenance needs been fulfilled? That is, do members of the group get along with one another, do they have a shared set of norms and values, and have they developed a good working relationship? Have individuals' needs been fulfilled as reflected in attendance, motivation, performance, satisfaction, citizenship, trust, and maintenance of the group membership?
- Have the group's task needs been met? That is, has the group accomplished the work it set out to do? Has the group reached its goals or achieved its purpose?

Formal vs. Informal Leadership

As we attempt to understand what leadership is all about, it is worth noting that not all leadership is based on an official position. That is, the title and official role of an individual within an organization do not always correspond to actual leadership influence.

Generally speaking, individuals who are assigned titles and positions of authority are expected to provide leadership. When a leadership role is officially recognized, it is known as **formal leadership**. Unfortunately, there are plenty of individuals who have formal leadership positions but do not actually provide strong leadership. This can leave groups or organizations lacking in direction and purpose.

However, there are also individuals who do not have official positions of leadership but who exhibit leadership qualities and practices. Such individuals help create vision and inspire and motivate their coworkers. When leadership is exhibited without an official position, it is known as **informal leadership**.

Paths to Leadership

People typically come to leadership positions in one of two ways. In some instances, people are put into positions of leadership through formal processes. For example, university-based ROTC programs and military academies (like West Point) formally prepare individuals to be leaders. These types of leaders are referred to as **designated leaders**.

Emergent leaders, on the other hand, arise from the dynamics and processes that unfold within and among a group of individuals as they endeavor to achieve a collective goal. Many leaders emerge out of the needs of a given situation. Different situations call for different configurations of knowledge, skills, and abilities. A group often turns to the member who possesses the knowledge, skills, and abilities that the group requires to achieve its goals.[5] People surrender their power to individuals whom they believe will make meaningful contributions to attaining group goals.[6]

It is important to recognize that the traits possessed by certain individuals contribute significantly to their emergence as leaders. Research indicates that people are unlikely to follow individuals who, for example, do not display drive, self-confidence, or integrity.

Influence and Power

As described earlier, leadership is the exercise of influence over those who depend on one another for attaining a mutual goal in a group setting. But how do leaders effectively exercise this influence? **Social (or interpersonal) influence** is one’s ability to effect a change in the motivation, attitudes, and/or behaviors of others. **Power**, then, essentially answers the “how” question: how do leaders influence their followers? The answer often is that a leader’s social influence is the source of his power.

A well-known typology identifies six distinct sources and types of power that may be at the disposal of leaders (Video 9.1): reward, coercive, legitimate, expert, referent, and informational.[7]

- **Reward power:** the power a person has because people believe that they can bestow rewards or outcomes, such as money or recognition that others desire.
- **Coercive power:** the power a person has because people believe that the person can punish them by inflicting punishment or by withholding or taking away something that they value.
- **Legitimate power:** the power a person has because others believe that the person possesses the “right” to influence them and that they ought to obey. This right can originate from cultural values, social structures, and designation (i.e., designated leadership, as described above).
- **Expert power:** the power a person has because others believe that the person has and is willing to share expert knowledge that they need.

- **Referent power:** the power a person has because others want to associate with or be accepted by them.
- **Informational power:** the power a person has because they have access to or control over valuable information.

Watch Video 9.1: *Leading with Influence* to learn about the 6 sources of power. Closed captioning is available. Click HERE to read a transcript.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=652#oembed-1

Not all forms of power are equally effective, nor is a leader's total power base the simple sum of the powers at his or her disposal. Different types of power elicit different forms of compliance. Reward and legitimate power (that is, relying on one's position to influence others) produce inconsistent results. Sometimes these powers lead to follower performance and satisfaction, yet they also sometimes fail. Coercive power can result in favorable performance, yet follower and resistance dissatisfaction are not uncommon. On the other hand, leaders who use referent and expert power commonly experience a favorable response in terms of follower satisfaction and performance. [8]

Good leaders, whether formal or informal, develop many sources of power. Leaders who rely solely on legitimate power and authority seldom generate the influence necessary to be successful in the long term. In the process of building their power base, effective leaders have discovered that the use of coercive power tends to dilute the effectiveness of other powers, while the development and use of referent power tends to magnify the effectiveness of other forms of power. A compliment or reward from a person we like generally has greater value than one from someone we dislike, and punishment from someone we admire and respect is typically less offensive than the pain inflicted by someone we do not respect.[9]

In sum, one key to effective leadership, especially as it pertains to the exercise of social and interpersonal influence, relates to the type of power employed by the leader. Leaders are generally most effective when people follow because they want to follow.

Leadership Styles

Individuals in leadership positions tend to be relatively consistent in the way they react to people and situations as well as how they attempt to influence the behavior of others. Such a pattern of behavior is referred to as *leadership style*. As Figure 9.2 shows, leadership styles can be placed on a continuum with an **autocratic** (boss-centered) style on one end and a **free-rein** (subordinate-centered) style on the other.[10]

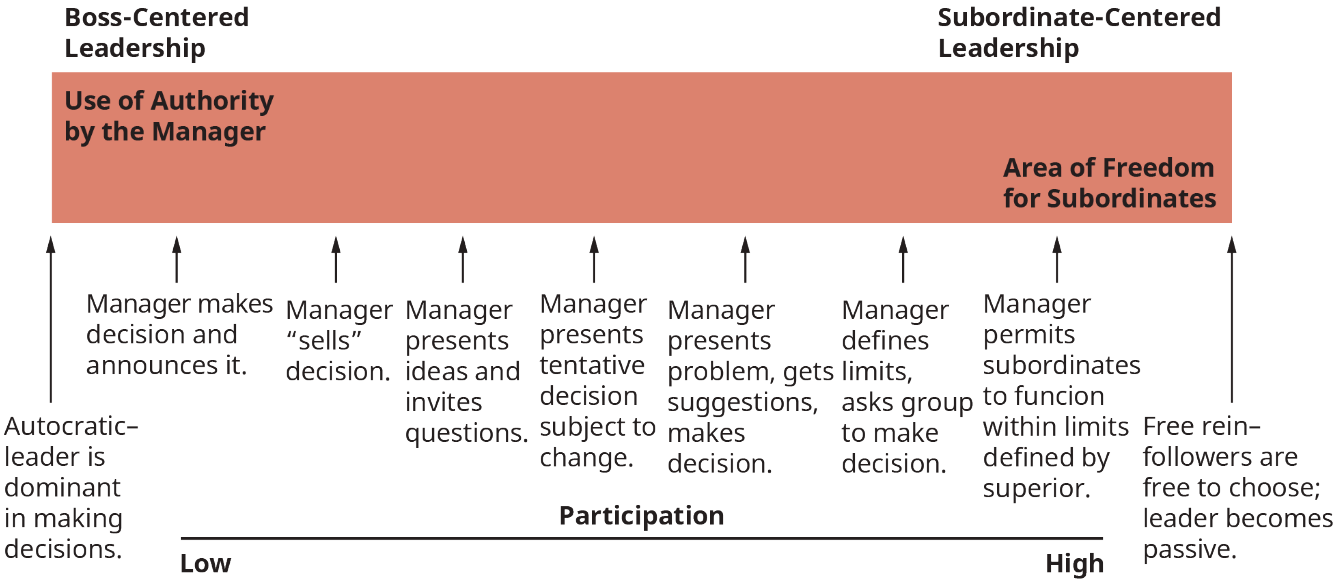

Figure 9.2: Leadership styles.

Autocratic leaders are directive leaders, allowing for very little input from subordinates. These leaders prefer to make decisions and solve problems on their own and expect subordinates to implement solutions according to very specific and detailed instructions. In this leadership style, information typically flows in one direction, from leader to subordinate. When autocratic leaders treat employees with fairness and respect, they may be considered knowledgeable and decisive. But often autocrats are perceived as heavy-handed in their unwillingness to share power, information, and decision-making in the organization.

At the opposite end of the continuum from an autocratic style is free-rein or laissez-faire (French for "leave it alone") leadership. Leaders who use this style typically turn over all authority and control to subordinates. Employees are assigned a task and then given free rein to figure out the best way to accomplish it. The leader generally doesn't get involved unless asked. Under this approach, subordinates often have unlimited freedom as long as they do not violate existing company policies.

Although one might at first assume that most subordinates would prefer a free-rein style, this approach can have several drawbacks. If free-rein leadership is accompanied by unclear expectations and lack of feedback from the leader, the experience can be frustrating for an employee. Employees may perceive the leader as being uninvolved and indifferent to what is happening or as unwilling or unable to provide the necessary structure, information, and expertise.

The trend in organizations today is away from the directive, controlling style of the autocratic leader. Instead, many businesses are looking more and more for participative leaders, meaning leaders who share decision-making with group members and encourage discussion of issues and alternatives. Participative leadership falls between autocratic and free-rein leadership on the leadership-style continuum.

No leadership style is effective all the time. Effective leaders recognize employee growth and use situational leadership, selecting a leadership style that matches the maturity and competency levels of those completing the tasks. Newly hired employees may respond well to more authoritative leadership until they understand the job requirements and demonstrate the ability to handle routine decisions. Once established, however, those same employees may perform better under a more participative or even free-rein leadership style.

Employee Empowerment

Participative and free-rein leaders use a technique called *empowerment* to share decision-making authority with subordinates. **Empowerment** means giving employees increased autonomy and discretion to make their own decisions, as well as control over the resources needed to implement those decisions. When decision-making power is shared at all levels of the organization, employees feel a greater sense of ownership in, and responsibility for, organizational outcomes.

Use of employee empowerment is on the rise. This increased level of involvement comes from the realization that people at all levels in the organization possess unique knowledge, skills, and abilities that can be of great value to the company.

Chapter Review

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=652#h5p-120

Optional Resources to Learn More

Articles

"Getting Beyond the BS of Leadership Literature" https://www.mckinsey.com/featured-insights/leadership/getting-beyond-the-bs-of-leadership-literature

"Great Leaders Are Confident, Connected, Committed, and Courageous" https://hbr.org/2018/07/great-leaders-are-confident-connected-committed-and-courageous

"Understanding Leadership" https://hbr.org/2004/01/understanding-leadership

Podcasts

Wisdom from the Top https://try.luminarypodcasts.com/listen/wisdom-from-the-top/65280dac52b38a00118a0cb7

Videos

Leadership Models, Theories, and Tips (playlist) https://www.youtube.com/playlist?list=PLrjP20LtSCNqVK8IwLd0rAiUVs8fwS0YQ

"What Makes a Great Leader?" https://youtu.be/ME5arjlSTGQ

Websites

Center for Creative Leadership https://www.ccl.org/insights-research/

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Figure 9.2: OpenStax. (2019, June 5). *Tannenbaum and Schmidt's leadership continuum*. OpenStax. https://openstax.org/books/organizational-behavior/pages/12-3-leader-emergence. Licensed with CC BY 4.0.

Video 9.1: Heidrick & Struggles. (2016, October 21). *Leading with influence the 6 power bases* [Video]. YouTube. https://youtu.be/A3sTrfvMdo4

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10. Teamwork in Organizations

Teamwork in Organizations

Much of the work that is performed today in organizations requires a focus on teamwork. A team has a specific purpose that it delivers on, has both individual and mutual accountabilities, and often involves shared leadership roles. Teams discuss, make decisions, and perform real work together, and they measure their performance by assessing their collective work products.

Effective teams give companies a significant competitive advantage. In a high-functioning team, the sum is truly greater than the parts. Team members not only benefit from each other's diverse experiences and perspectives but also stimulate each other's creativity. In addition, for many people, working in a team can be more fulfilling than working alone.

Figure 10.1: A team meeting in the workplace.

Several practices have been identified as important contributors to team success, including the following:[1]

Establish urgency, demanding performance standards, and direction. Teams work best when they have a compelling reason for being, and it is thus more likely that the teams will be successful and live up to performance expectations.

Select members for their skill and skill potential, not for their personality. Spend some time up front thinking about the purpose of the project and the anticipated deliverables you will be producing, and think through the specific types of skills you'll need on the team.

Pay particular attention to first meetings and actions. This is one way of saying that first impressions mean a lot, and it is just as important for teams as for individuals. Keeping an eye on your team's level of **emotional intelligence** is very important and will enhance your team's reputation and ability to navigate future challenges.

Set clear rules of behavior. There is a tendency for teams to rush through **ground rules** because it feels like they are obvious. However, it is critical that teams take the time up front to capture their own rules of the road in order to keep the team in check. Rules that address areas such as attendance, discussion, confidentiality, project approach, and conflict are key to keeping team members aligned and engaged appropriately.

*Set and seize upon a few immediate performance-oriented tasks and goals.*What does this mean? Have some quick wins that make the team feel that they're really accomplishing something and working together well. This is very important to the team's confidence, as well as just getting into the practices of working as a team. Success in the larger tasks will come soon enough, as the larger tasks are really just a group of smaller tasks that fit together to produce a larger deliverable.

*Challenge the team regularly with fresh facts and information.*That is, continue to research and gather information to confirm or challenge what you know about your project. Don't assume that all the facts are static and that you received them at the beginning of the project. Often, you don't know what you don't know until you dig in.

*Spend time together.*Here's an obvious one that is often overlooked. People are so busy that they forget that an important part of the team process is to spend time together, think together, and bond. Time in person, time on the phone, time in meetings—all of it counts and helps to build camaraderie and trust.

Figure 10.2: A team meeting in a university setting.

Exploit the power of positive feedback, recognition, and reward. Positive reinforcement is a motivator that will help the members of the team feel more comfortable contributing. It will also reinforce the behaviors and expectations that you're driving within the team. Although there are many extrinsic rewards that can serve as motivators, a successful team begins to feel that its own success and performance is the most rewarding.

Team Development

If you have been a part of a team, then you have likely intuitively felt that there are different "stages" of team development. A well-known and widely-used model of team development (Figure 10.3 and Video 10.1) suggests that there are four distinct stages of development that help explain the process and complexities of team development: forming, storming, norming, and performing.[2] A fifth stage, adjourning, was later added to explain the disbanding of a team at the end of a project.[3]

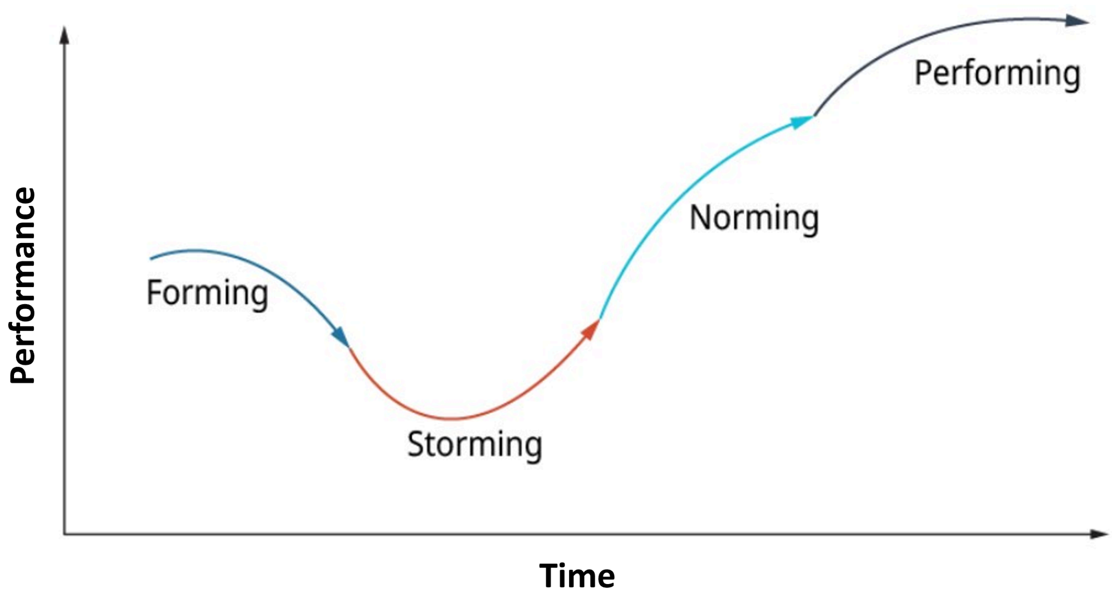

Figure 10.3: Model of team development.

Forming

The **forming stage** begins with the introduction of team members. This is known as the “polite stage” in which the team is mainly focused on similarities and the team looks to the leader for structure and direction. The team members at this point are enthusiastic, and issues are still being discussed on a global, ambiguous level. This is when the informal pecking order begins to develop, but the team is still friendly.

Storming

The **storming stage** begins as team members begin vying for leadership and testing the team processes. This is known as the “win-lose” stage, as members clash for control of the team and people begin to choose sides. The attitude about the team and the project begins to shift to negative, and there is frustration around goals, tasks, and progress.

Norming

After what can be a very long and painful storming process for the team, the **norming stage** may slowly start to take root. During norming, the team is starting to work well together, and buy-in to team goals occurs. The team is establishing and maintaining ground rules and boundaries, and there is willingness to share responsibility and control. At this point in the team formation, members begin to value and respect each other and their contributions.

Performing

Finally, as the team builds momentum and starts to get results, it is entering the **performing stage**. The team is completely self-directed and requires little management direction. The team has confidence, pride, and enthusiasm, and there is a congruence of vision, team, and self. As the team continues to perform, it may even succeed in becoming a high-performing team. High-performing teams have optimized both task and people relationships—they are maximizing performance and team effectiveness.

Watch Video 10.1: *The 5 Stages of Team Development* to learn about the team development process. Closed captioning is available. Click HERE to read a transcript.

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Team Development Process

The process of becoming a high-performing team is not a linear process, and there are factors that may cause a team to regress to an earlier stage of development. When a team member is added to the team, this may change the dynamic enough and be disruptive enough to cause a backwards slide to an earlier stage. Similarly, if a new project task is introduced that causes confusion or anxiety for the team, then this may also cause a backwards slide to an earlier stage of development. In such cases, a team has to re-group and will likely re-storm and re-form before getting back to performing as a team.

Task Interdependence

Task interdependence refers to the degree that team members are dependent on one another to get information, support, or materials from other team members to be effective. Interdependence takes three primary forms: pooled, sequential, and reciprocal (Figure 10.4).

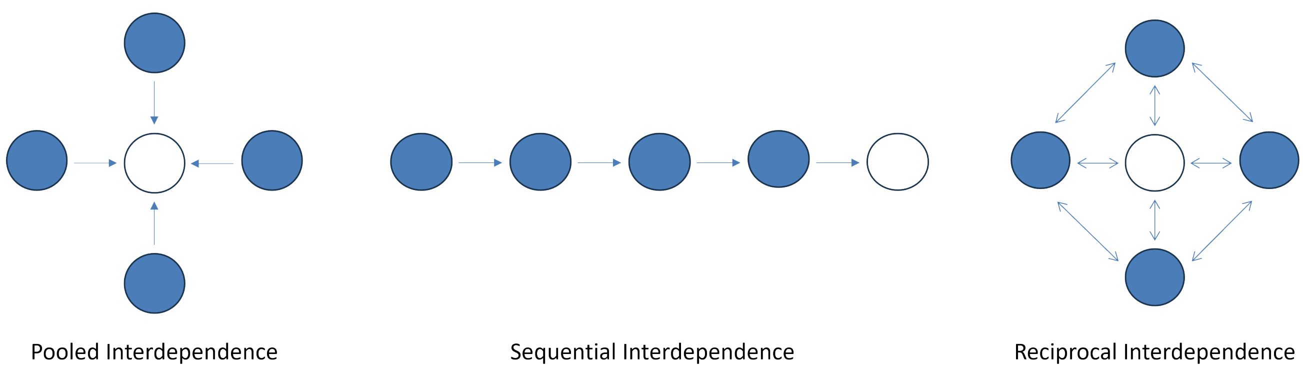

Figure 10.4: Types of interdependence.

1. **Pooled interdependence** exists when team members may work independently and simply combine their efforts to create the team's output. For example, when students divide the section of a research paper and then compile the sections to create one paper, the team is using the pooled interdependence model.
2. **Sequential interdependence** exists when the outputs of one team member becomes the inputs for another. For students using this approach for a research paper, one person may write the introduction of their research paper, then the second person reads what was written by the first person and, drawing from this section, writes about the findings within the paper. Using the findings section, the third person writes the conclusions.
3. **Reciprocal interdependence** occurs when two or more team members depend on one another for inputs. If students use this approach in writing a research paper, they make work together on each phase of the research paper, iterating back and forth among different sections until they complete the paper.

The type of interdependence utilized by teams determines in large part the coordinating mechanisms a team uses, as well as the degree to which team members interact. These are summarized in Table 10.1:

Table 10.1: Interdependence Coordination and Interaction

Type of Interdependence	Coordinating Mechanisms	Degree of Interaction
Pooled	Standardization (e.g., specifying criteria for output)	Low
Sequential	Planning (e.g., determining the workflow and schedule)	Medium
Reciprocal	Mutual adjustment (e.g., adapting to feedback or new information)	High

Opportunities and Challenges to Team Building

Conflict

There are many sources of conflict for a team, whether due to a communication breakdown, competing views or goals, power struggles, or conflicts between different personalities. The perception is that conflict is generally bad for a team and that it will inevitably bring the team down and cause it to spiral out of control and off track. Conflict does have some potential costs: if conflict is handled poorly, it can create distrust within a team, disrupt team progress and morale, and hinder building lasting relationships.

When managed effectively, however, conflict in teams can encourage a greater diversity of ideas and perspectives and can help people to better understand opposing points of view. It can also enhance a team's problem-solving capability and can highlight critical points of discussion and contention that need to be given more thought.

There are a variety of individual responses to conflict that you may encounter in your work on teams. Some team members will take the constructive and thoughtful path when conflicts arise, while others may jump immediately to destructive behaviors. To navigate team conflict effectively, the goal is to have a constructive response that encourages dialogue, learning, and resolution.[4] Constructive responses can take both passive and active forms. Passive-constructive responses include thinking, delay responding, and adapting, while active-constructive responses include perspective taking, creating solutions, expressing emotions, and reaching out.

Cohesion

Cohesion can be thought of as a kind of social glue. It refers to the degree of camaraderie within the team. Cohesive teams are those in which members are attached to each other and act as one unit. Generally speaking, the more cohesive a team is, the more productive it will be and the more rewarding the experience will be for the team's members.[5]

The fundamental factors affecting team cohesion include the following:

- *Similarity*: the more similar team members are in terms of age, sex, education, skills, attitudes, values, and beliefs, the more likely the team will bond.
- *Stability*: the longer a team stays together, the more cohesive it becomes.
- *Size*: smaller team tend to have higher levels of cohesion.
- *Support:* when team members receive coaching and are encouraged to support their fellow team members, team identity strengthens.

- *Satisfaction:* cohesion is correlated with how pleased team members are with each other's performance, behavior, and conformity to team norms.

As you might imagine, there are many benefits to creating a cohesive team. Members are generally more personally satisfied and feel greater self-confidence and self-esteem when in a team where they feel they belong. For many, membership in such a team can be a buffer against stress, which can improve mental and physical well-being. Because members are invested in the team and its work, they are more likely to regularly attend and actively participate in the team, taking more responsibility for the team's functioning. In addition, members can draw on the strength of the team to persevere through challenging situations that might otherwise be too hard to tackle alone.

Groupthink

When there's too much conformity, a team may fall victim to **groupthink**—the tendency to conform to team pressure in making decisions, while failing to think critically or to consider outside influences.[7]

Because members can come to value belonging over all else, an internal pressure to conform may arise, causing some members to modify their behavior to adhere to team norms. Members may become conflict avoidant, focusing more on trying to please each other so as not to be ostracized. In some cases, members might censor themselves to maintain the party line. As such, there is a superficial sense of harmony and less diversity of thought. Having less tolerance for deviants, who threaten the team's static identity, cohesive teams will often ostracize members who dare to disagree. Members attempting to make a change may even be criticized or undermined by other members, who perceive this as a threat to the status quo. The painful possibility of being marginalized can keep many members in line with the majority.

Example 10.1: *Challenger Shuttle Disaster*

Groupthink is often cited as a factor in the explosion of the space shuttle Challenger in January 1986: engineers from a supplier of components for the rocket booster warned that the launch might be risky because of the weather but were persuaded to set aside their warning by NASA officials who wanted the launch to proceed as scheduled.[6]

One way teams can reduce groupthink is by assigning a member to play the devil's advocate. The job of the devil's advocate is to point out flawed logic, to challenge the group's evaluations of various alternatives, and to identify weaknesses in proposed solutions. This pushes the other group members to think more deeply about the advantages and disadvantages of proposed solutions before reaching a decision and implementing it.

Social Loafing

Social loafing refers to the tendency of individuals to put in less effort when working in a team context. This phenomenon, also known as the *Ringelmann effect*, was first noted by French agricultural engineer Max Ringelmann in 1913. In one study, he had people pull on a rope individually and in teams. He found that as the number of people pulling increased, the team's total pulling force was less than the individual efforts had been when measured alone.[8]

Why do people work less hard when they are working with other people? Observations show that as the size of a team grows, this effect becomes larger as well.[9] The social loafing tendency is less a matter of being lazy and more a matter of perceiving that one will receive neither one's fair share of rewards if the team is successful nor blame if the team fails. Rationales for this behavior include, “My own effort will have little effect on the outcome,” “Others aren’t pulling their weight, so why should I?” or “I don’t have much to contribute, but no one will notice anyway.” This is a consistent effect across a great number of team tasks and countries.[10] Research also shows that perceptions of fairness are related to less social loafing.[11] Therefore, teams that are deemed as more fair should also see less social loafing.

Team Diversity

Decision-making and problem-solving can be much more dynamic and successful when performed in a diverse team environment. A 2015 McKinsey report on 366 public companies found that those in the top quartile for ethnic and racial **diversity** in management were 35% more likely to have financial returns above their industry mean, and those in the top quartile for gender diversity were 15% more likely to have returns above the industry mean.[12] Similarly, a global analysis conducted by Credit Suisse found that organizations with at least one female board member yielded a higher return on equity and higher net income growth than those that did not have any women on the board.[13] Another study by Boston Consulting Group found that diversity in teams is linked to greater innovation.[14]

When individuals are among homogeneous and like-minded teammates, a team is more susceptible to groupthink and may be reticent to think about opposing viewpoints. In a more diverse team with a variety of backgrounds and experiences, opposing viewpoints are more likely to come out and team members are more likely to research and address questions that have been raised. This enables a richer discussion and a more in-depth fact-finding and exploration of opposing ideas and viewpoints in order to solve problems.

Chapter Review

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Optional Resources to Learn More

Books

Ask a Manager: How to Navigate Clueless Colleagues, Lunch-Stealing Bosses, and the Rest of Your Life at Work by Alison Green https://www.askamanager.org/books

Videos

How Do I Say That? Skills to Speak Up When It Matters Most https://youtube.com/playlist?list=PLq6xHLjpckweKfwcqt2Iaj7ysDdHFzHvN

Websites

Student Guide to Group Work https://learningcommons.yorku.ca/groupwork/

Student Project Toolkit https://learningcommons.yorku.ca/projecttoolkit/

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Figure 10.3: Rice University. OpenStax. https://openstax.org/books/principles-management/pages/15-2-team-development-over-time. Licensed with CC BY-NC-SA 4.0.

Figure 10.5: Hoopes, C. (2023). *Types of interdependence*. Licensed with CC BY-NC-SA 4.0.

Video 10.1: The Right Questions. (2022, June 19). *The 5 stages of team development* [Video]. YouTube. https://youtu.be/-RwkZxGPQb8

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PART IV

ORGANIZATIONS IN CONTEXT

11. Ethics

What is Business Ethics?

Ethics consists of principles or standards of behavior to which we hold ourselves. In our professional lives, ethics guides our interactions with customers, clients, colleagues, employees, and other stakeholders affected by our business practices.

> Asked what he looked for in a new hire, Warren Buffett, CEO of Berkshire Hathaway and one of the world's most successful investors, replied: "I look for three things. The first is personal integrity, the second is intelligence, and the third is a high energy level." He paused and then added, "But if you don't have the first, the second two don't matter."[1]

Many people confuse ethics with *legal compliance*. These concepts, however, are not interchangeable. **Legal compliance** generally refers to the extent to which a company conducts its business operations in accordance with applicable regulations, statutes, and laws. Yet this represents only a baseline minimum. Ethical behavior builds on this baseline and reveals the principles of an individual employee or a specific organization.

As described by ethics researchers at the University of Virginia,

> Ethics is more than an individual's view of things; it is also tied to a larger communal context—an organization, an industry, a community, a nation, or the globe. Ethics is about how one should live as an individual as well as how to get along with others. Ethics assumes that people are accountable for their actions, both to themselves and others. Every day, managers make decisions that can affect customers, employees, financiers, partners, the community, and the world in powerful ways. Since managers are accountable to these groups, they should have good reasons for their actions that go beyond mere intuition and be able to explain why they make the choices they do.[2]

It is generally understood that the more ethical an organization is, the better it is positioned for long-term success. Thus, it is in the best interest of a company to hire and retain ethical employees and to foster a culture in which ethical behavior is modeled, reinforced, and valued.

Behaving Ethically

Many ethical challenges arise in business because companies, especially large ones, have multiple stakeholders who sometimes make competing demands. Making decisions that affect multiple stakeholders isn't easy even for seasoned managers; for new entrants to the business world, the task can be especially daunting.

Regardless of an individual's experience or position, ethic violations in business often involve three factors: pressure, opportunity, and rationalization. (Video 11.1). Together, these three factors make up what is known as the **fraud triangle**, which has relevance to many other types of ethical violations beyond just **fraud**.

Watch Video 11.1: *How People Rationalize Fraud* to learn more about the factors that contribute to ethical violations. Closed captioning is available. Click HERE to read a transcript.

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Giving Voice to Values

You can prepare for the ethical dilemmas you will inevitably face in the business world by understanding the nature of values conflicts and by developing, in advance, strategies to navigate these dilemmas (Videos 11.2 and 11.3). To this end, the remaining portion of this chapter will introduce you to **Giving Voice to Values (GVV)**, a powerful method to enable you to effectively act on your values in your professional life.

Watch Video 11.2: *The Client Who Fell Through the Cracks,* which presents an example of the type of values conflict you might encounter in the workplace. Closed captioning is available. Click HERE to read a transcript.

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Before going on, take a moment to consider the following question:

Put yourself in Susan's shoes and assume that there is a way that she can be effective, even if you're not sure there is. What could she say and do at this point to change the outcome for the client and for the meeting?

Now watch Video 11.3: *The Client Who Fell Through the Cracks: What Happened*. Closed captioning is available. Click HERE to read a transcript.

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Developed by Dr. Mary C. Gentile, Professor of Practice at the University of Virginia's Darden School of Business, GVV takes an action-oriented approach to values-driven leadership. Unlike most approaches to business ethics, GVV is not about persuading people to be more ethical. Rather, it starts from the premise that most people want to act on their values, but they also want their actions to be successful and effective.

Traditional approaches to business ethics seek to provide guidance for questions including the following:

- What is the right thing to do in my particular situation?
- Which model of ethical reasoning is the most appropriate to use in my situation?
- What evidence do I need to gather to support my ethical viewpoint?

In contrast, GVV seeks to answer the following question:

- Once I know what the right thing to do is, how do I get it done effectively?

The seven pillars of the Giving Voice to Values (GVV) approach to ethics capture the ways of thinking that make it easier for people to act effectively on their values (Video 11.4). The seven pillars and the specific questions each seeks to answer are as follows:

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Watch Video 11.4: *Giving Voice to Values* to learn more about the GVV seven pillars. To view a larger version of this video, click HERE. Click HERE to read a transcript.

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Optional Resources to Learn More

Books

Giving Voice to Values by Mary Gentile https://givingvoicetovaluesthebook.com/

Websites

Ethics Unwrapped: Giving Voice to Values https://ethicsunwrapped.utexas.edu/series/giving-voice-to-values

Ethics Unwrapped: Glossary https://ethicsunwrapped.utexas.edu/ethics-defined

Violations Tracker https://violationtracker.goodjobsfirst.org/

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Video 11:2: Online Ethics Center at UVA. (2022, April 14). *The client who fell through the cracks* [Video]. https://youtu.be/UcXF_KhGZ2c

Video 11.3: Online Ethics Center at UVA. (2022, April 14). *The client who fell through the cracks – what happened?* [Video]. YouTube. https://youtu.be/_qztHqUITRs

Video 11.4: CFA Institute. *Giving voice to values* [Video]. CFA Institute.https://www.cfainstitute.org/en/ethics-standards/ethics/giving-voice-to-values

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12. Corporate Social Responsibility and Stakeholder Management

Corporate Social Responsibility

Corporate social responsibility (CSR) is the practice by which a business views itself within a broader context, as a member of society with certain implicit social obligations and environmental responsibilities (Video 12.1). CSR ensures that a company is engaging in sound ethical practices and policies in accordance with the company's culture and mission, above and beyond any mandatory legal standards. A business that practices CSR cannot have maximizing shareholder wealth as its sole purpose, because this goal would infringe on the rights of other stakeholders. For instance, a mining company that disregards its corporate social responsibility may infringe on the right of its local community to clean air and water if it pursues only profit. In contrast, CSR places all stakeholders within a proper contextual framework.

An additional perspective to take concerning CSR is that ethical business leaders opt to do good at the same time that they do well. This is a simplistic summation, but it speaks to how CSR plays out within a corporate. The idea is that a corporation is entitled to make money, but it should not only make money. It should also be a good civic neighbor and commit itself to the general prospering of society as a whole. It ought to make the communities of which it is part better at the same time it pursues legitimate profit goals. These ends are not mutually exclusive, and it is possible—indeed, praiseworthy—to strive for both. When a company approaches business in this fashion, it is engaging in a commitment to corporate social responsibility.

Watch Video 12.1: *What is Corporate Social Responsibility (CSR)?* Closed captioning is available. Click HERE to read a transcript.

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CSR and Sustainability

In recent years, corporations have made efforts to respond to stakeholder concerns about the environment and **sustainability** (Video 12.2). There is a growing awareness that human actions can, and do, harm the environment. Destruction of the environment can ultimately lead to reduction of resources, declining business opportunities, and lowered quality of life.

Watch Video 12.2: *What is Sustainability*. Closed captioning is available. Click HERE to read a transcript.

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Stakeholders such as customers, state governments, NGOs, citizen groups, and political action committees in the United States apply social and legal pressure on businesses to improve their environmental practices. For example, the state of California in 2015 enacted a set of laws, referred to as the California Transparency in Supply Chains Act, which requires firms to report on the working conditions of the employees of their suppliers. The law requires only disclosures, but the added transparency is a step toward holding U.S. and other multinational corporations responsible for what goes on before their products appear in stores. The legislators who wrote California's Supply Chains Act recognize that consumer stakeholders are likely to bring pressure to bear on companies found to use slave labor in their supply chains, so forcing disclosure can bring about change because corporations would rather adjust their relationships with supply-chain stakeholders than risk alienating massive numbers of customers.[1]

As instances of this type of pressure on corporations increase around the world, stakeholder groups become simultaneously less isolated and more powerful. All stakeholders exist in an interdependent network of relationships, and what is most needed is a sustainable system that enables all types of key stakeholders to establish and apply influence.

People, Planet, Profit: The Triple Bottom Line

How can corporations and their stakeholders measure some of the effects of CSR programs? The **triple bottom line (TBL)** offers a way (Video 12.3).

Watch Video 12.3: *What is the Triple Bottom Line*? Closed Captioning is available. Click HERE to read a transcript.

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TBL is a measure described in 1994 by John Elkington, a British business consultant, and it forces us to reconsider the very concept of the "bottom line." Most businesses, and most consumers for that matter, think of the bottom line as a shorthand expression of their financial well-being. Are they making a profit, staying solvent, or falling into debt? That is the customary bottom line, but Elkington suggests that businesses need to consider not just one but rather three measures of their *true* bottom line: the economic and also the social and environmental results of their actions. The social and environmental impacts of doing business, called people and planet in the TBL, are the **externalities** of their operations that companies must take into account.

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The TBL concept recognizes that external stakeholders consider it a corporation's responsibility to go beyond making money. If increasing wealth damages the environment or makes people sick, society demands that the corporation revise its methods or leave the community. Society, businesses, and governments have realized that all stakeholders have to work for the common good. When they are successful at acting in a socially responsible way, corporations will and should claim credit. In acting according to the TBL model and promoting such acts, many corporations have reinvested their efforts and their profits in ways that can ultimately lead to the development of a sustainable economic system.

CSR as Public Relations Tool

Unfortunately, for some, CSR is nothing more than an opportunity for publicity as a firm tries to look good through various environmentally or socially friendly initiatives without making systemic changes that will have long-term positive effects. Carrying out superficial CSR efforts that merely cover up systemic ethics problems in this inauthentic way (especially as it applies to the environment), and acting simply for the sake of public relations is called **greenwashing** (Figure 12.1). To truly understand a company's approach toward the environment, we need to do more than blindly accept the words on its website or its advertising.

Figure 12.1: Marchers protest greenwashing.

Example 12.1: *Coca-Cola*

In its 2016 sustainability report, Coca-Cola stated the following:

> Engaging our diverse stakeholders in long-term dialogue provides important input that informs our decision making, and helps us continuously improve and make progress toward our 2020 sustainability goals . . . We are committed to ongoing stakeholder engagement as a core component of our business and sustainability strategies, our annual reporting process, and our activities around the world. As active members of the communities where we live and work, we want to strengthen the fabric of our communities so that we can prosper together.[2]

Approximately 20 percent of the people on Earth consume a Coca-Cola product each day, meaning a very large portion of the global population belongs to the company's consumer stakeholder group. Depending on the process and location, it is estimated that it takes more than three liters of water to produce a liter of Coke. Each day, therefore, millions of liters of water are removed from the Earth to make Coke products, so the company's water footprint can endanger the water supplies of both employee and neighbor stakeholders. For example, in Chiapas, Mexico, the Coca-Cola bottling plant consumes more than one billion liters of water daily, but only about half the population has running water.[3] Mexico leads the world in per capita consumption of Coke products.

If consumers are aware only of Coca-Cola's advertising campaigns and corporate public relations writings online, they will miss the very real concerns about water security associated with it and other corporations producing beverages in similar fashion. Thus, it requires interest on the part of stakeholders to continue to drive real CSR practices and to differentiate true CSR efforts from greenwashing.

Stakeholder Management

Many individuals and groups inside and outside a business have an interest in the way it brings products or services to market to turn a profit. These stakeholders include customers, clients, employees, shareholders, communities, the environment, the government, and the media, among others (Figure 12.2). All stakeholders should be considered relevant to a business, but not all have equal priority. Different groups of stakeholders carry different weights with decision makers in companies and assert varying levels of interest and influence. Stakeholder theory argues that corporations should treat all their constituencies fairly and that doing so can strengthen companies' reputations, customer relations, and performance in the marketplace.[4]

Figure 12.2: Stakeholders.

The term *stakeholder* has become commonplace in business. Companies and organizations that base their strategic decisions on the principle of duty to earn stakeholder trust "are likely to yield a number of strategic benefits, too, and can help manage political, social, and reputational risk."[5]

Identifying and Influencing Major Stakeholders

There are several methods for analyzing stakeholder transactions and relationships with an organization.[7] Using an ethical perspective, a goal of this approach is for organizations to employ values of transparency, fairness, and consideration of stakeholder interests in strategic decisions and transactions. Toward that end, the following questions can help an organization's leaders inform, involve, obtain feedback from, and influence each of their stakeholders with regard to strategy, issues, or opportunities the organization pursues:

> According to R. Edward Freeman, often considered the father of stakeholder theory, "If organizations want to be effective, they will pay attention to all and only those relationships that can affect or be affected by the achievement of the organization's purposes."[6]

1. Who are the stakeholders (that is, people who have an interest in supporting or resisting a proposed course of action, resolving an issue, and addressing

a change)?
2. What are their stakes in either supporting or resisting the change?
3. What do the supporters stand to gain and lose from the change?
4. What do the resisters stand to gain and lose from the change?
5. What type(s) of power do the supporters have with regard to the change?
6. What type(s) of power do the resisters have with regard to the change?
7. What strategies can we use to keep the support of the supporters?
8. What strategies can we use to neutralize or win over the resisters?

CSR and stakeholder management have demonstrated benefits to firms' reputations and profitability.[8] The relationship of an organization's ethics and social responsibility to its performance concerns both managers and organization scholars. Studies have shown a positive relationship between ethical and socially responsible behavior and financial results. For example, one study of the financial performance of large U.S. corporations that are considered "best corporate citizens" found that they have both superior reputations and superior financial performance.[9] Similarly, Governance Metrics International, an independent corporate governance ratings agency, found that the stocks of companies run on more selfless principles perform better than those run in a self-serving manner. Top-ranked companies also outperformed lower-ranking firms on measures such as return on assets, return on investment, and return on capital.[10]

Profitability and Success: Thinking Long Term

Decades ago, some management theorists argued that a conscientious manager in a for-profit setting acts ethically by emphasizing solely the maximization of earnings. In contrast, there is growing consensus today that ethical business leadership is grounded in doing right by all stakeholders directly affected by a firm's operations, including, but not limited to, stockholders, or those who own shares of the company's stock. That is, business leaders do right when they give thought to what is best for *all* who have a stake in their companies. Not only that, there is growing evidence that firms may actually reap greater material success when they take such an approach, especially over the long run.

Nobel Prize–winning economist Milton Friedman stated in a now-famous *New York Times* article in 1970 that the only "social responsibility of a business is to increase its profits."[11] This concept took hold in business and even in business school education. However, although it is certainly permissible and even desirable for a company to pursue profitability as a goal, managers must also have an understanding of the context within which their business operates and of how the wealth they create can add positive value to the world. The context within which they act is society, which permits and facilitates a firm's existence.

Thus, a company enters a social contract with society as whole, an implicit agreement among all members to cooperate for social benefits. Even as a company pursues the maximizing of stockholder profit, it must also acknowledge that society will be affected to some extent by its operations. In return for society's permission to incorporate and engage in business, a company owes a reciprocal obligation to do what is best for as many of society's members as possible, regardless of whether they are stockholders. Therefore, when applied specifically to a business, the social contract implies that a company gives back to the society that permits it to exist, benefiting the community at the same time it enriches itself.

In addition to taking this more nuanced view of profits, managers must also use a different time frame for obtaining them. Wall Street's focus on periodic (i.e., quarterly and annual) earnings has led many managers to adopt a short-term perspective, which fails to take into account effects that require a longer time to develop. For example, charitable donations in the form of corporate assets or employees' volunteered time may not show a return on investment until a sustained effort has been maintained for years. A long-term perspective is a more balanced view of profit maximization that recognizes that the impacts of a business decision may not manifest for a longer time.

The Ultimate Stakeholder Benefit

CSR used in good faith has the potential to reshape the orientation of multinational corporations to their stakeholders. By positioning themselves as stakeholders in a broader global community, conscientious corporations can be exemplary organizations. They can demonstrate interest and influence on a global scale and improve the way the manufacture of goods and delivery of services serve the local and global environment. They can return to communities as much as they extract and foster automatic financial reinvestment so that people willing and able to work for them can afford not only the necessities but a chance to pursue happiness.

In return, global corporations will have sustainable business models that look beyond short-term growth forecasts. They will have a method of operating and a framework for thinking about sustained growth with stakeholders and *as* stakeholders. Ethical stakeholder relationships systematically grow wealth and opportunity in dynamic fashion. Without them, the global consumer economy may fail. On an alternate and ethical path of prosperity, today's supplier is a consumer in the next generation and Earth is still inhabitable after many generations of dynamic change and continued global growth.

Chapter Review

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Articles

"What is Stakeholder Engagement and Why Do It?" https://www.fws.gov/stakeholder-engagement/what-and-why

"Stakeholder Analysis" https://www.mindtools.com/aol0rms/stakeholder-analysis

Books

Deep Purpose by Ranjay Gulati https://deeppurpose.net/

Moral Capitalism by Steven Pearlstein https://us.macmillan.com/books/9781250251459/moralcapitalism

Podcasts

The Stakeholder Podcast https://stakeholdermedia.libsyn.com/

Deep Purpose https://hbswk.hbs.edu/Pages/browse.aspx?HBSContentType=Deep+Purpose

Videos

"Business is about Purpose" https://youtu.be/7dugfwJthBY

Websites

Creating Shared Value https://www.isc.hbs.edu/creating-shared-value/Pages/default.aspx

Stakeholder Thoery http://stakeholdertheory.org/about/

United Nations Sustainable Development Goals https://sdgs.un.org/goals

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Video 12.2: UCLA. (2021, April 13). *What is sustainability* [Video]. YouTube. https://youtu.be/zx04Kl8y4dE

Vide 12.3: HBS Online. (2022, September 28). *What is the triple bottom line?* [Video]. YouTube. https://youtu.be/1-Ct_53XKYY

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13. Innovation

What is Innovation?

In today's rapidly changing business world, it seems the only thing that is constant is change. Nearly every new, ground-breaking product or service will eventually become obsolete, commoditized, or surpassed by new and better solutions. **Innovation** can be described in broad terms as any new idea, product, service, process, or business model, or a change to an existing product, service, process, or business model that adds value. While innovation is often linked to entrepreneurship, ongoing innovation is essential for any organization to remain competitive and survive.

Individuals and organizations innovate for many reasons, including the following:

- Solve a problem
- Take advantage of an opportunity
- Expand market share
- Improve efficiency and/or effectiveness
- Increase revenues
- Reduce expenses
- Keep up with evolving and shifting customer demands, preferences, and trends
- Adapt to and/or take advantage of changes in modern technology
- Remain competitive and relevant

Types of Innovation

Because not all innovation is the same, various typologies of innovation have been proposed. According to one framework, innovation can be distinguished based on:

1. How well a problem the innovation is aimed at solving is defined.
2. How well the domain in which the problem is situated is defined.

Considering these two factors together results in four types of innovation: basic research, breakthrough innovation, disruptive innovation, and sustaining innovation (Figure 13.1).[1]

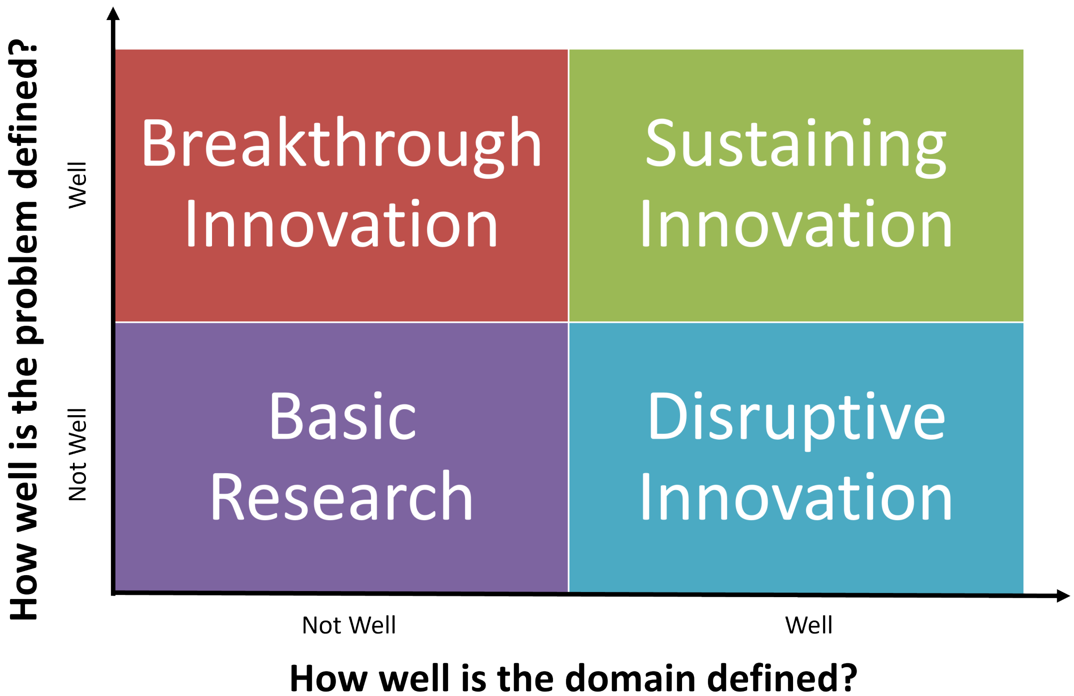

Figure 13.1: Based on (1) how well a problem is defined and (2) how well the domain within which the problem is situated is defined, four types of innovation emerge: basic research, breakthrough innovation, disruptive innovation, and sustaining innovation.

Basic research involves efforts to build knowledge and understand principles and phenomena. It often precedes practical applications and is generally undertaken without immediate commercial goals. It is often conducted in academic settings, labs, or research centers. For example, scientists discovered messenger RNA, or mRNA, in the 1960s, and spent decades working to understand its structure and function. This basic research eventually made it possible for companies like Moderna and Pfizer to rapidly develop vaccines targeting COVID-19, but was not undertaken with this specific objective in mind.[2]

Breakthrough innovation seeks to solve problems that are well defined but exceptionally challenging to solve, often requiring knowledge and insights from seemingly unrelated domains. **Open innovation** is one approach to achieving breakthrough innovation in which organizations actively seek external insight and ideas. Unlike traditional closed innovation models, in which companies rely primarily on their internal research and development (R&D) departments, open innovation takes a more inclusive and integrative approach by actively seeking external inputs and partnerships.

For example, the National National Aeronautics and Space Administration (NASA) regularly engages in open innovation, including recent efforts related to "Moon and Mars" in which "NASA invited the national and global community to participate in its Moon to Mars planning through open innovation initiatives. These initiatives tapped into the ingenuity and passion of individuals of all ages and walks of life, resulting in ideas for lunar power and energy, life on the Moon, and managing payloads, deliveries, and storage."[4]

Disruptive innovation "describes a process by which a product or service initially takes root in simple applications at the bottom of a market—typically by being less expensive and more accessible—and then relentlessly moves upmarket, eventually displacing established competitors."[5] It takes two forms: *low-end disruption*, which targets customers who do not need the full performance valued by customers at the high end of the market, and *new-market disruption*, which targets customers who have needs that are unserved by existing offerings (Video 13.1).[6] Notably, most disruptive innovations are not overnight sensations. Instead, a relatively small group of customers embrace a disruptive innovation as early adopters and then a critical mass of customers builds over time.

Example 13.1: *Open Innovation at NASA*

According to NASA, "The agency is expanding the NASA community to broaden its capacity for innovation and discovery even further. Many federal agencies and global organizations harness the perspectives, expertise, and enthusiasm of 'the crowd' outside their walls to reduce costs, accelerate projects, enhance creativity, and better engage their stakeholders.

NASA is doing the same, collaborating with diverse entities nationally and internationally through open innovation' initiatives. These initiatives include problem-focused challenges and prize competitions, data hackathons, and citizen science and crowdsourcing projects that invite the public to lend their skills, ideas, and time to support NASA projects. NASA also uses open innovation internally to share knowledge across our workforce."[3]

An example of low-end disruption is digital cameras. Few photographers embraced digital cameras initially because the cameras offered poor picture quality relative to traditional film cameras. As digital cameras improved, however, they gradually won over almost everyone who takes pictures. Similarly, cameras on mobile phones, which initially were far inferior in quality compared to digital cameras, have since disrupted the digital camera industry. An example of new-market disruption is smart phones, which disrupted the market for laptop computers by offering consumers a way to connect to the internet from a small, handheld device.

Sustaining innovation, also referred to as incremental innovation, involves making small-scale improvements to existing products, services, processes, and business models (Video 13.1). Sustaining innovation focuses on improving existing offerings to align with current consumer trends and is considered a relatively low-risk approach for businesses. This approach is the most common type of innovation and has helped many companies remain competitive for decades. For example, each new version of Apple's iPhone that comes out typically reflects sustaining innovation. iPhone features such as the camera and processor are tweaked to make an improvement over the previous model.

Watch Video 13.1: *Sustaining vs. Disruptive Innovation* to learn about two types of innovation. Closed captioning is available. Click HERE to read a transcript.

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Objects of Innovation

Another way to distinguish innovation efforts is by the object of innovation. Four of the most common objects of innovation are product, service, process, and business model.

Product Innovation

When people think of innovation, often, they're thinking of product innovation. **Product Innovation** can come in three different forms: the development of a new product, an improvement in the performance of an existing product, or a new feature to an existing product. Drivers of product innovation might be technological advancements, changes in customer requirements and demands, or outdated product design. Product innovation is generally visible to the customer and should result in a greater demand for a product.[7]

Service Innovation

With the growing economic importance of the services sector, service innovation is playing an ever more significant role in driving growth in today's knowledge-intensive economy. **Service innovation**, which involves introducing new services or improving the delivery of existing services, ensures and enhances the utility, performance, and apparent value of an offering. Some offerings are purely service, such as getting a haircut, hiring someone to paint your house, or taking an Uber to your friend's place. Other services may be combined with product offerings, such as purchasing groceries (products) and having them delivered to your home (service), or buying a new television (product), and purchasing the warranty (service).

Process Innovation

An organization is essentially made up of a series of processes: how a product is designed is a process; how it is manufactured is another process; and how it is transported to reach customers is yet another process. If a company can make its processes work faster, cost less, and/or result in a higher quality product/ service most likely that company will see higher profits and increasingly happy customers.

While product innovation is often visible to customers, a change in process is typically only seen and valued internally. Generally, changes in process reduce costs of production more often than they drive an increase in revenue. **Process innovation**, which involves the implementation of a new or significantly improved production or delivery method, can include changes in the equipment and technology used in manufacturing (including the software used in product design and development), improvement in the tools, techniques, and software solutions used to help in supply chain and delivery system, changes in the tools used to sell and maintain goods, as well as methods used for accounting and customer service.[9]

> ***Example 13.2:*** *The Assembly Line*
>
> One of the most famous and groundbreaking examples of process innovation is Henry Ford's invention of the world's first moving assembly line. This process change not only simplified vehicle assembly but shortened the time necessary to produce a single vehicle from 12 hours to 90 minutes.[8]

Business Model Innovation

Business model innovation refers to the process of creating, adapting, or fundamentally changing the way a company delivers value to its customers and/or generates revenue. It involves rethinking and redesigning various elements of a business's core model, which may include its customer segments, value proposition, channels, revenue streams, cost structure, and more.

Business model innovation is essential for organizations seeking to remain competitive and adapt to changing market conditions. It often involves thinking creatively and exploring new approaches to disrupt existing industry norms or create entirely new markets. This innovation can result in improved customer experiences, increased efficiency, and potentially higher profits. Successful business model innovation can be a source of sustainable competitive advantage for companies in an ever-evolving business environment.

Business Model Innovation is perhaps the most challenging of the innovation types as it will likely present an organization with major requirements for change. Often, the very capabilities or processes that have been optimized to make a company successful and profitable will become the targets for transformation. In some cases, these changes can threaten elements of the company's identity and come into conflict with brand expectations or promises.[10]

Whereas product, service, and process innovation can be incremental and moderate, business model innovation is almost always radical, risky, and transformative. When talking about business model innovation, without a doubt, names like AirBnB, Uber, or Spotify will come up. These are perfect examples of fast-moving companies that were able to disrupt age-old markets (hotel, taxi, music) by tweaking or inverting their industry's traditional business model.[11]

Creative Thinking

Creativity relates to generating ideas, which are integral to and fuel innovation. Organizations are increasingly turning to creative thinking and problem-solving techniques like *SCAMPER* and *design thinking* to help them continue to innovate.

SCAMPER

One of the easiest and most direct methods of creative thinking is the **SCAMPER technique**, which is based very simply on the idea that many "new" ideas are actually modifications of existing products, services, processes, and business models.[12] The SCAMPER acronym refers to the following:

- Substitute (e.g., components, materials, people)
- Combine (e.g., mix, combine with other assemblies or services, integrate)
- Adapt (e.g., alter, change function, use part of another element)
- Modify/Magnify (e.g., increase or reduce in scale, change shape, modify attributes)
- Put to other uses (e.g., more than one way to use, more than one function)
- Eliminate (e.g., remove elements, simplify, reduce to core functionality)
- Rearrange/Reverse (e.g., turn inside out or upside down)[13]

Click on the information icon beside each of the letters below to learn more about SCAMPER.

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Design Thinking

Design thinking is another well-known and widely-used technique for creative problem-solving. Design thinking encourages organizations to keep the user at the center of everything and is focused around asking different questions and looking at problems in new ways.

Design thinking is an iterative and non-linear process involving the following five phases (Figure 13.2):

- Empathize with users: learn about and understand the people you're designing for.
- Define the design problem: identify users' needs and focus on a design challenge.
- Ideate: generating and evaluating creative ideas.
- Prototype solutions: turn insights and ideas into tangible models.
- Test: evaluate and evolve solutions by gathering actionable feedback from users.

Figure 13.2: Design thinking consists of five phases: emphasize, define, ideate, prototype, and test.

The iterative and ideation-oriented nature of design thinking means that individuals constantly question and acquire knowledge throughout the process. This helps them redefine a problem so they can identify alternative strategies and solutions that aren't instantly apparent with their initial level of understanding (Figure 13.3).

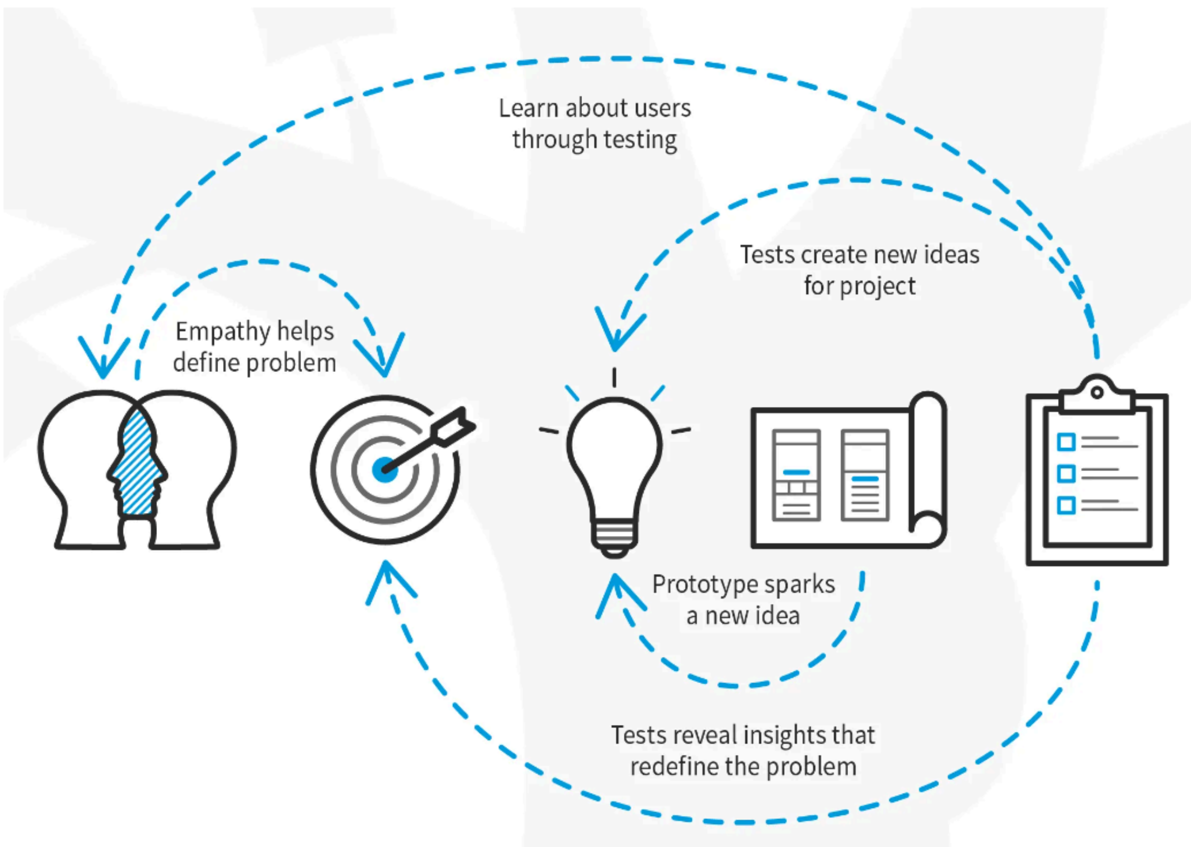

Figure 13.3: Design thinking is an iterative and non-linear process.

A common core of design thinking is its application beyond the design studio, as the methods and tools have been articulated for use by those outside of the field, particularly business managers. Design practice is now being applied beyond product and graphic areas to the design of digital interactions, services, business strategy, and social policy (Video 14.2).

Watch Video 14.2: *The Design Thinking Process* to learn about the five phases of the design thinking process. Closed captioning is available. Click HERE to read a transcript.

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Chapter Review

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Optional Resources to Learn More

Articles

"What is Disruptive Innovation?" https://hbr.org/2015/12/what-is-disruptive-innovation

"The Four Types of Innovation and the Problems they Solve" https://hbr.org/2017/06/the-4-types-of-innovation-and-the-problems-they-solve

Books

How Innovation Works by Matt Ridley https://www.mattridley.co.uk/books/how-innovation-works/

Creativity Rules by Tina Seelig http://www.tinaseelig.com/books.html

The Innovator's Dilemma by Clayton M. Christensen https://www.hbs.edu/faculty/Pages/item.aspx?num=46

The Innovator's DNA by Jeff Dyer, Hal Gregersen, and Clayton M. Christensen https://www.innovatorsdna.com/books-publications

Podcasts

Leaders in Innovation https://www.fastcompany.com/podcasts/leaders-in-innovation

Most Innovative Companies https://www.fastcompany.com/podcasts/most-innovative-companies

Better Innovation https://teybip.libsyn.com/website

Videos

"Business Innovation" https://youtu.be/Ve7vs_jAB_8

Hard Reset (series) https://www.freethink.com/series/hard-reset

"Mapping Innovation" https://youtu.be/ByccBS30M2E

Websites

IDEO: *Innovation Resources* https://www.ideou.com/pages/innovation-resources

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Figure 13.3: Dam, R. F. and Teo, Y. S. (2022, June 27). *What is design thinking and why is it so popular?* Interaction Design Foundation. https://www.interaction-design.org/literature/article/what-is-design-thinking-and-why-is-it-so-popular#the_take_away-7. Licensed with CC BY-SA 3.0.

Video 13.1: HBS Online. (2023, July 26). *Sustaining vs. disruptive innovation* [Video]. YouTube. https://youtu.be/vF9jLDyp7cE

Video 13.2: Sprouts. (2017, October 23). *The design thinking process* [Video]. YouTube. https://youtu.be/_r0VX-aU_T8

Notes

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PART V

FUNCTIONAL AREAS OF BUSINESS

14. Marketing

What is Marketing?

Figure 14.1: Times Square in New York City.

When you consider the functional areas of business—accounting, finance, management, marketing, and operations—marketing is the one you probably know the most about. After all, as a consumer and target of all sorts of advertising messages, you've been on the receiving end of marketing initiatives for most of your life. What you may not have been as aware of, however, is the extent to which marketing focuses on providing value to the customer.

According to the American Marketing Association, **marketing** "is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large."[1] Put more simply, marketing is the process of creating, communicating, and delivering offerings that have value for customers.

At its most basic level, marketing is made up of every process involved in moving a product or service from the organization to the consumer. It includes discerning the needs of customers, developing products or services to meet those needs, identifying who is likely to purchase the products or services, promoting them, and moving them through the appropriate distribution channels to reach those customers.

Marketing, quite simply, is about understanding what customers want and using that understanding to drive the business.

The Marketing Concept

To achieve profitability goals, an organization needs to do the following:

1. Find out what customers or potential customers need.
2. Develop products and services to meet those needs.
3. Engage the entire organization in efforts to satisfy customers.

This basic philosophy—satisfying customer needs while meeting organizational goals—is called the **marketing concept**, and when it is effectively applied, it guides all of an organization's marketing activities.

The marketing concept was built on the premise that an organization will achieve its goals when it satisfies the needs and wants of the consumer. As a result, firms began to focus on customer needs *before* developing products, rather than developing products and then trying to "sell" them to consumers. The marketing concept was also the start of relationship marketing—fostering long-term relationships with customers in order to ensure repeat sales and achieve stable relationships and reduced costs.

The marketing concept puts the customer first. But this doesn't mean that a business should ignore the bottom line; if it wants to survive and grow, it need to make some profit. In terms of marketing, profitability means adding value to a product so that the price customers pay is greater than the cost of making the product.[2]

Target Market

Businesses earn profits by selling goods or providing services. Imagine you were a business preparing to launch a new product. It would be nice if everybody in the marketplace was interested in your product, but if you tried to sell it to everybody, you'd probably spread your resources too thin. You would need to identify a specific group of consumers who should be particularly interested in your product, who would have access to it and have the means to buy it. This group would represent your **target market**, and you would need to aim your marketing efforts at its members.

Segmenting the Market

One of the first steps in identifying a target market is to divide the entire market into smaller portions, or **market segments**—groups of potential customers with common characteristics that influence their buying decisions. An especially narrow market segment is known as a **niche market**, for example, extreme luxury goods that less than 1 percent of people can afford. Let's look at some of the most useful categories.

Demographic segmentation divides the market into groups based on such variables as age, marital status, gender, ethnic background, income, occupation, and education.

Age, for example, will be of interest to marketers who develop products for children, retailers who cater to teenagers, colleges that recruit students, and assisted-living facilities that promote services among the elderly.

Geographic segmentation—dividing a market according to such variables as climate, region, and population density (urban, suburban, small-town, or rural)—is also quite common. Climate is crucial for many products: snow shovels would not sell in Hawaii. Consumer tastes also vary by region. Likewise, differences between urban and suburban life can influence product selection.

Dividing consumers by such variables as attitude toward the product, user status, or usage rate is called **behavioral segmentation**. Companies selling technology-based products might segment the market according to different levels of receptiveness to technology. They could rely on a segmentation scale developed by Forrester Research that divides consumers into five categories along a spectrum, ranging from progressive pioneers, who "lead the demand for product and experience innovation," to reserved resisters, who "are least enthusiastic about product or experience innovation."[3]

Some companies segment consumers according to user status, distinguishing among nonusers, potential users, first-time users, and regular users of a product. Depending on the product, they can then target specific groups, such as first-time users. Credit-card companies use this approach when they offer membership points to potential customers in order to induce them to get a card.

Psychographic segmentation classifies consumers on the basis of individual lifestyles as they're reflected in people's interests, activities, attitudes, and values. Do you live an active life and love the outdoors? If so, you may be a potential buyer of hiking or camping equipment or apparel. If you're a risk taker, you might catch the attention of a gambling casino.

Clustering Segments

Typically, marketers determine target markets by combining, or **clustering**, segmenting criteria. What characteristics does Starbucks look for in marketing its products? Three demographic variables come to mind: age, geography, and income. Buyers are likely to range in age from about 25 to 40 (although college students, aged 18 to 24, are moving up in importance). Geography is a factor as customers tend to live or work in cities or upscale suburban areas. Those with relatively high incomes are willing to pay a premium for Starbucks specialty coffee and so income—a socioeconomic factor—is also important.

The Marketing Mix

After identifying a target market, your next step is developing and implementing a marketing program designed to reach it. Such a program involves a combination of tools called the **marketing mix**, often referred to as the four *P*s of marketing (Figure 14.2, Video 14.1):

1. Developing a **product** that meets the needs of the target market (note that this chapter will use the term "product" to refer to both products and services).
2. Setting a **price** for the product.
3. Distributing the product—getting it to a **place** where customers can buy it.
4. **Promoting** the product—informing potential buyers about it.

Figure 14.2: The four P's of the marketing mix: product, price, place, and promotion.

Watch Video 14.1: *What are the 4 P's (The Marketing Mix)?* to learn about the marketing mix. Closed captioning is available. Click HERE to read a transcript.

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Product

When a customer makes a purchase, they expect value from that exchange. Think about what you ate for breakfast today. You paid money to receive a product that satisfied your hunger. Is that all the value you received? Perhaps not. If you ate eggs, bacon, and coffee at a restaurant, you had both a product and a service experience. Maybe someone at the restaurant handed you a menu, took your order, brought your food, refilled your coffee, cleaned up dishes, and collected payment for your meal. The eggs, bacon, and coffee were the product, while the acts of the restaurant staff were a service. And the summation of it all was the product–service experience.

Products are tangible items that are part of an exchange between a buyer and seller. Products can be seen, touched, owned, and stored. For example, perhaps you are using a MacBook or iPad to view this textbook (Figure 14.3). You may have visited the Apple Store to see and touch the product before purchasing to ensure it met your needs. Post-purchase, the computer or tablet is yours to own and store for later use as you please.

Figure 14.3: Apple products.

Services are intangible solutions that are also an exchange between buyer and seller. Unlike products, services cannot be touched, owned, or stored for later use. For example, a college course is a service. Students cannot own the course; they cannot store it for later, nor will they have a tangible object representing the course. Another defining feature of a service is the customer is typically a part of the service experience. Imagine buying tickets to your favorite band in concert. You will have to attend the concert to realize the full benefit of the service experience.

Brands

A **brand** is an intangible asset with tangible value. The value of a brand is challenging to measure, but it can be one of the most valuable parts of a company.

Branding

Companies can adopt one of three major strategies when it comes to branding a product:

1. With **private branding** (or private labeling), a company makes a product and sells it to a retailer who in turn resells it under its own name. A soft-drink maker, for example, might make cola for Wal-Mart to sell as its Sam's Choice Cola.
2. With **generic branding**, the maker attaches no branding information to a product except a description of its contents. Customers are often given a choice between a brand-name prescription drug or a cheaper generic drug with the same formula.
3. With **manufacturer branding**, a company sells one or more products under its own brand names. Adopting a **multiproduct-branding** approach, it sells many products under one brand name. Food-maker ConAgra sells soups, frozen treats, and complete meals under its *Healthy Choice* label. Using a **multi-branding** approach, the company assigns different brand names to products covering different segments of the market. Automakers often use multi-branding. The Volkswagen group of brands also includes Audi

and Lamborghini.

Benefits of Branding

The central benefit of branding is establishing a connection with customers that encourages them to purchase the brand, creating a financial return (Video 14.2). But you may be wondering how companies can measure the impact of their brand. **Brand value** is the financial asset associated with a brand. There is no singular measure of brand value, so the valuation process is subjective and may be based on brand visibility, customer loyalty, and perception of the brand, along with financial measures such as revenue.

> Watch Video 14.2: *1,000 Years of Branding Explained in 6 Minutes* to learn more about branding. Closed captioning is available. Click HERE to read a transcript.
>
> *One or more interactive elements has been excluded from this version of the text. You can view them online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=500#oembed-2*

Brand Equity

Brand equity refers to added value generated by favorable consumer experiences with a product. To get a better idea of how valuable brand equity is, think for a moment about the effect of the name Apple on a product. When you have a positive experience with an Apple product—say, a laptop or phone—you come away with a positive opinion of the entire Apple product line and will probably buy more Apple products. Over time, you may even develop brand loyalty: you may prefer—or even insist on—Apple products.

Not surprisingly, brand loyalty can be extremely valuable to a company. Because of customer loyalty, Apple's brand tops Interbrand's *Best Global Brands* ranking with a value of over $482 billion. Microsoft's brand is valued at $278 billion, Amazon's at $275 billion, Google's at $252 billion, and Samsung rounds out the top five at $88 billion.[4]

Price

Figure 14.4: Prices in a Walmart store in Glen Allen, Virginia.

The prices of the products and services a business offers are a key determinant in how profitable the business is. The price of a product times the number of units sold equals gross revenue. Revenue is what pays for every activity of the company (production, finance, sales, distribution, and so forth). The money that is left (if any) after all expenses are accounted for is profit. Thus, when it comes to pricing, the goal for a business is to set prices such that the business will be able to attract customers *and* generate a profit.

The chosen price for a product must be neither too high nor too low, and the price must equal the perceived value to target consumers. If consumers think the price is too high, sales opportunities will be lost. Lost sales mean lost revenue. If the price is too low, consumers may view the product as a great value, but the company may not meet its profit goals. Sometimes, a price that is too low can cause a product to be perceived as less reliable or of lower quality, and which could lead to lost sales for a company.

Following are several pricing strategies companies may use; click the name of each strategy in the interactive list below to learn more:

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Place

A great deal is involved in getting a product to the place in which it is ultimately sold. If you're a fast food retailer, for example, you'll want your restaurants to be in high-traffic areas to maximize your potential business. If your business is selling beverages, you'll want them to be offered in locations like grocery stores, convenience stores, restaurants, and vending machines (Figure 14.5). Placing a product in each of these locations requires substantial negotiations with the owners of the space, and often involves the payment of **slotting fees**, which are allowances paid by a manufacturer to a retailer to secure space on store shelves.

Figure 14.5: Beverages in an Amazon Go store in San Francisco, California.

Of course, in an age where e-commerce is taking an increasing share of the retail spending dollar, "place" is not always a physical location that the customer visits. Products ordered online ship from manufacturers to distribution centers and then directly on to the end customer without passing through a traditional retail outlet. An emerging trend in retailing is **showrooming** in which a customer visits a traditional retailer, gets familiar with particular items available, and then orders the item online, often from an unrelated online retailer. The term comes from the fact that in such a situation, the traditional retail outlet has served only as a showroom—a place to view the product, as opposed to a place where the sale is made. As shopping habits change, retailers have been challenged to keep their space relevant and attractive to the ultimate consumer.

Promotion

A **promotion mix**—the means by which a business communicates with customers—may include advertising, personal selling, sales promotion, and publicity. These are all tools for telling people about your product and persuading potential customers to buy it.

The following questions can help guide an organization's promotional strategy:

- What's the main purpose of the promotion?
- Who is our target market?
- Which product features should be emphasizes?
- How much can we afford to invest in a promotion campaign?
- How do our competitors promote their products?

Figure 14.6: The Ritz-Carlton hotel in Berlin, Germany.

To promote a product, an organization needs to imprint a clear image of it in the minds of its target audience. What do you think of, for instance, when you hear "Ritz-Carlton"? What about "Motel 6"? They're both hotel chains, that have been quite successful in the hospitality industry, but they project very different images to appeal to different clienteles. The differences are evident in their promotions. Ritz-Carlton describes "luxury hotels" and promises that the chain provides "the finest personal service and facilities throughout the world" (Figure 14.6).[5] Motel 6, by contrast, characterizes its facilities as "discount hotels" and assures you that you'll pay "the lowest price of any national chain."[6]

We'll now examine each of the elements that can go into the promotion mix: advertising, personal selling, sales promotion, and publicity.

Advertising

Figure 14.7: A Coca-Cola advertisement on a streetcar in Lisbon, Portugal.

Advertising is paid communication designed to create an awareness of a product or company. Ads are everywhere—in print media (such as newspapers and magazines), on billboards, in broadcast media (radio and TV), and on the Internet. It's hard to escape the constant barrage of advertising messages, and it's possible that the average consumer is confronted by up to hundreds of ad messages daily[7] Ironically, because consumers are so accustomed to ads and have learned to tune them out, companies now have to come up with innovative ways to get through to potential customers.

The choice of advertising media depends on the product, target audience, and advertising budget. A popular vacation destination selling spring-break getaways to college students might post flyers on campus bulletin boards or run ads on social media platforms, for example.

Personal Selling

Personal selling refers to one-on-one communication with customers or potential customers. This type of interaction is necessary in selling large-ticket items, such as homes, and it's also effective in situations in which personal attention helps to close a sale, such as sales of cars and insurance policies.

Many retail stores depend on the expertise and enthusiasm of their salespeople to persuade customers to buy. For example, Best Buy's knowledgeable sales associates make them "uniquely positioned to help consumers navigate the increasing complexity of today's technological landscape," according to former CEO Hubert Joly.[8]

Sales Promotion

It's likely that at some point, you have purchased an item with a coupon or because it was advertised with a special discount, such as as a buy-one-get-one-free deal. If so, you have responded to a **sales promotion**, one of the many ways that sellers provide incentives for customers to buy. Sales promotion activities include not only those mentioned above but also other forms of discounting, sampling, trade shows, in-store displays, and even sweepstakes. Some promotional activities are targeted directly to consumers and are designed to motivate them to purchase now. You've probably heard advertisers make statements like "limited time only" or "while supplies last." If so, you've encountered a sales promotion directed at consumers.

Other forms of sales promotion are directed at dealers and intermediaries. Trade shows are one example of a dealer-focused promotion. At food shows, for example, potential buyers can sample products that manufacturers hope to launch to the market. Feedback from prospective buyers can even result in changes to new product formulations or decisions not to launch.

Publicity and Public Relations

Free **publicity**—say, getting your company or your product mentioned or pictured in a newspaper or on TV—can generate more customer interest than a costly ad. When Dr. Dre and Jimmy Iovine were finalizing the development of their Beats headphones, they sent a pair to LeBron James. He liked them so much he asked for 15 more pairs, and they "turned up on the ears of every member of the 2008 US Olympic basketball team when they arrived in Shanghai. 'Now that's marketing,' says Iovine."[9] It wasn't long before the pricey headphones became a must-have fashion accessory for everyone from celebrities to high school students.

Consumer perception of a company is often important to a company's success. Many companies, therefore, manage their **public relations** in an effort to garner favorable publicity for themselves and their products. When the company does something noteworthy, such as sponsoring a fundraising event, the public relations department may issue a press release to promote the event. When the company does something negative, such as selling a prescription drug that has unexpected side effects, the public relations department will work to control the damage to the company.

Conducting Marketing Research

To zero in on their target market and create an effective marketing strategy, marketers have to find out what various people think of their product. More precisely, they needed answers to questions like the following:

- Who are our potential customers?
- What do they like about our product? What would they change?
- How much are they willing to pay for it?
- Where will they expect to buy it?
- How can we distinguish it from competing products?
- Will enough people buy our product to return a reasonable profit for the company?

Answers to key questions like these can be obtained through **marketing research**—the process of collecting and analyzing the data that are relevant to a specific marketing situation. This data has to be collected in a systematic way. Market research seeks two types of data:

1. Marketers generally begin by looking at **secondary data**—information already collected, whether by the

company or by others, that pertains to the target market.
2. With secondary data in hand, they're prepared to collect **primary data**—newly collected information that addresses specific questions.

Secondary data can come from inside or outside the organization. Internally available data includes sales reports and other information on customers. External data can come from a number of sources. The US Census Bureau, for example, posts demographic information on American households (such as age, income, education, and number of members), both for the country as a whole and for specific geographic areas.

Using secondary data that is already available (and free) is generally much easier than collecting primary data. Unfortunately, however, secondary data may not answer all the questions that a marketing team may be asking. To get these answers, the marketing team has to conduct primary research, working directly with members of their target market. First they have to decide exactly what they need to know, then determine who to ask and what methods will be most effective in gathering the information.

The most common marketing research tools for obtaining primary data include:

- **Surveys:** Sometimes marketers mail questionnaires to members of the target market. The process is time consuming and the response rate generally low. Online surveys are easier to answer and so get better response rates than other approaches.
- **Personal interviews:** Though time consuming, personal interviews allow marketers to talk with real people as well as demonstrate the product. They can provide an opportunity to ask open-ended questions and clarify answers.
- **Focus groups:** With a focus group, you can bring together a group of individuals (perhaps 8 to 12) and ask them questions. A trained moderator can explain the purpose of the group and lead the discussion. If sessions are run effectively, you can come away with valuable information about customer responses to both your product and your marketing strategy.

Researching a target market is important before launching a new product, but the benefits of marketing research don't extend merely to brand-new products. Companies also use it when they're deciding whether or not to refine an existing product or develop a new marketing strategy for an existing product.

Interacting with Customers

Customer-Relationship Management

Without enough good customers, no company can survive. Firms must not only attract new customers but also retain existing customers. In fact, repeat customers are, in many cases, more profitable than new customers. It's estimated that it costs as much as five times more to attract and sell to a new customer than to an existing one.[10] Repeat customers also tend to spend more, and they're much more likely to recommend a brand or product to other people.

Retaining customers is the purpose of **customer-relationship management**, a marketing strategy that focuses on using information about current customers to nurture and maintain strong relationships with them. The underlying theory is fairly basic: to keep customers happy, companies must treat them well, give them what they want, listen to them, reward them with discounts or other loyalty incentives, and deal effectively with their complaints.

Another advantage of keeping in touch with customers is the opportunity to offer them additional products. Amazon.com is a master at this strategy, using your purchasing patterns and preferences to make suggestions for future purchases.

Social Media Marketing

In recent years, the popularity of **social media marketing** has exploded. Social media marketing is the practice of including social media as part of a company's marketing program, through such platforms asFacebook, X (formerly Twitter), LinkedIn, TikTok, YouTube, and any number of other online sites that allow you to network, share your opinions, ideas, photos, etc.

Why do businesses use social media marketing? Before responding, ask yourself these questions: how much time do I spend watching TV? When I watch TV, do I sit through the ads? Do I read newspapers or magazines and flip right past the ads? For many companies, the answer is clear. The days of trying to reach most customers through ads on TV, in newspapers, or in magazines are largely over. Social media marketing provides a number of advantages to companies, including enabling them to:

- create brand awareness;
- connect with customers and potential customers by engaging them in two-way communication;
- build brand loyalty by providing opportunities for a targeted audience to participate in company-sponsored activities, such as contests;
- offer and publicize incentives, such as special discounts or coupons;
- gather feedback and ideas on how to improve products and marketing initiatives;
- allow customers to interact with each other and spread the word about a company's products or marketing initiatives; and
- take advantage of low-cost marketing opportunities by being active on free social sites, such as Facebook.

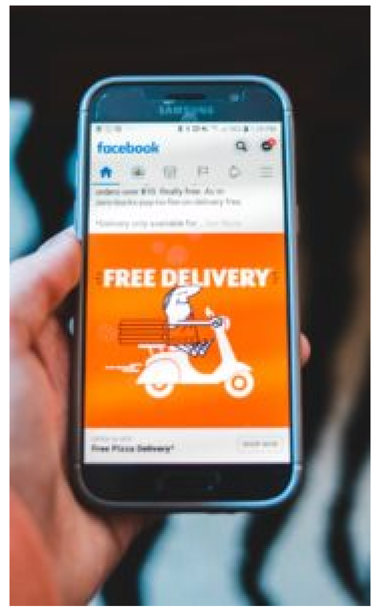

Figure 14.8: A Little Caesers Pizza advertisement on Facebook.

Social Media Marketing Challenges

The main challenge of social media marketing is that it can be very time consuming. It takes determination and resources to succeed. Small companies often lack the staff to initiate and manage social media marketing campaigns.[11] Even large companies can find the management of media marketing initiates overwhelming.

What is clear, however, is that marketing, and particularly advertising, has changed forever. For example, Duolingo, a language-learning app, previously relied on traditional marketing aimed at increasing awareness of the brand. However, in recent years, the company determined that the vast majority of new-user growth stemmed from word-of-mouth, and that most new users were signing up for the company's free version—indicating that the company's investments in traditional advertising were not paying off. Instead, it shifted its marketing strategy to focus more on social media outlets such as TikTok, Instagram, and Twitter (now X). According to Luis von Ahn, co-founder and chief executive, "Our marketing team has really found its stride in terms of…the levers that work and don't . . . We've just found that we have a brand that is very good for social media. And it's organic, it's not paid stuff."[12]

Chapter Review

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Optional Resources to Learn More

Articles

"Why Great Innovation Needs Great Marketing" https://hbr.org/2019/02/why-great-innovation-needs-great-marketing

Books

The Essentials of Contemporary Marketing by Mo Willan https://www.bloomsbury.com/us/essentials-of-contemporary-marketing-9781472963710/

Podcasts

Marketing Companion https://businessesgrow.com/podcast-the-marketing-companion-2/

Videos

"Introduction To Marketing" https://youtu.be/8Sj2tbh-ozE

Websites

American Marketing Association Definition of Marketing https://www.ama.org/the-definition-of-marketing-what-is-marketing/

The Universal Marketing Dictionary https://marketing-dictionary.org/

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Video 141: Eye on Tech. (2022, July 22). *What are the 4 p's (the marketing mix)?* [Video]. YouTube. https://youtu.be/kx7iADO9kfA

Video 14.2: Big Think. (2022, June 22). *10,000 years of branding explained in 6 minutes* [Video]. YouTube. https://youtu.be/s2eka_dWAxs

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15. Accounting

Accounting: More than Numbers

Figure 15.1: Accounting is about more than numbers: it is the process of collecting, recording, classifying, summarizing, reporting, and analyzing financial activities.

Accounting is the process of collecting, recording, classifying, summarizing, reporting, and analyzing financial activities. It results in reports that describe the financial condition of an organization. All types of organizations—businesses, hospitals, schools, government agencies, and civic groups—use accounting procedures. Accounting provides a framework for looking at past performance, current financial health, and possible future performance. It also provides a framework for comparing the financial positions and financial performances of different firms.

Who Uses Financial Reports?

The accounting system generates two types of financial reports: internal and external (Figure 15.2). Internal reports are used within the organization. As the term implies, **managerial accounting** provides financial information that managers inside the organization can use to evaluate and make decisions about current and future operations. For instance, the sales reports prepared by managerial accountants show how well marketing strategies are working, as well as the number of units sold in a specific period of time. This information can be used by a variety of managers within the company in operations as well as in production or manufacturing to plan future work based on current financial data. Production cost reports can help departments track and control costs, as well as zero in on the amount of labor needed to produce goods or services. In addition, managers may prepare very detailed financial reports for their own use and provide summary reports to top management, providing key executives with a "snapshot" of business operations in a specific timeframe.

Financial accounting focuses on preparing external financial reports that are used by outsiders; that is, people who have an interest in the business but are not part of the company's management. Although they provide useful information for managers, these reports are used primarily by lenders, suppliers, investors, government agencies, and others to assess the financial strength of a business.

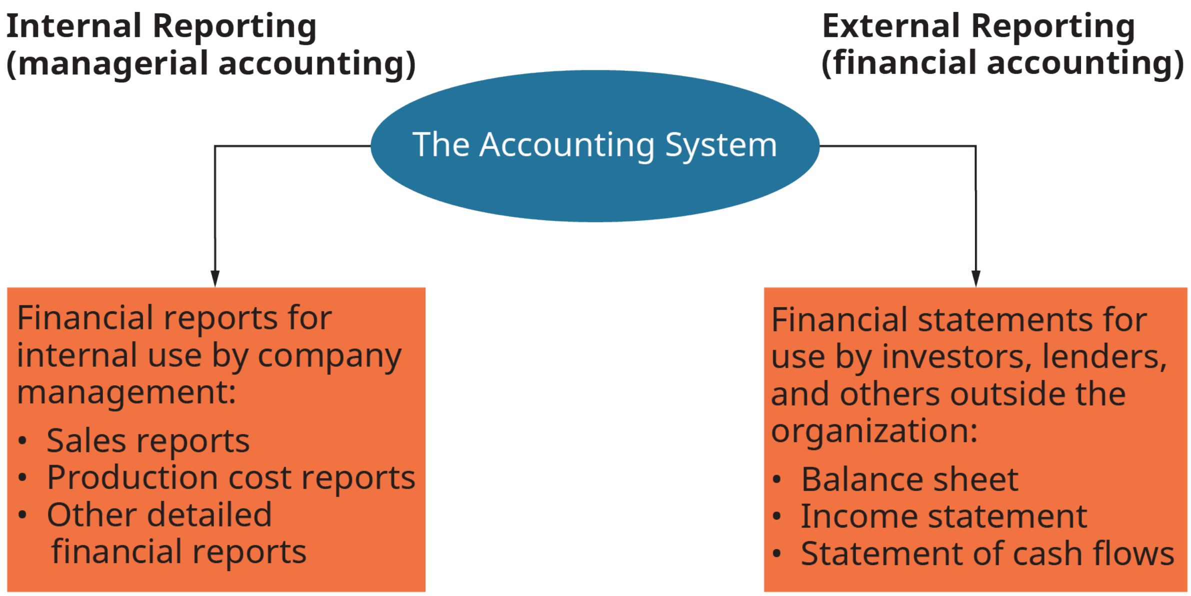

Figure 15.2: Reports provided by the accounting system.

Basic Accounting Procedures

Financial statements are the chief element of the **annual report**, a yearly document that describes a firm's financial status. Annual reports usually discuss the firm's activities during the past year and its prospects for the future.

Three primary financial statements included in the annual report are:

- The balance sheet
- The income statement (or statement of operations)
- The statement of cash flows

Using **generally accepted accounting principles (GAAP)**, accountants record and report financial data in similar ways for all firms. They report their findings in financial statements that summarize a company's business transactions over a specified time period.

The Accounting Equation

The accounting procedures used today are based on those developed in the late 15th century by an Italian monk, Brother Luca Pacioli. He defined the three main accounting elements as assets, liabilities, and owners' equity. **Assets** are things of value owned by a firm. They may be *tangible,* such as cash, equipment, and buildings, or *intangible,* such as a patent or trademarked name. **Liabilities**—also called *debts*—are what a firm owes to its creditors. **Owners' equity** is the total amount of investment in the firm minus any liabilities. Another term for owners' equity is *net worth*.

The relationship among these three elements is expressed in the accounting equation:

Assets	**–**	**Liabilities**	**=**	**Owners' equity**

This equation can also be written as follows:

Assets	=	Liabilities	+	Owners’ equity

The accounting equation must always be in balance (that is, the total of the elements on one side of the equals sign must equal the total on the other side).

Suppose you start a coffee shop and put $10,000 in cash into the business. At that point, the business has assets of $10,000 and no liabilities. This would be the accounting equation:

Assets	=	Liabilities	+	Owners’ equity
$10,000	**=**	**$0**	**+**	**$10,000**

The liabilities are zero and owners’ equity (the amount of your investment in the business) is $10,000. The equation balances.

To keep the accounting equation in balance, every transaction must be recorded as two entries. As each transaction is recorded, there is an equal and opposite event so that two accounts or records are changed. This method is called **double-entry bookkeeping**.

Suppose that after starting your business with $10,000 cash, you borrow another $10,000 from the bank. The accounting equation will change as follows:

Assets	=	Liabilities	+	Owners’ equity	
$10,000	**=**	**$0**	**+**	**$10,000**	**Initial equation**
$10,000	**=**	**$10,000**	**+**	**$0**	**Borrowing transaction**
$20,000	**=**	**$10,000**	**+**	**$10,000**	**Ending equation**

Now you have $20,000 in assets—your $10,000 in cash and the $10,000 loan proceeds from the bank. The bank loan is also recorded as a liability of $10,000 because it’s a debt you must repay. Making two entries keeps the equation in balance.

Before continuing, take a moment to practice the accounting equation:

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The Balance Sheet

The **balance sheet**, one of three financial statements generated from the accounting system, summarizes a firm's financial position at a specific point in time. It reports the resources of a company (assets), the company's obligations (liabilities), and the difference between what is owned (assets) and what is owed (liabilities), or owners' equity.

The assets are listed in order of their **liquidity**, the speed with which they can be converted to cash. The most liquid assets come first, and the least liquid are last. Because cash is the most liquid asset, it is listed first. Buildings, on the other hand, have to be sold to be converted to cash, so they are listed after cash. Liabilities are arranged similarly: liabilities due in the short term are listed before those due in the long term.

The balance sheet as of December 31, 2022, for Delicious Desserts, Inc., a fictitious bakery, is illustrated in Table 15.1**.** The basic accounting equation is reflected in the three totals highlighted on the balance sheet: assets of $148,900 equal the sum of liabilities and owners' equity ($70,150 + $78,750). The three main categories of accounts on the balance sheet are explained below.

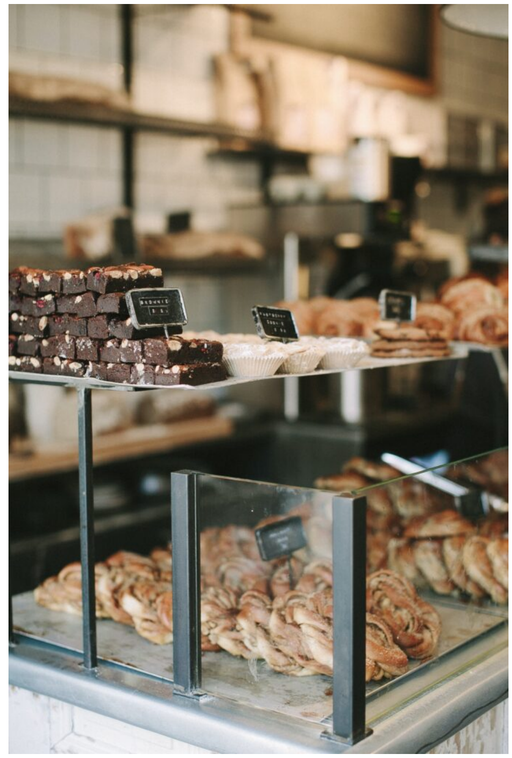

Figure 15.3: This chapter will present a set of financial statements for Delicious Desserts, Inc., a fictitious bakery.

Table 15.1

Delicious Desserts, Inc. **Balance Sheet as of December 31, 2022**			
Assets			
Current Assets			
Cash		15,000	
Marketable securities		4,500	
Accounts receivable	45,000		
Less: Allowance for doubtful accounts	1,300	43,700	
Notes receivable		5,000	
Inventory		15,000	
Total current assets			***83,200***
Fixed Assets			
Bakery equipment	56,000		

Less: Accumulated depreciation	16,000	40,000	
Furniture and fixtures	18,450		
Less: Accumulated depreciation	4,250	14,200	
Total fixed assets			***54,200***
Intangible assets			
Trademark		4,500	
Goodwill		7,000	
Total intangible assets			***11,500***
Total Assets			**148,900**
Liabilities and owners' equity			
Liabilities			
Current liabilities			
Accounts payable	30,650		
Notes payable	15,000		
Accrued expenses	4,500		
Income taxes payable	5,000		
Current portion of long-term debt	5,000		
Total current liabilities		60,150	
Long-term liabilities			
Bank loan for bakery equipment	10,000		
Total long-term liabilities		10,000	
Total liabilities			***70,150***
Owners' equity			
Common stock (10,000 shares outstanding)		30,000	
Retained earnings		48,750	
Total owners' equity			***78,750***
Total liabilities and owners' equity			**148,900**

Assets

Assets can be divided into three broad categories: current assets, fixed assets, and intangible assets. **Current assets** are assets that can or will be converted to cash within the next 12 months. They are important because they provide the funds used to pay the firm's current bills. They also represent the amount of money the firm can quickly raise. Current assets include:

Cash: Funds on hand or in a bank.

Marketable securities: Temporary investments of excess cash that can readily be converted to cash.

Accounts receivable: Amounts owed to the firm by customers who bought goods or services on credit.

Notes receivable: Amounts owed to the firm by customers or others to whom it lent money.

Inventory: Stock of goods being held for production or for sale to customers.

Fixed assets are long-term assets used by the firm for more than a year. They tend to be used in production and include land, buildings, machinery, equipment, furniture, and fixtures. Except for land, fixed assets wear out and become outdated over time. Thus, they decrease in value every year. This declining value is accounted for through depreciation.

Figure 15.4: A commercial-grade mixer which, for a business like Delicious Desserts, Inc., would be depreciated and included in fixed assets.

Depreciation is the allocation of the asset's original cost to the years in which it is expected to produce revenues. A portion of the cost of a depreciable asset—a building or piece of equipment, for instance—is charged to each of the years in which it is expected to provide benefits. This practice helps match the asset's cost against the revenues it provides. Because it is impossible to know exactly how long an asset will last, estimates are used. They are based on past experience with similar items or IRS guidelines for assets of that type. Notice that, through 2022, Delicious Desserts has taken a total of $16,000 in depreciation on its bakery equipment (Figure 15.4).

Intangible assets are long-term assets with no physical existence. Common examples are patents, copyrights, trademarks, and goodwill. *Patents* and *copyrights* shield the firm from direct competition, so their benefits are more protective than productive. For instance, no one can use more than a small amount of copyrighted material without permission from the copyright holder. *Trademarks* are registered names that can be sold or licensed to others. One of Delicious Desserts' intangible assets is a trademark valued at $4,500. *Goodwill* occurs when a company pays more for an acquired firm than the value of its tangible assets. Delicious Desserts' other intangible asset is goodwill of $7,000.

Liabilities

Liabilities are the amounts a firm owes to creditors. Those liabilities coming due sooner—current liabilities—are listed first on the balance sheet, followed by long-term liabilities.

Current liabilities are those due within a year of the date of the balance sheet. These short-term claims may strain the firm's current assets because they must be paid in the near future. Current liabilities include:

> **Accounts payable:** Amounts the firm owes for credit purchases due within a year. This account is the liability counterpart of accounts receivable.
>
> **Notes payable:** Short-term loans from banks, suppliers, or others that must be repaid within a year. For example, Delicious Desserts has a six-month, $15,000 loan from its bank that is a note payable.
>
> **Accrued expenses:** Expenses, typically for wages and taxes, that have accumulated and must be paid at a specified future date within the year although the firm has not received a bill.
>
> **Income taxes payable:** Taxes owed for the current operating period but not yet paid. Taxes are often shown separately when they are a large amount.
>
> **Current portion of long-term debt:** Any repayment on long-term debt due within the year. Delicious Desserts is scheduled to repay $5,000 on its equipment loan in the coming year.

Long-term liabilities come due more than one year after the date of the balance sheet. They include bank loans (such as Delicious Desserts' $10,000 loan for bakery equipment), mortgages on buildings, and the company's bonds sold to others.

Owners' Equity

Owners' equity is the owners' total investment in the business after all liabilities have been paid. For sole proprietorships and partnerships, amounts put in by the owners are recorded as capital. In a corporation, the owners provide capital by buying the firm's common stock. For Delicious Desserts, the total common stock investment is $30,000. **Retained earnings** are the amounts left over from profitable operations since the firm's beginning. They are total profits minus all dividends (distributions of profits) paid to stockholders. Delicious Desserts has $48,750 in retained earnings.

Before continuing, take a moment to practice classifying asset, liability, and equity terms into the correct category:

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The Income Statement

The balance sheet shows the firm's financial position at a certain point in time. The **income statement** summarizes the firm's revenues and expenses and shows its total profit or loss over a period of time. Most companies prepare monthly income statements for management and quarterly and annual statements for use by investors, creditors, and other outsiders. The primary elements of the income statement are revenues, expenses, and net income (or net loss). The income statement for Delicious Desserts for the year ended December 31, 2022, is shown in Table 15.2.

Table 15.2

Delicious Desserts, Inc. **Income Statement for the Year Ending December 31, 2022**			
Revenues			
Gross sales		275,000	
Less: Sales discounts		2,500	
Less: Returns and allowances		2,000	
Net Sales			***270,500***
Cost of Goods Sold			
Beginning inventory, January 1	18,000		
Cost of goods manufactured	109,500		
Total cost of goods available for sale		127,500	
Less: Ending inventory December 31		15,000	
Cost of Goods Sold			***112,500***
Gross Profit			**$158,000**
Operating Expenses			
Selling expenses			
Sales salaries		31,000	
Advertising		16,000	
Other selling expenses		18,000	
Total selling expenses			***65,000***
General and administrative expenses			
Professional and office salaries		20,500	
Utilities		5,000	
Office supplies		1,500	
Interest		3,600	
Insurance		2,500	
Rent		17,000	
Total general and administrative expenses			***50,100***
Total operating expenses			**115,100**

Net profit before taxes			***42,900***
Less: Income taxes			***10,725***
Net profit			**32,175**

Revenues

Revenues are the dollar amount of sales plus any other income received from sources such as interest, dividends, and rents. The revenues of Delicious Desserts arise from sales of its bakery products. Revenues are determined starting with **gross sales**, the total dollar amount of a company's sales. Delicious Desserts had two deductions from gross sales. *Sales discounts* are price reductions given to customers that pay their bills early. For example, Delicious Desserts gives sales discounts to restaurants that buy in bulk and pay at delivery. *Returns and allowances* is the dollar amount of merchandise returned by customers because they didn't like a product or because it was damaged or defective. **Net sales** is the amount left after deducting sales discounts and returns and allowances from gross sales. Delicious Desserts' gross sales were reduced by $4,500, leaving net sales of $270,500.

Expenses

Expenses are the costs of generating revenues. Two types are recorded on the income statement: cost of goods sold and operating expenses.

Figure 15.5: For a business like Delicious Desserts, Inc., the cost of ingredients like eggs and flour would be part of raw materials, or costs of goods sold.

The **cost of goods sold** is the total expense of buying or producing the firm's goods or services. For manufacturers, cost of goods sold includes all costs directly related to production: purchases of raw materials and parts, labor, and factory overhead (utilities, factory maintenance, machinery repair). For wholesalers and retailers, it is the cost of goods bought for resale. For all sellers, cost of goods sold includes all the expenses of preparing the goods for sale, such as shipping and packaging.

Delicious Desserts' cost of goods sold is based on the value of inventory on hand at the beginning of the accounting period, $18,000. During the year, the company spent $109,500 to produce its baked goods. This figure includes the cost of raw materials, labor costs for bakery workers, and the cost of operating the bakery area (Figure 15.5). Adding the cost of goods manufactured to the value of beginning inventory, we get the total cost of goods available for sale, $127,500. To determine the cost of goods sold for the year, we subtract the cost of inventory at the end of the period:

$127,500 – $15,000 = $112,500

The amount a company earns after paying to produce or buy its products but before deducting operating expenses is the **gross profit**. It is the difference between net sales and cost of goods sold. Because service firms do not produce goods, their gross profit equals net sales. Gross profit is a critical number for a company because it is the source of funds to cover all the firm's other expenses.

The other major expense category is **operating expenses**. These are the expenses of running the business that are not related directly to producing or buying its products. The two main types of operating expenses are selling expenses and general and administrative expenses. **Selling expenses** are those related to marketing and distributing the company's products. They include salaries and commissions paid to salespeople and the costs of advertising, sales supplies, delivery, and other items that can be linked to sales activity, such as insurance, telephone and other utilities, and postage. **General and administrative expenses** are the business expenses that cannot be linked to either cost of goods sold or sales. Examples of general and administrative expenses are salaries of top managers and office support staff; utilities; office supplies; interest expense; fees for accounting, consulting, and legal services; insurance; and rent. Delicious Desserts' operating expenses totaled $115,100.

Net Profit or Loss

The final figure—or bottom line—on an income statement is the **net profit (or net income)**, or **net loss**. It is calculated by subtracting all expenses from revenues. If revenues are more than expenses, the result is a net profit. If expenses exceed revenues, a net loss results.

Several steps are involved in finding net profit or loss. First, cost of goods sold is deducted from net sales to get the gross profit. Then total operating expenses are subtracted from gross profit to get the net profit before taxes. Finally, income taxes are deducted to get the net profit. As shown in Table 15.2, Delicious Desserts earned a net profit of $32,175 in 2022.

It is very important to recognize that profit does not represent cash. The income statement is a summary of the firm's operating results during some time period. It does not present the firm's actual cash flows during the period. Those are summarized in the statement of cash flows, which is discussed briefly in the next section.

Before continuing, take a moment to review components of the income statement:

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The Statement of Cash Flows

Net profit or loss is one measure of a company's financial performance. However, creditors and investors are also keenly interested in how much cash a business generates and how it is used. The **statement of cash flows**, a summary of the money flowing into and out of a firm, is the financial statement used to assess the sources and uses of cash during a certain period, typically one year. All publicly traded firms must include a statement of cash flows in their financial reports to shareholders. The statement of cash flows tracks the firm's cash receipts and cash payments. It gives financial managers and analysts a way to identify cash flow problems and assess the firm's financial viability.

Using income statement and balance sheet data, the statement of cash flows divides the firm's cash flows into three groups:

Cash flow from operating activities: Those related to the production of the firm's goods or services.

Cash flow from investment activities: Those related to the purchase and sale of fixed assets.

Cash flow from financing activities: Those related to debt and equity financing.

Delicious Desserts' statement of cash flows for 2022 is presented in Table 15.3. It shows that the company's cash and marketable securities have increased over the last year. And during the year the company generated enough cash flow to increase inventory and fixed assets and to reduce accounts payable, accruals, notes payable, and long-term debt. Note that the parentheses used around numbers represent negative numbers, or cash outflows.

Table 15.3

Delicious Desserts, Inc. Statement of Cash Flows for 2023		
Cash Flow from Operating Activities		
Net profit after taxes	32,175	
Depreciation	1,500	
Decrease in accounts receivable	3,140	
Increase in inventory	(4,500)	
Decrease in accounts payable	(2,065)	
Decrease in accruals	(1,035)	
Cash provided by operating activities		***29,215***
Cash Flow from Investment Activities		
Increase in gross fixed assets	(5,000)	
Cash used in investment activities		***(5,000)***
Cash Flow from Financing Activities		
Decrease in notes payable	(3,000)	
Decrease in long-term debt	(1,000)	
Cash used by financing activities		***(4,000)***
Net increase in cash and marketable securities		**$20,215**

Before continuing, take a moment to review the three components of the statement of cash flows, as well as the three financial statements:

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Analyzing Financial Statements

Individually, the balance sheet, income statement, and statement of cash flows provide insight into the firm's operations, profitability, and overall financial condition. By studying the relationships among the financial statements, however, one can gain even more insight into a firm's financial condition and performance. Financial statements at any given time can provide a snapshot of a company's overall health. Company management must use certain standards and measurements to determine whether they need to implement additional strategies to keep the company fit and making a profit.

Ratio analysis involves calculating and interpreting financial ratios using data taken from the firm's financial statements in order to assess its condition and performance. A financial ratio states the relationship between financial data on a percentage basis. The ratios can then be compared over time, typically three to five years. A firm's ratios can also be compared to industry averages or to those of another company in the same industry. Period-to-period and industry ratios provide a meaningful basis for comparison, so that we can answer questions such as, "Is this particular ratio good or bad?"

It's important to remember that ratio analysis is based on historical data and may not indicate future financial performance. Ratio analysis merely highlights potential problems; it does not prove that they exist. However, ratios can help managers monitor the firm's performance from period to period to understand operations better and identify trouble spots.

Ratios are also important to a firm's present and prospective creditors (lenders), who want to see if the firm can repay what it borrows and assess the firm's financial health. Often loan agreements require firms to maintain minimum levels of specific ratios. Both present and prospective shareholders use ratio analysis to look at the company's historical performance and trends over time.

Ratios can be classified by what they measure: liquidity, profitability, activity, and debt. Using Delicious Desserts' 2022 balance sheet and income statement (Table 15.1 and Table 15.2), we can calculate and interpret the key ratios in each group. Table 15.4 summarizes the calculations of these ratios for Delicious Desserts.

Table 15.4

Ratio Analysis for Delicious Desserts, Inc. at Year-End 2022			
Ratio	**Formula**	**Calculation**	**Result**

Liquidity Ratios			
Current ratio	Total current assets / Total current liabilities	$83,200 / $60,150	1.4
Acid-test (quick) ratio	(Total current assets – inventory) / Total current liabilities	($83,200 – $15,000) / $60,150	1.1
Net working capital	Total current assets – Total current liabilities	$83,200 – $60,150	$23,050
Profitability Ratios			
Net profit margin	Net profit / Net sales	$32,175 / $270,500	11.9%
Return on equity	Net profit / Total owners' equity	$32,175 / $78,750	40.9%
Earnings per share	Net profit / # of shares of common stock outstanding	$32,17 / 510,000	$3.22
Activity Ratio			
Inventory turnover	Cost of goods sold / Average inventory		
	Cost of goods sold / (Beginning inventory + (Ending inventory/2))	$112,500 / ($18,000 + ($15,000/2))	
		$112,500 / $16,500	6.8 times
Debt Ratio			
Debt-to-equity ratio	Total liabilities / Owners' equity	$70,150 / $78,750	89.1%

We'll now discuss how to calculate the ratios and how to interpret the ratio value.

Liquidity Ratios

Liquidity ratios measure the firm's ability to pay its short-term debts as they come due. These ratios are of special interest to the firm's creditors. The three main measures of liquidity are the current ratio, the acid-test (quick) ratio, and net working capital.

The **current ratio** is the ratio of total current assets to total current liabilities. Traditionally, a current ratio of 2 ($2 of current assets for every $1 of current liabilities) has been considered good. Whether it is sufficient depends on the industry in which the firm operates. Public utilities, which have a very steady cash flow, operate quite well with a current ratio well below 2. A current ratio of 2 might not be adequate for manufacturers and merchandisers that carry high inventories and have lots of receivables. The current ratio for Delicious Desserts for 2022, as shown in Table 15.4, is 1.4. This means little without a basis for comparison. If the analyst found that the industry average for small bakeries was 2.4, Delicious Desserts would appear to have low liquidity.

The **acid-test (quick) ratio** is like the current ratio except that it excludes inventory, which is the least-liquid current asset. The acid-test ratio is used to measure the firm's ability to pay its current liabilities without selling inventory. The name *acid-test* implies that this ratio is a crucial test of the firm's liquidity. An acid-test ratio of at least 1 is preferred. But again, what is an acceptable value varies by industry. The acid-test ratio is a good measure of liquidity when inventory cannot easily be converted to cash (for instance, if it consists of very specialized goods with a limited market). If inventory is liquid, the current ratio is better. Delicious Desserts' acid-test ratio for 2022 is 1.1. Because the bakery's products are perishable, it does not carry large inventories. Thus, the values of its acid-test and current ratios are fairly close. At a manufacturing company, however, inventory typically makes up a large portion of current assets, so the acid-test ratio will be lower than the current ratio.

Net working capital, though not really a ratio, is often used to measure a firm's overall liquidity. It is calculated by subtracting total current liabilities from total current assets. Delicious Desserts' net working capital for 2022 is $23,050. Comparisons of net working capital over time often help in assessing a firm's liquidity.

Profitability Ratios

To measure profitability, a firm's profits can be related to its sales, equity, or stock value. **Profitability ratios** measure how well the firm is using its resources to generate profit and how efficiently it is being managed. The main profitability ratios are net profit margin, return on equity, and earnings per share.

The ratio of net profit to net sales is the **net profit margin**, also called *return on sales*. It measures the percentage of each sales dollar remaining after all expenses, including taxes, have been deducted. Higher net profit margins are better than lower ones. The net profit margin is often used to measure the firm's earning power. "Good" net profit margins differ quite a bit from industry to industry. A grocery store usually has a very low net profit margin, perhaps below 1 percent, whereas a jewelry store's net profit margin would probably exceed 10 percent. Delicious Desserts' net profit margin for 2022 is 11.9 percent. In other words, Delicious Desserts is earning 11.9 cents on each dollar of sales.

The ratio of net profit to total owners' equity is called **return on equity (ROE)**. It measures the return that owners receive on their investment in the firm, a major reason for investing in a company's stock. Delicious Desserts has a 40.9 percent ROE for 2022. On the surface, a 40.9 percent ROE seems quite good. But the level of risk in the business and the ROE of other firms in the same industry must also be considered. The higher the risk, the greater the ROE investors look for. A firm's ROE can also be compared to past values to see how the company is performing over time.

Earnings per share (EPS) is the ratio of net profit to the number of shares of common stock outstanding. It measures the number of dollars earned by each share of stock. EPS values are closely watched by investors and are considered an important sign of success. EPS also indicates a firm's ability to pay dividends. Note that EPS is the dollar amount earned by each share, not the actual amount given to stockholders in the form of dividends. Some earnings may be put back into the firm. Delicious Desserts' EPS for 2022 is $3.22.

Activity Ratios

Activity ratios measure how well a firm uses its assets. They reflect the speed with which resources are converted to cash or sales. A frequently used activity ratio is inventory turnover. The **inventory turnover ratio** measures the speed with which inventory moves through the firm and is turned into sales. It is calculated by dividing cost of goods sold by the average inventory. (Average inventory is estimated by adding the beginning and ending inventories for the year and dividing by 2.) Based on its 2022 financial data, Delicious Desserts' inventory, on average, is turned into sales 6.8 times each year, or about once every 54 days (365 days ÷ 6.8). The acceptable turnover ratio depends on the line of business. A grocery store would have a high turnover ratio, maybe 20 times a year, whereas the turnover for a heavy equipment manufacturer might be only three times a year.

Debt Ratios

Debt ratios measure the degree and effect of the firm's use of borrowed funds (debt) to finance its operations. These ratios are especially important to lenders and investors. They want to make sure the firm has a healthy mix of debt and equity. If the firm relies too much on debt, it may have trouble meeting interest payments and repaying loans. The most important debt ratio is the *debt-to-equity ratio*.

The **debt-to-equity ratio** measures the relationship between the amount of debt financing (borrowing) and the amount of equity financing (owners' funds). It is calculated by dividing total liabilities by owners' equity. In general, the lower the ratio, the better. But it is important to assess the debt-to-equity ratio against both past values and industry averages. Delicious Desserts' ratio for 2022 is 89.1 percent. The ratio indicates that the company has 89 cents of debt for every dollar the owners have provided. A ratio above 100 percent means the firm has more debt than equity. In such a case, the lenders are providing more financing than the owners.

The Accounting Profession

Public Accountants

Independent accountants who serve organizations and individuals on a fee basis are called **public accountants**. Public accountants offer a wide range of services, including preparation of financial statements and tax returns, independent auditing of financial records and accounting methods, and management consulting. **Auditing**, the process of reviewing the records used to prepare financial statements, is an important responsibility of public accountants. They issue a formal *auditor's opinion* indicating whether the statements have been prepared in accordance with accepted accounting rules. This written opinion is an important part of a company's annual report.

Private Accountants

Accountants employed to serve one particular organization are **private accountants**. Their activities include preparing financial statements, auditing company records to be sure employees follow accounting policies and procedures, developing accounting systems, preparing tax returns, and providing financial information for management decision-making.

Chapter Review

Watch Video 15.1: *Understanding Financial Statements and Accounting* to review the three financial statements. Note that this video is framed around using the financial statements in a start-up business. Closed captioning is available. Click HERE to read a transcript.

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Optional Resources to Learn More

Articles

"Beginners' Guide to Financial Statements" https://www.sec.gov/reportspubs/investor-publications/investorpubsbegfinstmtguidehtm.html

"How to Read a 10-K/10-Q" https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/how-read

Books

Financial Intelligence by Karen Berman, Joe Knight, and John Case https://financialintelligencebook.com/

Principlesofaccounting.com (free online textbook) https://www.principlesofaccounting.com/

Videos

Accounting Stuff https://www.youtube.com/@AccountingStuff/playlists

Websites

Association of International Certified Professional Accountants (AICPA): Career Resources https://www.thiswaytocpa.com/work-experience/plan-career/

AICPA: Terms and Definitions: Accounting Glossary https://www.startheregoplaces.com/students/games-tools/glossary/

Business Literacy Institute: Terms and Definitions: Financial Concepts Dictionary http://www.business-literacy.com/financial-concepts/

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Video 15.1: CrashCourse. (2019, November 29). *Understanding financial statements and accounting: Crash course entrepreneurship #15* [Video]. YouTube. https://youtu.be/_HK5gpg39pY

16. Corporate Finance

What is Finance?

Finance is the study of the management, movement, and raising of money. The word *finance* can be used as a verb, such as when a bank agrees to finance a home mortgage loan. It can also be used as a noun referring to an entire industry. At its essence, the study of finance is about understanding the sources and uses of cash, as well as the concept of risk-reward tradeoff.

Finance is divided into three primary areas: corporate finance, investments, and financial markets and institutions (Figure 16.1). Corporate finance is the focus of this chapter, investments will be covered in Chapter 17, and financial markets were covered in Chapter 2.

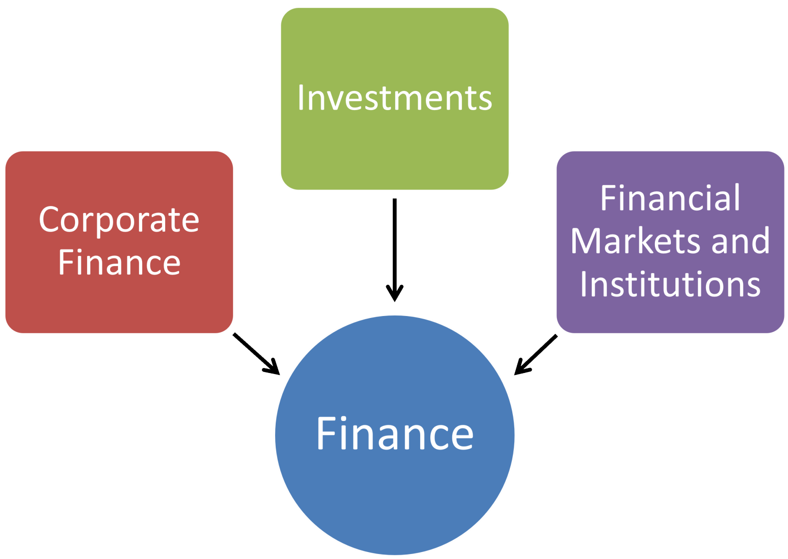

Figure 16.1: The three areas of study in finance: corporate finance, investments, and financial markets and institutions.

The Role of Finance in an Organization

Any company, whether it's a small-town bakery or General Motors, needs money to operate. To make money, it must first spend money—on inventory and supplies, equipment and facilities, and employee wages and salaries. Therefore, finance is critical to the success of all companies. It may not be as visible as marketing or production, but management of a firm's finances is just as much a key to the firm's success.

Financial management—the art and science of managing a firm's money so that it can meet its goals—is not just the responsibility of the finance department. All business decisions have financial consequences. Managers in all departments must work closely with financial personnel. If you are a sales representative, for example, the company's credit and collection policies will affect your ability to make sales. The head of the IT department will need to justify any requests for new computer systems or employee laptops.

Revenues from sales of the firm's products should be the chief source of funding. But money from sales doesn't always come in when it's needed to pay the bills. Financial managers must track how money is flowing into and out of the firm (Figure 16.2). They work with the firm's other department managers to determine how available funds will be used and how much money is needed. Then they choose the best sources to obtain the required funding.

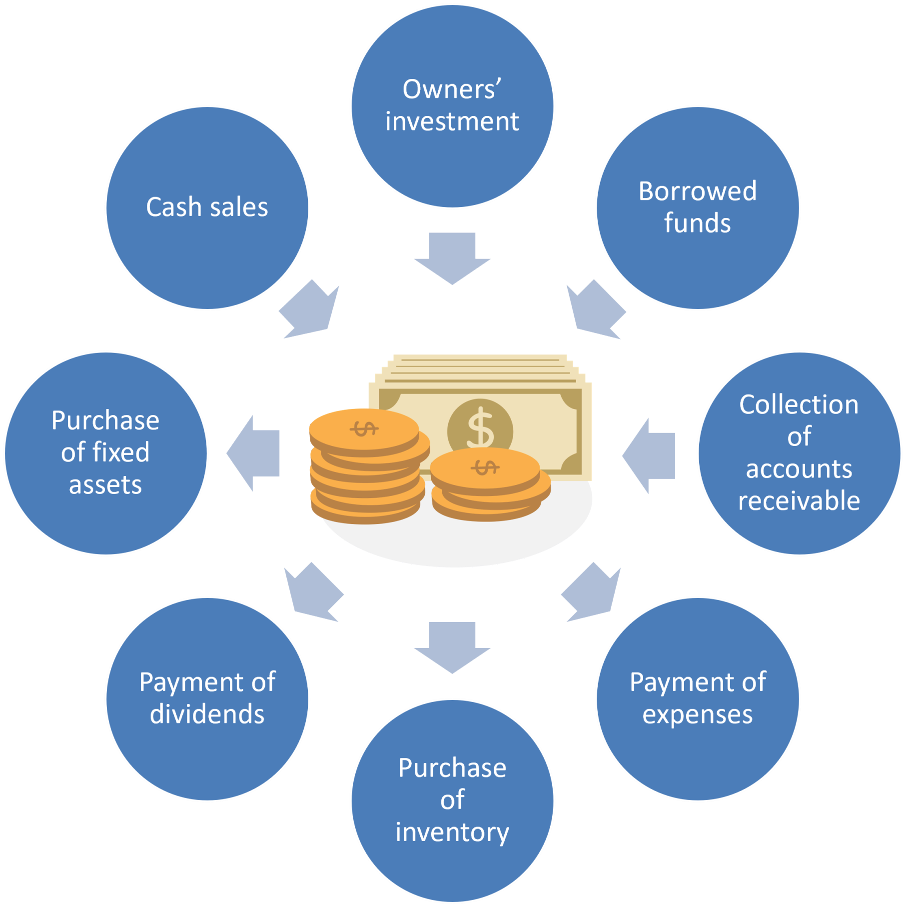

Figure 16.2: How cash flows into and out of a business.

For example, a financial manager will track day-to-day operational data such as cash collections and disbursements to ensure that the company has enough cash to meet its obligations. Over a longer time horizon, the manager will thoroughly study whether and when the company should open a new manufacturing facility. The manager will also suggest the most appropriate way to finance the project, raise the funds, and then monitor the project's implementation and operation.

Financial management is closely related to accounting. In most firms, both areas are the responsibility of the vice president of finance or chief financial officer (CFO). But the accountant's main function is to collect and present financial data. Financial managers use financial statements and other information prepared by accountants to make financial decisions. Financial managers focus on **cash flows**, the inflows and outflows of cash. They plan and monitor the firm's cash flows to ensure that cash is available when needed.

The Financial Manager's Responsibilities and Activities

Financial managers have a complex and challenging job. They analyze financial data prepared by accountants, monitor the firm's financial status, and prepare and implement financial plans. One day they may be developing a better way to automate cash collections, and the next they may be analyzing a proposed acquisition. The key activities of the financial manager are:

- ***Financial planning:*** Preparing the financial plan, which projects revenues, expenditures, and financing needs over a given period.
- ***Investment (spending money):*** Investing the firm's funds in projects and securities that provide high returns in relation to their risks.
- ***Financing (raising money):*** Obtaining funding for the firm's operations and investments and seeking the best balance between debt (borrowed funds) and equity (funds raised through the sale of ownership in the business).

The Goal of the Financial Manager

How can financial managers make wise planning, investment, and financing decisions? An important goal of the financial manager is to maximize the value of the firm for its owners. The value of a publicly owned corporation is measured by the share price of its stock. A private company's value is the price at which it could be sold.

To maximize the firm's value, the financial manager has to consider both short- and long-term consequences of the firm's actions. Maximizing profits is one approach, but it should not be the only one. Such an approach favors making short-term gains over achieving long-term goals. What if a firm in a highly technical and competitive industry did no research and development? In the short run, profits would be high because research and development is very expensive. But in the long run, the firm might lose its ability to compete because of its lack of new products.

This is true regardless of a company's size or point in its life cycle. At Corning, a company founded more than 160 years ago, management believes in taking the long-term view and not managing for quarterly earnings to satisfy Wall Street's expectations. The company, once known to consumers mostly for kitchen products such as Corelle dinnerware and Pyrex heat-resistant glass cookware, is today a technology company that manufactures specialized glass and ceramic products. It is a leading supplier of Gorilla Glass, a special type of glass used for the screens of mobile devices, including the iPhone, the iPad, and devices powered by Google's Android operating system. The company was also the inventor of optical fiber and cable for the telecommunications industry. These product lines require large investments during their long research and development (R&D) cycles and for plant and equipment once they go into production.[1]

As the Corning situation demonstrates, financial managers constantly strive for a balance between the opportunity for profit and the potential for loss. In finance, the opportunity for profit is termed **return**; the potential for loss, or the chance that an investment will not achieve the expected level of return, is **risk**. A basic principle in finance is that the higher the risk, the greater the return that is required (Figure 16.3). This widely accepted concept is called the **risk-return tradeoff**. Financial managers consider many risk and return factors when making investment and financing decisions. Among them are changing patterns of market demand, interest rates, general economic conditions, market conditions, and social issues (such as environmental effects and equal employment opportunity policies).

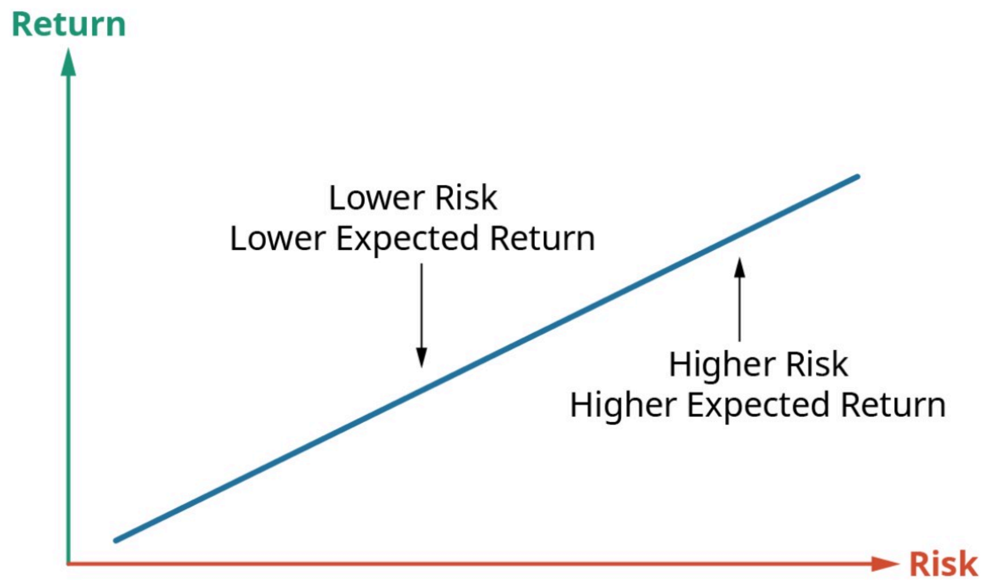

Figure 16.3: Invested money can bring higher profits if the investor is willing to accept the risk of possible loss, a concept referred to ask the risk-return tradeoff.

How Organizations Use Funds

To grow and prosper, a firm must keep investing money in its operations. The financial manager decides how best to use the firm's money. *Short-term expenses* support the firm's day-to-day activities. For instance, athletic-apparel maker Nike regularly spends money to buy such raw materials as leather and fabric and to pay employee salaries. *Long-term expenses,* also referred to as *capital expenditures*, are typically for fixed assets. For Nike, these would include outlays to build a new factory, buy automated manufacturing equipment, or acquire a small manufacturer of sports apparel.

Short-Term Expenses

Short-term expenses are outlays used to support current production and selling activities. They typically result in current assets, which include cash and any other assets (accounts receivable and inventory) that can be converted to cash within a year. The financial manager's goal is to manage current assets so the firm has enough cash to pay its bills and to support its accounts receivable and inventory.

Cash

Cash is the lifeblood of business. Without it, a firm could not operate. An important duty of the financial manager is **cash management**, or making sure that enough cash is on hand to pay bills as they come due and to meet unexpected expenses.

Businesses estimate their cash requirements for a specific period. Many companies keep a minimum cash balance to cover unexpected expenses or changes in projected cash flows. The financial manager arranges loans to cover any shortfalls. If the size and timing of cash inflows closely match the size and timing of cash outflows, the company needs to keep only a small amount of cash on hand. A company whose sales and receipts are fairly predictable and regular throughout the year needs less cash than a company with a seasonal pattern of sales and receipts. A toy company, for instance, whose sales are concentrated in the fall, spends a great deal of cash during the spring and summer to build inventory. It has excess cash during the winter and early spring, when it collects on sales from its peak selling season.

Because cash held in checking accounts earns little, if any, interest, the financial manager tries to keep cash balances low and to invest the surplus cash. Surpluses are invested temporarily in **marketable securities**, short-term investments that are easily converted into cash. The financial manager looks for low-risk investments that offer high returns. Three of the most popular marketable securities are **Treasury bills**, **certificates of deposit**, and **commercial paper**. Today's financial managers have new tools to help them find the best short-term investments, such as online trading platforms that save time and provide access to more types of investments. These have been especially useful for smaller companies who don't have large finance staffs.

In addition to seeking the right balance between cash and marketable securities, the financial manager tries to shorten the time between the purchase of inventory or services (cash outflows) and the collection of cash from sales (cash inflows). The three key strategies are to collect money owed to the firm (accounts receivable) as quickly as possible, to pay money owed to others (accounts payable) as late as possible without damaging the firm's credit reputation, and to minimize the funds tied up in inventory.

Accounts Receivable

Accounts receivable represent sales for which the firm has not yet been paid. Because the product has been sold but cash has not yet been received, an account receivable amounts to a use of funds. For the average manufacturing firm, accounts receivable represent about 15 to 20 percent of total assets.

The financial manager's goal is to collect money owed to the firm as quickly as possible, while offering customers credit terms attractive enough to increase sales. Accounts receivable management involves setting credit policies, guidelines on offering credit, credit terms, and specific repayment conditions, including how long customers have to pay their bills and whether a cash discount is given for quicker payment. Another aspect of accounts receivable management is deciding on collection policies, the procedures for collecting overdue accounts.

Inventory

Another use of funds is to buy **inventory** needed by the firm (Figure 16.4). In a typical manufacturing firm, inventory is nearly 20 percent of total assets. The cost of inventory includes not only its purchase price, but also ordering, handling, storage, interest, and insurance costs.

Production, marketing, and finance managers usually have differing views about inventory. Production managers want lots of raw materials on hand to avoid production delays. Marketing managers want lots of finished goods on hand so customer orders can be filled quickly. But financial managers want the least inventory possible without harming production efficiency or sales. Financial managers must work closely with production and marketing to balance these conflicting goals.

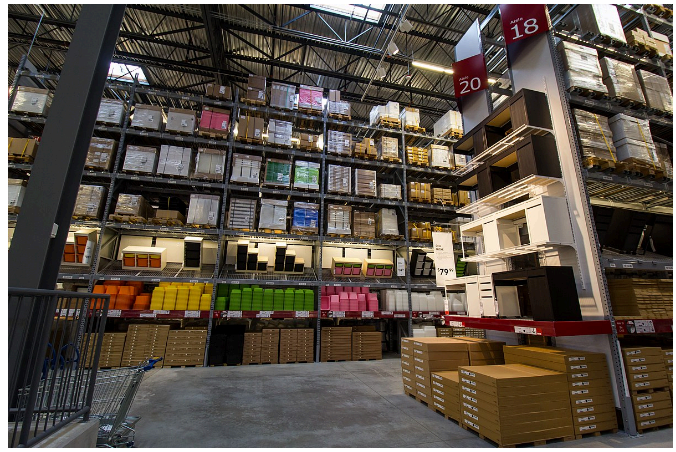

Figure 16.4: Goods a firm has purchased or manufactured for sale represent inventory, such as these products for sale in the self-serve area of the Renton, Washington Ikea store.

Long-Term Expenses

A firm also invests funds in physical assets such as land, buildings, machinery, equipment, and information systems. These are called **capital expenditures**. Unlike operating expenses, which produce benefits within a year, the benefits from capital expenditures extend beyond one year. For instance, a printer's purchase of a new printing press with a usable life of seven years is a capital expenditure and appears as a fixed asset on the firm's balance sheet. Paper, ink, and other supplies, however, are expenses. Mergers and acquisitions are also considered capital expenditures.

Firms make capital expenditures for many reasons. The most common are to expand, to replace or renew fixed assets, and to develop new products. Most manufacturing firms have a big investment in long-term assets. Boeing Company, for instance, puts billions of dollars a year into airplane-manufacturing facilities. Because capital expenditures tend to be costly and have a major effect on the firm's future, the financial manager uses a process called **capital budgeting** to analyze long-term projects and select those that offer the best returns while maximizing the firm's value. Decisions involving new products or the acquisition of another business are especially important. Managers look at project costs and forecast the future benefits the project will bring to calculate the firm's estimated return on the investment.

Obtaining Financing

How do firms raise the funds they need? They borrow money (debt), sell ownership shares (equity), and retain earnings (profits). The financial manager must assess all these sources and choose the one most likely to help maximize the firm's value.

Short-term Financing

Like expenses, borrowed funds can be divided into short- and long-term loans. A short-term loan comes due within one year; a long-term loan has a maturity greater than one year. Short-term financing is shown as a current liability on the balance sheet and is used to finance current assets and support operations. Short-term loans can be unsecured or secured.

Unsecured loans are made on the basis of the firm's creditworthiness and the lender's previous experience with the firm. An unsecured borrower does not have to pledge specific assets as security.

Secured loans require the borrower to pledge specific assets as collateral, or security. The secured lender can legally take the collateral if the borrower doesn't repay the loan. Commercial banks and commercial finance companies are the main sources of secured short-term loans to business. Borrowers whose credit is not strong enough to qualify for unsecured loans use these loans.

Long-term Financing

A basic principle of finance is to match the term of the financing to the period over which benefits are expected to be received from the associated outlay. Short-term items should be financed with short-term funds, and long-term items should be financed with long-term funds. Long-term financing sources include both debt (borrowing) and equity (ownership). Equity financing comes either from selling new ownership interests or from retaining earnings. Financial managers try to select the mix of long-term debt and equity that results in the best balance between cost and risk.

Debt versus Equity Financing

Say that the Boeing Company plans to spend $2 billion over the next four years to build and equip new factories to make jet aircraft. Boeing's top management will assess the pros and cons of both debt and equity and then consider several possible sources of the desired form of long-term financing.

The major advantage of debt financing is the deductibility of interest expense for income tax purposes, which lowers its overall cost. In addition, there is no loss of ownership. The major drawback is **financial risk**: the chance that the firm will be unable to make scheduled interest and principal payments. The lender can force a borrower that fails to make scheduled debt payments into bankruptcy. Most loan agreements have restrictions to ensure that the borrower operates efficiently.

Equity, on the other hand, is a form of permanent financing that places few restrictions on the firm. The firm is not required to pay dividends or repay the investment. However, equity financing gives common stockholders voting rights that provide them with a voice in management. Equity is more costly than debt. Unlike the interest on debt, dividends to owners are not tax-deductible expenses. Table 16.1 summarizes the major differences between debt and equity financing.

Table 16.1: Major Differences between Debt and Equity Financing

	Debt Financing	Equity Financing
Ability to influence management	Creditors typically have none, unless the borrower defaults on payments. Creditors may be able to place restraints on management in event of default.	Common stockholders have voting rights.
A claim on income and assets	Debt holders rank ahead of equity holders. Payment of interest and principal is a contractual obligation of the firm.	Equity owners have a residual claim on income (dividends are paid only after paying interest and any scheduled principal) and no obligation to pay dividends.
Maturity (date when debt needs to be paid back)	Debt has a stated maturity and requires repayment of principal by a specified date.	The company is not required to repay equity, which has no maturity date.
Tax treatment	Interest is a tax-deductible expense.	Dividends are not tax-deductible and are paid from after-tax income.

Debt Financing

Long-term debt is used to finance long-term (capital) expenditures. The initial maturities of long-term debt typically range between 5 and 20 years. Three important forms of long-term debt are term loans, bonds, and mortgage loans.

A **term loan** is a business loan with a maturity of more than one year. Term loans generally have maturities of 5 to 12 years and can be unsecured or secured. They are available from commercial banks, insurance companies, pension funds, commercial finance companies, and manufacturers' financing subsidiaries. A contract between the borrower and the lender spells out the amount and maturity of the loan, the interest rate, payment dates, the purpose of the loan, and other provisions such as operating and financial restrictions on the borrower to control the risk of default. The payments include both interest and principal, so the loan balance declines over time. Borrowers try to arrange a repayment schedule that matches the forecast cash flow from the project being financed.

Bonds are long-term debt obligations (liabilities) of corporations and governments. A bond certificate is issued as proof of the obligation. The issuer of a bond must pay the buyer a fixed amount of money—called **interest**, stated as the **coupon rate**—on a regular schedule, typically every six months. The issuer must also pay the bondholder the amount borrowed—called the **principal**, or *par value*—at the bond's maturity date (due date). Bonds are usually issued in units of $1,000—for instance, $1,000, $5,000, or $10,000—and have initial maturities of 10 to 30 years. They may be secured or unsecured, include special provisions for early retirement, or be convertible to common stock.

A **mortgage loan** is a long-term loan made against real estate as collateral. The lender takes a mortgage on the property, which lets the lender seize the property, sell it, and use the proceeds to pay off the loan if the borrower fails to make the scheduled payments. Long-term mortgage loans are often used to finance office buildings, factories, and warehouses.

Equity Financing

Equity refers to the owners' investment in the business. In corporations, the preferred and common stockholders are the owners. A firm obtains equity financing by selling new ownership shares (external financing), by retaining earnings (internal financing), or for small and growing, typically high-tech, companies, through venture capital (external financing).

Selling New Issues of Common Stock

Figure 16.5: Members of the SmileDirectClub team celebrate ringing the bell at Nasdaq on their IPO day in September, 2019.

Common stock is a security that represents an ownership interest in a corporation. A company's first sale of stock to the public is called an **initial public offering (IPO)** (Figure 16.5). An IPO often enables existing stockholders, usually employees, family, and friends who bought the stock privately, to earn big profits on their investment. Companies that are already public can issue and sell additional shares of common stock to raise equity funds.

But going public has some drawbacks. For one thing, there is no guarantee an IPO will sell. It is also expensive. Big fees must be paid to investment bankers, brokers, attorneys, accountants, and printers. Once the company is public, it is closely watched by regulators, stockholders, and securities analysts. The firm must reveal such information as operating and financial data, product details, financing plans, and operating strategies. Providing this information is often costly.

Going public is the dream of many small company founders and early investors, who hope to recoup their investments and become instant millionaires. However, some companies choose to remain private. Cargill, SC Johnson, Mars, Publix Super Markets, and Bloomberg are among the largest U.S. private companies.

Dividends and Retained Earnings

Dividends are payments to stockholders from a corporation's profits. Dividends can be paid in cash or in stock. **Stock dividends** are payments in the form of more stock. Stock dividends may replace or supplement cash dividends. After a stock dividend has been paid, more shares have a claim on the same company, so the value of each share often declines. A company does not have to pay dividends to stockholders. But if investors buy the stock expecting to get dividends and the firm does not pay them, the investors may sell their stocks.

At their quarterly meetings, the company's board of directors (typically with the advice of its CFO) decides how much of the profits to distribute as dividends and how much to reinvest. A firm's basic approach to paying dividends can greatly affect its share price. A stable history of dividend payments indicates good financial health.

If a firm that has been making regular dividend payments cuts or skips a dividend, investors start thinking it has serious financial problems. The increased uncertainty often results in lower stock prices. Thus, most firms set dividends at a level they can keep paying. They start with a relatively low dividend payout ratio so that they can maintain a steady or slightly increasing dividend over time.

Retained earnings, profits that have been reinvested in the firm, have a big advantage over other sources of equity capital: They do not incur underwriting costs. Financial managers strive to balance dividends and retained earnings to maximize the value of the firm. Often the balance reflects the nature of the firm and its industry. Well-established and stable firms and those that expect only modest growth, such as public utilities, financial services companies, and large industrial corporations, typically pay out much of their earnings in dividends.

Most high-growth companies, such as those in technology-related fields, finance much of their growth through retained earnings and pay little or no dividends to stockholders. As they mature, many decide to begin paying dividends, as Apple decided to do in 2012, after 17 years of paying no annual dividends to shareholders.[2]

Preferred Stock

Another form of equity is **preferred stock**. Unlike common stock, preferred stock usually has a dividend amount that is set at the time the stock is issued. These dividends must be paid before the company can pay any dividends to common stockholders. Also, if the firm goes bankrupt and sells its assets, preferred stockholders get their money back before common stockholders do.

Like debt, preferred stock increases the firm's financial risk because it obligates the firm to make a fixed payment. But preferred stock is more flexible. The firm can miss a dividend payment without suffering the serious results of failing to pay back a debt.

Preferred stock is more expensive than debt financing, however, because preferred dividends are not tax-deductible. Also, because the claims of preferred stockholders on income and assets are second to those of debtholders, preferred stockholders require higher returns to compensate for the greater risk.

Venture Capital

Venture capital is another source of equity capital. It is most often used by small and growing firms that aren't big enough to sell securities to the public. This type of financing is especially popular among high-tech companies that need large sums of money.

Venture capitalists invest in new businesses in return for part of the ownership, sometimes as much as 60 percent. They look for new businesses with high growth potential, and they expect a high investment return within 5 to 10 years. By getting in on the ground floor, venture capitalists buy stock at a very low price. They earn profits by selling the stock at a much higher price when the company goes public. Venture capitalists generally get a voice in management through seats on the board of directors. Getting venture capital is difficult, even though there are hundreds of private venture-capital firms in this country. Most venture capitalists finance only about one to five percent of the companies that apply.

Chapter Review

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=1212#h5p-135

Optional Resources to Learn More

Articles

"What is Risk?" https://www.investor.gov/introduction-investing/investing-basics/what-risk

Books

Finance People: An Introduction to Their World and How They Think by Michael Schill

Principles of Finance (free textbook) https://openstax.org/details/books/principles-finance

Podcasts

The Better Finance Podcast https://www.ey.com/en_us/podcasts/better-finance-podcast-series

Videos

Introduction to Corporate Finance https://youtu.be/5eGRi66iUfU

Websites

Corporate Finance Institute https://corporatefinanceinstitute.com/resources/

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Notes

1. Pisano, G. P. (2015). *You need an innovation strategy*. Harvard Business Review. https://hbr.org/2015/06/you-need-an-innovation-strategy
2. Vascellaro, J. E. (2012, March 21. Apple pads investor wallets. *The Wall Street Journal.* https://www.wsj.com/articles/SB10001424052702304724404577291071289857802.

17. Investments

This chapter introduces foundational concepts in finance related to investing: the time value of money, risk and return, volatility, and diversification.

Time Value of Money

Impact of Time on Saving and Spending

Figure 17.1: The choice to spend or save and invest is really a choice between consumption today versus consumption in the future.

The choice to spend or save and invest is really a choice between consumption today versus consumption in the future. An important aspect of the trade-off between saving and spending involves your short-, intermediate-, and long-term goals. Delaying consumption until later comes with risks. Will your consumption choices still be available? Will the prices be attainable? Will you still be able to consume and enjoy your future purchases?

When saving for short-term objectives, the safety of the principal invested is important, and the value of compounding returns is minimal compared to longer-term investments. Most short-term investors have a low tolerance for risk and hope to beat the rate of inflation with a little extra besides. An example could be to start a holiday savings account at your local bank as a way to save, earn a small rate of return, and assure that you have funds set aside for consumption at the end of the year.

An intermediate investment may be to save for a new car or for the down payment on a house or vacation home. Again, maintaining the principal is important, but you have some time to recover from poor investment returns. Intermediate-term investments tend to earn higher average annual rates of return than short-term investments, but they also have greater uncertainty and risk.

Long-term investments have the advantage of enough time to recover from temporary poor performance and the luxury of compounded returns over a long period. Further, long-term investments tend to have greater risk and higher expected average annual rates of return.

To illustrate, Table 17.1 demonstrates four different investment scenarios. In scenario 1, you invest $5,000 annually from ages 26 through 60 into an account earning an average annual rate of return of 10% per year. Over your lifetime, you invest a total of $175,000, and at age 60, you have an estimated portfolio value of $1,490,634. This is a healthy amount that has almost certainly beaten the average annual rate of inflation. In scenario 1, by investing regularly, you accumulate roughly 8.5 times the value of what you invested.

Compare your results in scenario 1 with your college roommate in scenario 2, who is able to invest $5,000 per year from ages 19 through 25 and leave her investments until age 60 in an account that continues to earn an annual rate of 10%. She makes her investments earlier than yours, but they total only $35,000. However, despite a much smaller investment, her head start advantage and the high average annual compounded rate of return leave her with an expected portfolio value of $1,466,369. Her total is almost as great as the amount you would accumulate, but with a much smaller total investment.

Scenarios 3 and 4 are even more dramatic. In both scenarios, only five $5,000 investments are made, but they are made earlier in the investor's life. Parents or grandparents could make these investments on behalf of the recipients. In both scenarios, the portfolios grow to amounts greater than those of you or your roommate with smaller total investments. The common factor is that greater time leads to additional compounding of the investments and thus greater future values.

Table 17.1: Four Investment Scenarios: Assumptions and Expected Outcomes

	Average Annual Rate of Return = 10%			
Assumptions	**Scenario 1**	**Scenario 2**	**Scenario 3**	**Scenario 4**
Starting investment age	26	19	14	9
Ending investment age	60	25	18	13
Total investments	35	7	5	5
Annual investment	$5,000	$5,000	$5,000	$5,000
Total investment amount	$175,000	$35,000	$25,000	$25,000
Value at age 60	$1,490,634	$1,466,369	$1,838,858	$2,961,500

Time Value of Money Concept

One of the single most important concepts in the study of finance is the **time value of money (TVM)**. This concept puts forward the idea that a dollar received today is worth more than, and therefore preferable to, a dollar received at some point in the future. The three primary reasons for this are that (1) money received now can be saved or invested now and earn **interest** or a return, resulting in more money in the future; (2) any promise of future payments of cash will always carry the risk of default; and (3) it is simple human nature for people to prefer making their purchases of goods and services in the present rather than waiting to make them at some future time.

The concept of TVM is predicated on the fact that it is possible to earn interest income on cash that you decide to deposit in an investment or interest-bearing account. As times goes by, interest is earned on amounts you have invested (*present value*), which effectively means that time will add value (*future value*) to your savings (Figure 17.2). The longer the period of time you have your money invested, the more interest income will accrue. Also, the higher the rate of interest your account or investment is earning, again, the more your money will grow.

Because we can invest our money in interest-bearing accounts and investments, its value can grow over time as interest income accrues or returns are realized on our investments. This concept is referred to as **future value (FV)**. In short, future value refers to how a specific amount of money today can have greater value tomorrow.

Figure 17.2: Time value of money.

Future Value and Compounding

Let's illustrate the concept with the following example. Your friend is considering putting money in a bank account that will pay 4% interest per year and is particularly interested in knowing how much money they will have one year from now if they deposit $1,000 in this account. By using the TVM principle of future value (FV), you can tell your friend that the answer is $1,040. The additional $40 that will be in the account after one year will be due to interest earned over that time. You can calculate this amount relatively easily by taking the original deposit (also referred to as the principal) of $1,000 and multiplying it by the annual interest rate of 4% for one period (in this case, one year):

Interest Earned = $1,000 × 0.04 = $40

By taking the interest earned amount of $40 and adding it to the original principal of $1,000, you will arrive at a total value of $1,040 in the bank account at the end of the year. So, the $1,040 one year from today is equal to $1,000 today when working with a 4% earning rate. Therefore, based on the concept of TVM, we can say that $1,040 represents the future value of $1,000 one year from today and at a 4% rate of interest.

The Impact of Compounding

What would happen if your friend were willing to wait one more year to receive their lump sum payment? What would the future dollar value in their account be after a two-year period? Returning to our example, assume that during the second year, your friend leaves the principal ($1,000) and the earned interest ($40) in the account, thereby reinvesting the entire account balance for another year. The quoted interest rate of 4% reflects the interest the account would earn each year, not over the entire two-year savings period. So, during the second year of savings, the $1,000 deposit and the $40 interest earned during the first year would both earn 4%:

($1,000 × 0.04) + (40 × 0.04) = $41.60

The additional $1.60 is interest on the first year's interest and reflects the compounding of interest. **Compound interest** is the term we use to refer to interest income earned in subsequent periods that is based on interest income earned in prior periods. To put it simply, compound interest refers to interest that is earned on interest. Here, it refers to the $1.60 of interest earned in the second year on the $40 of interest earned in the first year. Therefore, at the end of two years, the account would have a total value of $1,081.60. This consists of the original principal of $1,000 plus the $40 interest income earned in year one and the $41.60 interest income earned in year two.

The amount of money your friend would have in the account at the end of two years, $1,081.60, is referred to as the future value of the original $1,000 amount deposited today in an account that will earn 4% interest every year.

Simple interest applies to year 1 while compound interest or "interest on interest" applies to year 2. This is calculated as follows:

Year 1: $1,000 × 0.04 = $40

Year 2: $1,040 × 0.04 = $41.60

So, the total amount that would be in the account after two years, at 4% annual interest, would be:

$1,000 + $40 + $41.60 = $1,081.60

To determine any future value of money in an interest-bearing account, we multiply the principal amount by 1 plus the interest rate for each year the money remains in the account. From this, we can develop the future value formula:

Future Value = Original Deposit × (1 + *r*) × (1 + *r*)

In this formula, the number of times we multiply by (1+r)(1+r)">(1 + *r*) depends entirely on the number of years the money will remain in the bank account, earning interest, before it is withdrawn in a final lump sum distribution paid out from the account at the end of the chosen savings period. The 1 in the formula represents the principal amount, or the original $1,000 deposit, which will be included in the final total lump sum payment when the account is closed and all money is withdrawn at the end of the predetermined savings period.

We can write the above equation in a more condensed mathematical form using time value of money notation, as follows:

FV = Future value

PV = Present value

r = Interest rate

n = number of periods

Using these inputs, we have the following formula:

$FV = PV \times (1 + r)^n$

With this equation, we can calculate the value of the savings account after any number of years. For example, suppose we are considering 3, 10, and 50 years from the original deposit date at the annual 4% interest rate:

3 years: FV = \$1,000 × $(1.04)^3$ = \$1,000 × 1.12486 = \$1,124.86

10 years: FV = \$1,000 × $(1.04)^{10}$ = \$1,000 × 1.48024 = \$1,480.24

50 years: FV = \$1,000 × $(1.04)^{50}$ = \$1,000 × 7.106683 = \$7,106.68

How can this savings account have grown to be so large after 50 years? This question is answered by the impact of compounding interest. Every year, the interest earned in previous years will also earn interest along with the initial deposit. This will have the effect of accelerating the growth of the total dollar value of the account.

This is the important effect of the compounding of interest: money grows in larger and larger increments the longer you leave it in an interest-bearing account. In effect, the compounding of interest over time accelerates the growth of money.

In order to determine the FV of any amount of money, it will always be necessary to know the following pieces of information: (1) the principal, initial deposit, or present value (PV); (2) the rate of interest, usually expressed on an annual basis as *r*; and (3) the number of time periods that the money will remain in the account (*n*).

The interest rate is often referred to as the **growth rate**, or the annual percentage increase on savings or on an investment. When the rate is raised to the power of the number of periods, the formula (1+r)n(1+r)n">$(1+r)^n$ will yield a number that is commonly referred to as the *future value interest factor* (FVIF). As a result of this process, as *n* (time, or the number of periods) increases, the future value interest factor will increase. Also, as *r* (interest rate) increases, the FVIF will increases. For these reasons, the future value calculation is directly determined by both the interest rate being used and the total amount of time—specifically, the number of periods—being considered.

Present Value and Discounting

There will often be situations when you need to determine the **present value (PV)** of a cash flow that is scheduled to occur several years in the future. We can again use the formula for present value to calculate a value today of future cash flows over multiple time periods.

An example of this would be if you wanted to buy a savings bond. The face value of the savings bond you have in mind is $1,000, which is the amount you would receive in 30 years (the future value). If the government is currently paying 5% per year on savings bonds, how much will it cost you today to buy this savings bond?

The $1,000 face value of the bond is the future value, and the number of years *n* that you must wait to get this face value is 30 years. The interest rate *r* is 5.0% and is the **discount rate** for the savings bond. Applying the present value equation, we calculate the current price of this savings bond as follows:

$$PV = \$1{,}000 \times (1/(1+0.05)^{30}) = \$1{,}000 \times 0.231377 = \$231.38$$

Thus, it would cost you $231.38 to purchase this 30-year, 5%, $1,000 face-valued bond.

What we have done in the above example is reduce, or *discount*, the future value of the bond to arrive at a value expressed in today's dollars. Effectively, this discounting process is the exact opposite of compounding interest that we covered earlier in our discussion of future value.

An important concept to remember is that **compounding** is the process that takes a present valuation of money to some point in the future, while **discounting** takes a future value of money and equates it to present dollar value terms.

Common applications in which you might use the present value formula include determining how much money you would need to invest in an interest-bearing account today in order to meet your retirement plans 40-50 years from now.

Risk and Return

Risk and *return* are often referred to as the two Rs of finance. Investors are interested in both risk and return because understanding one without the other is really meaningless. In terms of investment, the concept of return is fairly straightforward; **return** is the benefit, or profit, the investor expects from an expenditure. It is the reward for investing—the reason an investment is made in the first place. However, no investment is a sure thing. The return may not be what the investor was expecting. This uncertainty about what the return will be is referred to as **risk**.

Return could be the interest earned on an investment in a bond or the dividend from the purchase of stock. Return could be the higher income received and the greater job satisfaction realized from investing in a college education. Individuals tend to be risk averse. This means that for investors to take greater risks, they must have the expectation of greater returns. Investors would not be satisfied if the average return on stocks and bonds were the same as that for a risk-free savings account. Stocks and bonds have greater risk than a savings account, and that means investors expect a greater average return.

The overall uncertainty of returns has several components:

- **Default risk** on a financial security is the chance that the issuer will fail to make the required payment. For example, a homeowner may fail to make a monthly mortgage payment, or a corporation may default on required semiannual interest payments on a bond.
- **Inflation risk** occurs when investors have less purchasing power from the realized cash flows from an investment due to rising prices or inflation.
- **Diversifiable risk**, also known as unsystematic risk, occurs when investors hold individual securities or smallish portfolios and bear the risk that a larger, more well-rounded portfolio could eliminate. In these situations, investors carry additional risk or uncertainty without additional compensation.
- **Non-diversifiable risk**, or systematic risk, is what remains after portfolio diversification has eliminated unnecessary diversifiable risk.
- **Political risk** is associated with macroeconomic issues beyond the control of a company or its managers. This is the risk of local, state, or national governments "changing the rules" and disrupting firm cash flows. Political risk could come about due to zoning changes, product liability decisions, taxation, or even nationalization of a firm or industry.

Volatility

Investors purchase a share of stock hoping that the stock will increase in value and they will receive a positive return. However, even with well-established companies, returns are highly volatile. Investors can never perfectly predict what the return on a stock will be, or even if it will be positive.

Volatility refers to the fluctuations in a security or index over time. Why are stock returns so volatile? The value of the stock of a company changes as the expectations of the future revenues and expenses of the company change. These expectations may change due to a number of events and new information. Good news about a company will tend to result in an increase in the stock price. For example, Delta (ticker symbol DAL) announcing that it will be opening new routes and flying to cities it has not previously serviced suggests that DAL will have more customers and more revenue in future years. Or if CVS announces that it has negotiated lower rent for many of its locations, investors will expect the expenses of the company to fall, leading to more profits. Those types of announcements are often associated with a higher stock price. Conversely, if the pilots and flight attendants for DAL negotiate higher salaries, the expenses for DAL will increase, putting downward pressure on profits and the stock price.

Diversification

Most investors own shares of stock in multiple companies. This collection of stocks is known as a **portfolio**. Let's explore why it is wise for investors to hold a portfolio of stocks rather than to pick just one favorite stock to own.

Suppose, for example, you have saved $50,000 that you want to invest. If you purchased $50,000 of DAL stock, you would not be diversified. Your return would depend solely on the return on DAL stock. If, instead, you used $5,000 to purchase DAL stock and used the remaining $45,000 to purchase nine other stocks, you would be diversifying. Your return would depend not only on DAL's return but also on the returns of the other nine stocks in your portfolio. Investors practice **diversification**, or owning a variety of stocks in their portfolios, to manage risk.

It is akin to the saying "Don't put all of your eggs in one basket" (Video 17.1). If you place all of your eggs in one basket and that basket breaks, all of your eggs will fall and crack. If you spread your eggs out across a number of baskets, it is unlikely that all of the baskets will break and all of your eggs will crack. One basket may break, and you will lose the eggs in that basket, but you will still have your other eggs. The same idea holds true for investing. If you own stock in a company that does poorly, perhaps even goes out of business, you will lose the money you placed in that particular investment. However, with a diversified portfolio, you do not lose all your money because your money is spread out across a number of different companies.

Watch Video 17.1: *BizBasics: "What is Diversification" with Rich Evans* to learn about diversification.

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Chapter Review

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=2514#h5p-140

Optional Resources to Learn More

Articles

"Asset Allocation and Diversification" https://www.finra.org/investors/investing/investing-basics/asset-allocation-diversification

"Going All-in: Investing vs. Gambling" https://www.investopedia.com/articles/basics/09/compare-investing-gambling.asp

Books

The Intelligent Investor by Benjamin Graham

The Little Book of Common Sense Investing by John C. Bogle

The Psychology of Money by Morgan Housel

Podcasts

Planet Money https://www.npr.org/sections/money/

Videos

William Ackman: Everything You Need to Know About Finance and Investing in Under an Hour https://youtu.be/WEDIj9JBTC8

Websites

Introduction to Investing https://www.investor.gov/introduction-investing

TeenVestor https://www.teenvestor.com/

Chapter Attribution

Chapters 1, 7, and 15 of Dahlquist, J. & Rainford, K. (2022). *Principles of finance*. OpenStax. https://openstax.org/details/books/principles-finance. Licensed with CC BY 4.0.

Media Attributions

Figure 17.2: Rice University. (2022, March 24). *Determining future cash flow.* OpenStax. https://openstax.org/books/principles-finance/pages/7-4-applications-of-tvm-in-finance#fig-00001. Licensed with CC BY 4.0.

Video 17.1: Darden MBA. (2015, April 13). *BizBasics: "What is diversification" with Rich Evans* [Video]. YouTube. https://youtu.be/Z8qGf3_d3PQ

PART VI
PREPARING FOR YOUR FUTURE IN ORGANIZATIONS

18. Professionalism

What is Professionalism?

There are few things an employer values more than employees who carry out their duties in a professional manner and demonstrate *business etiquette* (Video 18.1).

Watch Video 18.1: *Business Etiquette Basics* to learn more about ways you can demonstrate business etiquette, or professionalism. Closed captioning is available. Click HERE to read a transcript.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=607#oembed-1

Professionalism isn't one thing; it's a combination of qualities (Video 18.2). A professional employee arrives on time for work and manages time effectively. Professional workers take responsibility for their own behavior and work effectively with others. High quality work standards, honesty, and integrity are also part of the package. Professional employees dress appropriately for the job. Communicating effectively and appropriately for the workplace is also an essential part of professionalism.

Watch Video 18.2: *Professionalism* to hear different perspectives on what professionalism involves. Closed captioning is available. Click HERE to read a transcript.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=607#oembed-2

Professionalism may look slightly different in various settings, but the core elements are the same, and will give employees an edge as they begin their careers.

Career Readiness and Professionalism

For college students preparing to enter the workforce, **career readiness** is the foundation upon which a successful career is launched. For employers, career readiness plays an important role in sourcing talent, providing a means of identifying key skills and abilities across different job functions.

The National Association of Colleges and Employers (NACE), which is the leading source of information on the employment of college educated individuals, has identified professionalism as one of eight competencies that contribute to career readiness. NACE describes **professionalism** as understanding and demonstrating effective work habits and acting in the interest of the larger community and workplace. More specifically, professionalism involves such behaviors as:

- Acting equitably with integrity and accountability to self, others, and the organization.
- Maintaining a positive personal brand in alignment with organization and personal career values.
- Being present and prepared.
- Demonstrating dependability (e.g., consistently showing up for work or meetings).
- Prioritizing and completing tasks to accomplish organizational goals.
- Consistently meeting or exceeding goals and expectations.
- Having an attention to detail, resulting in few if any errors in their work.
- Showing a high level of dedication toward doing a good job.[1]

Read the "Guide to Professionalism in the Workplace" to learn more about how you can demonstrate behaviors associated with professionalism.

Don't skip this! It is part of this chapter's material.

Developing Professionalism in College

In its 2022 Job Outlook Survey, NACE found that "while 86.9% of responding employers say professionalism is very or extremely important, just 44.2% of employers indicate that new college graduates are very or extremely proficient in it."[2] In other words, despite the importance of professionalism in the workplace, many college graduates fall short of demonstrating it at the level employers are expecting.

Some students assume they can wait until they are in "the real world" to practice and develop professional behaviors. But there is no better time than college to do so.

Read the article "A Memo to My Students Re: College and the Real World" to better understand why college is the ideal time to work on and demonstrate essential professional skills.

Don't skip this! It is part of this chapter's material.

Optional Resources to Learn More

Articles

"Professionalism in College" https://collegepossible.org/news/professionalism-in-college/

"Competencies for a Career-ready Workforce" https://www.naceweb.org/uploadedFiles/files/2021/resources/nace-career-readiness-competencies-revised-apr-2021.pdf

Books

How to Win at College: Surprising Secrets for Success from the Country's Top Students by Cal Newport https://calnewport.com/writing/

True Professionalism by David Maister https://davidmaister.com/books/tp/

The Etiquette Advantage in Business https://emilypost.com/shop/books/the-etiquette-advantage-in-business-3rd-edition-personal-skills-for-professional-success

Videos

"5 Proper Workplace Etiquette Tips to Practice for Professional Success" https://youtu.be/etxASaYtJu8

"How to Be More Professional as a Leader at Work: TOP 8 Qualities of Leaders Who Are Professional" https://youtu.be/p9nFuPfqxgg

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Media Attributions

Video 18.1: GCFLearnFree. (2018, September 20). *Business etiquette basics* [Video]. YouTube. https://youtu.be/qWbWL0l3ySk

Video 18.2: Candid Career. (2017, May 12). *Professionalism* [Video]. YouTube. https://youtu.be/eVOdR7Z_zb0

Notes

1. NACE. (n.d.) *What is career readiness?* NACE. https://www.naceweb.org/career-readiness/competencies/career-readiness-defined. List reprinted courtesy of the National Association of Colleges and Employers.
2. Gray, K. (2022, March 4). *Addressing the shifting standards of professionalism.* NACE. https://www.naceweb.org/career-readiness/competencies/addressing-the-shifting-standards-of-professionalism/

19. Communication: Writing

Why Communication Matters

Communication is at the heart of the professional world. Short emails, complex reports, private chats and formal presentations circulate information and ideas and drive decisions.

Professional communication typically has one or more of the following purposes; click each purpose in the interactive list below to learn more:

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Regardless of your specific purpose, powerful communication matters:

- Clear and concise writing gets noticed and leads to action.
- Demonstrated communication skills improve your job prospects.
- Powerful communication enables you to inspire and guide others.

Formal education and on-the-job training help you deepen your technical knowledge in your chosen field. However, if you do not learn to effectively pitch a new idea to your team, persuade a stakeholder, or clarify data for a client, your influence will be blunted.

Employers are eager to hire good writers because clear writing demonstrates clear thinking. Hone your written communication skills to contribute solutions to your workplace and enhance your own career.

Business Writing

Plain language is a term used to describe clear, concise writing. Figures 19.1 and 19.2 illustrate plain language with before-and-after examples.[1]

✖ **Before**

We must receive your completed application form on or before the 15th day of the second month following the month you are reporting if you do not submit your application electronically or the 25th day of the second month following the month you are reporting if you submit your application electronically.

✔ **After**

If you submit your form:	**We must receive it by:**
Electronically	25th of the second month
Not electronically	15th of the second month

Figure 19.1: Plain language example, before and after.

✖ **Before**

This program promotes efficient water use in homes and businesses throughout the country by offering a simple way to make purchasing decisions that conserve water without sacrificing quality or product performance.

✔ **After**

This program helps homeowners and businesses buy products that use less water without sacrificing quality or performance.

Figure 19.2: Plain language example, before and after.

The sections that follow highlight key guidelines[2] for writing with plain language, including:

1. Consider your audience
2. Be concise
3. Choose your language carefully
4. Organize your writing

1. Consider Your Audience

Your audience determines your communication style. When writing, keep the following in mind:

- A busy audience wants concise, no-nonsense information.
- An analytical audience wants solid evidence and transparency.
- A diverse audience needs language that does not create misunderstandings or confusion.
- A decisive audience wants well-reasoned recommendations.
- A decision-maker audience wants only pertinent, reliable, accessible information.

Use language your audience understands and feels comfortable with. Take your audience's current level of knowledge into account. Then, guide them through the information they need to know. To help you do this, try answering the following questions:

- Who is my audience?
- What does my audience already know about the subject?
- What does my audience need to know?
- What questions will my audience have?
- What's the best outcome for those involved? What do I need to say to get this outcome?

2. Be Concise

Wordy, dense construction is one of the biggest problems in business writing. Nothing is more confusing to the user than long, complex sentences containing multiple phrases and clauses. Unnecessary words come in all shapes and sizes. To address this problem, become more critical of your own writing, and consider whether you need every word.

Unnecessary words waste your audience's time. Great writing is like a conversation. Omit information that the audience doesn't need to know. This can be difficult if you are subject matter expert, so it's important to have someone look at the information from the audience's perspective.

Write Concise Sentences

Express only one idea in each sentence. Long, complicated sentences often mean that you aren't sure about what you want to say. Shorter sentences are also better for conveying complex information; they break the information up into smaller, easier-to-process units.

Write Concise Paragraphs

Write short paragraphs and cover one topic per paragraph. Short paragraphs are easier to read and understand. Writing experts recommend paragraphs of three to eight sentences. Vary the lengths of your paragraphs to make your writing more interesting.

Write Concise Sections

Short sections break up material so it appears easier to comprehend. Long, dense sections with no white space are visually unappealing, and give the impression your writing is difficult to understand. Short sections also help you organize your thoughts more effectively.

Short sections give you the opportunity to add useful headings, which help the reader skim and scan the page. Long sections are impossible to summarize meaningfully in a heading. When you break up different concepts into short sections, each heading can give the reader a clear picture of what's in that section.

3. Choose Your Words Carefully

Words matter. They are the most basic building blocks of written and spoken communication. Don't complicate things by using **jargon**, technical terms, or abbreviations that people won't understand. Choose your words carefully and be consistent in your writing style.

Use Clear Language

When you're making word choices, pick the familiar or commonly used word over the unusual or obscure.

Special terms can be useful shorthand within a particular audience and may be the clearest way to communicate with that group. However, going beyond necessary technical terms to write in jargon can cause misunderstanding or alienation, even if your only readers are specialists.

Readers complain about jargon more than any other writing fault, because writers often fail to realize that terms they know well may be difficult or meaningless to their audience. Try to substitute everyday language for jargon as often as possible.

When you have no way to express an idea except to use technical language, make sure to define your terms. However, it's best to keep definitions to a minimum. Remember to write to communicate, not to impress.

Use Active Voice

Active voice makes it clear who is supposed to do what. Passive voice obscures who is responsible for what and is one of the biggest problems with business writing. Don't confuse passive voice with past tense.

In an active sentence, the person or entity that is acting is the subject of the sentence. In a passive sentence, the person or item that is acted upon is the subject of the sentence. Passive sentences often do not identify who is performing the action (Figure 19.3).

✖ Passive voice	✔ Active voice
The lake was polluted by the company.	The company polluted the lake.
New regulations were proposed.	We proposed new regulations.
The following information must be included in the application for it to be considered complete.	You must include the following information in your application.

Figure 19.3: Passive versus active voice.

Use Examples

Examples help you clarify complex concepts. When you ask for clarification of something, people often respond by giving you an example. Good examples can substitute for long explanations. The more complex the concept you are writing about, the more you should consider using an example. By giving your audience an example that's relevant to their situation, you help them relate to your writing.

4. Organize Your Writing

Organize your writing so it's easy to follow along. To do so:

Arrange Content in a Logical Order

In some situations, presenting information chronologically may work best. In other situations, you may want to put general information first, and specialized information or exceptions later. That way, the material that addresses most readers in most situations comes first.

Use Headings

Logically-ordered writing will still be difficult for users to follow if they can't see how it's organized. An effective way to reveal your document's organization is to use lots of useful headings.

It's often useful to start writing your document by developing the headings, structuring them to your audience's concerns. This approach can also reveal major groupings of information that you might want to identify with headings.

Use Topic Sentences

Establish a context for your audience before you provide them with the details. If you flood readers with details first, they become impatient and may resist hearing your message. A good topic sentence draws the reader in.

Use Lists

Use lists to help your user focus on important material in a visually clear way.

Lists are useful because they:

- Highlight levels of importance
- Help the reader understand the order in which things happen
- Help readers skim and scan
- Make it easy to identify all steps in a process
- Add white space for easy reading

You can overuse lists. Remember to use them to highlight important information, not to overemphasize trivial matters.

Highlight Important Information

You can also add **bold** and *italics* to emphasize important concepts within a particular section. Only emphasize important information, and do so sparingly, otherwise you'll dilute its impact.

PUTTING EVERYTHING IN CAPITAL LETTERS IS NOT A GOOD EMPHASIS TECHNIQUE. ALTHOUGH IT MAY DRAW THE USER'S ATTENTION TO THE SECTION, IT MAKES IT HARDER TO READ. AND ONLINE, IT'S CONSIDERED SHOUTING.

<u>Similarly, underlining will draw the user's attention to the section, but it makes it hard to read.</u>

Besides, when reading online, people expect underlined text to be a link. It's better to use **bold** and *italics* for important issues.

Business Writing, In Summary

Watch Video 19.1: *Business Writing Tips* to review ways to write effectively for professional audiences. Closed captioning is available. Click HERE to read a transcript.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=614#oembed-1

Watch Video 19.2: *Formatting a Business Document* to review ways to create effective documents for professional audiences. Closed captioning is available. Click HERE to read a transcript.

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Professional Email

In the workplace, email remains a dominant form of collaborative communication between individuals and among teams, and (especially) with external audiences like suppliers and customers. For now, being a savvy emailer continues to be an important aspect of achieving career success.

Email Strategy and Etiquette

Writing effective emails involves many of the guidelines for plain language described in the first part of this chapter. Thinking specifically about email, keep the following strategies in mind:

1. Keep your email messages short and direct. Rarely should an email message exceed one screen. If the

reader has to scroll, your message is likely too long.

2. Formally open and close your email messages.
3. Put thought into your subject line. Craft a line that grabs attention and provides substantive information. Your recipient likely receives many emails per day. Write a subject line that stands out! If you need a response, say so in the subject line. For example, "Response needed: Dates for our next meeting."
4. Because emails are more formal than texting, adopt a tone that is friendly but not gushy. Limit the use of exclamation points; one per email is generally an appropriate limit.

The following examples illustrate plain language guidelines applied to email.

Use Paragraphs

Suppose you're emailing a potential business partner. This is an external message—perfect for email.

The first example below is an uninviting wall of text (Figure 19.4). The second example uses paragraphs to divide the meaning into sections and make the email more visually appealing. Which would you rather read?

NO

To: Brad Smith <brad.smith@email.com>
From: Bryce Jones <brycej@email.com>
Subject: I had an idea

We're expanding our marketing efforts into Arizona, and I think our two companies would benefit by collaborating on a custom health-cost software package. We've nearly finished our health-cost analysis algorithms. If you are still working on your health-cost visualizations, I believe that our analysis package and your visualization package together would give us both an edge on the market. If you are interested, let's have our teams meet and work out details on the APIs this month. I've attached a list that Jen Clark, our market research analyst, put together of businesses in the Phoenix area that would benefit from our co-developed application. Jen has strong connections, and we'd be happy to share our connections with you if we proceed on this exciting project. Let's discuss this by phone. Are you free on Monday or Tuesday?

Bryce

YES

To: Brad Smith <brad.smith@email.com>
From: Bryce Jones <brycej@email.com>
Subject: Let's Collaborate

We're expanding our marketing efforts into Arizona, and I think our two companies would benefit by collaborating on a custom health-cost software package.

We've nearly finished our health-cost analysis algorithms. If you are still working on your health-cost visualizations, I think that our packages together would give us both an edge on the market.

Take a look at this list that Jen Clark, our market research analyst, put together of businesses in the Phoenix area that would benefit from our co-developed application. Jen has strong connections, and we'd be happy to share them with you if we proceed on this project.

If you're interested, our teams could meet and work out details on the APIs this month. Let's discuss this by phone. Are you free on Monday or Tuesday?

Bryce

Figure 19.4: Use paragraphs.

Use Visual Signposts and Topics Sentences

Visual signposts catch the reader's eye. Bold text, bullet lists, and indents all highlight your important points. Topic sentences help readers get your message even if they skim your email.

Below are two versions of an email to a colleague in another department of the same company—again, an appropriate use of email (Figure 19.5). Note the rambling structure and chatty tone of the "NO" example vs. the clarity and professionalism of the "YES" example.

NO

To: Amy Wright <amy.wright@email.com>
From: Adam Kim <akim@email.com>
Subject: Get better soon!

Amy,

Sorry you missed the meeting last week! That cold sounds really rough. Let me know if there's anything I can do to help.

It was a good meeting. Not as much rambling as usual. We just covered the basics like the new client list, the ongoing audit, the yearly initiatives. Nothing new to report that you wouldn't have guessed. Oh, and HR came by and gave us all an update on the new health insurance. It looks really good. It will cost most of us less and should cover more. I'm stoked. Oh, yeah, and we're supposed to send any tweets about the company on to someone in CX. Then they'll take over. Well, get better soon.

Adam

YES

To: Amy Wright <amy.wright@email.com>
From: Adam Kim <akim@email.com>
Subject: Report on June 12 meeting

Amy,

I hope you're feeling better. Here's a quick report on the June 12 meeting that you missed:

- **CLIENTS** New clients are up slightly. We have lost Case and Quest but signed FastUP and one startup with promise (Coral).
- **AUDIT** The audit drags on but is projected to finish by August. Victoria needs your billing files by the end of this month.
- **CX INITIATIVE** Using Twitter as a customer response tool has increased interaction with our millennial clients by 75%. Libby will continue overseeing our Twitter account—she's been phenomenal!
- **HEALTH INSURANCE** Our new health insurance (Advantage) will cost us 7% less and cover 15% more. Here's the link to the signup form. It's due by 5 p.m. next Friday, June 25.

Looking forward to having you back in the office soon. Take care.

Adam

Figure 19.5: Use visual signposts.

Include Supporting Information

Find the balance between giving enough and too much information. You don't want to overburden your reader, but you need to be credible. Use hyperlinks or attachments so the recipient can seek greater specifics if desired.

In this example, a manager in the finance organization is emailing someone in the supply chain organization regarding the need for new office furniture (Figure 19.6).

NO

To: Melanie Morgan <mmorgan@email.com>
From: Raj Singh <rajie@email.com>
Subject: Update on office furniture

I'm so stoked that we get to buy new office furniture. My back has been killing me lately and I'm thinking it might be this dumb chair I've been sitting in. It's definitely not as comfortable as it looks. Hahaha. And there's the desks. No cord pull holes at all, just a slab, and the workmanship is so shoddy that it's always wobbling whenever I push back to go get snacks. (Forty times a day.) So yes, we definitely need new furniture. We get to decide what to buy. We could go to Ikea, or we could order online. Brad said we have a budget of $2,500. What are you thinking? Should we even try to match the stuff in the back office, or just get something comfortable? I am thinking we should just go for comfort, but I don't know. I've started looking at the manufacturers and it looks like SitSmart, PosturePod, Wellesley, and BrainComfort are good. We have to decide whether we want to go local or order it shipped to us. I have so many things I want in a good chair, like posture control and height control, also mesh so we don't get too hot in the summer. But those are more expensive. I don't know. It's all so complicated, but I'm glad we get an upgrade!

Raj

YES

To: Melanie Morgan <mmorgan@email.com>
From: Raj Singh <rajie@email.com>
Subject: Update on office furniture

Brad finally approved a budget of $2,500 for new office furniture!

I've attached a spreadsheet listing our current inventory. Hopefully, with the budget, we will be able to replace all of our desks and chairs.

I researched replacements, focusing on stability, cord access ports, lumbar support, and height adjustment. I've narrowed our options to the following:

Local (already assembled):

- SitSmart at OfficeBarn
- BrainComfort at Furnishall

Online (assembly required):

- Wellsley from ModernOffice,
- PosturePod from Saunders

Look these over and let me know what you think—you may have other feature priorities. Let's make a decision by Thursday at noon.

Raj

Figure 19.6: Include supporting information.

Professional Email, In Summary

Watch Video 19.3: *Writing an Effective Business Email* for a summary of how to compose professional email messages. Closed captioning is available. Click HERE to read a transcript.

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Optional Resources to Learn More

Articles

"Why You Can't Abandon the Written Word, Even in a Tech-Driven World" https://www.inc.com/john-hall/why-you-cant-abandon-written-word-even-in-a-tech-driven-world.html

Books

Management Communication (free textbook) https://mcom320.net/index.html

A Plain English Handbook (free handbook from the SEC) https://www.sec.gov/pdf/handbook.pdf

Writing on the Job: Best Practices for Communicating in the Digital Age by Martha B. Coven

They Say I Say by Gerald Graff and Cathy Birkenstein

On Writing Well by William Zinsser

Style: Lessons in Clarity and Grace by Joseph M. Williams and Joseph Bizup

Videos

"3 Ways To Make Your Writing Clearer" https://youtu.be/prUqCd2R3Zw

"Plain Language for Everyone, Even Experts" https://youtu.be/bAvW1A7UiYM

Websites

Plain Language https://www.plainlanguage.gov/

Purdue Owl – Email Etiquette https://owl.purdue.edu/owl/general_writing/academic_writing/email_etiquette.html

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Video 19.1: GCFLearnFree. (2017, November 22). *Business writing tips* [Video]. YouTube. https://youtu.be/LrKesGslOYs

Video 19.2: GCFLearnFree. (2018, May 14). *Formatting a business document* [Video]. YouTube. https://youtu.be/vO2Mbyu4NSM

Video 19.3: GCFLearnFree. (2017, December 6). *Writing an effective business email* [Video]. YouTube. https://youtu.be/amJZXjxnhTI

Notes

1. https://www.plainlanguage.gov/examples/before-and-after/
2. These guidelines are adapted from plainlanguage.gov, where you can find more comprehensive and detailed recommendations to improve your written communication.

20. Guide to Group Work

Introduction to Group Work

This guide is intended to help you engage in successful group work, which is an important part of not just the college experience, but the workplace as well.

Watch Video 20.1: *Introduction to Group Work*. Closed captioning is available. Click HERE to read a transcript.

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Understanding the Team

Your group is most likely to be successful when you build a solid foundation for the work and stages that follow.

Watch Video 20.2: *Understanding the Team*. Closed captioning is available. Click HERE to read a transcript.

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Groups are most likely to be successful when members attend to both the climate within the group and the process by which they accomplish their tasks. Click on each item in the interactive lists below to learn more.

Skills for a Healthy Group Climate

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=822#h5p-142

Skills for an Effective Group Process

An interactive H5P element has been excluded from this version of the text. You can view it online here: https://pressbooks.library.virginia.edu/foundationsofcommerce/?p=822#h5p-143

Communicating Effectively

Regular open communication, in which group members share their thoughts, ideas and feelings, is a must for successful group work. Unspoken assumptions and issues can be very destructive to productive group functioning.

Effective communicators do the following:

- explain their ideas
- express their feelings in an open but non-threatening way
- listen carefully to others
- ask questions to clarify others' ideas and emotions
- sense how others feel based on their nonverbal communication
- initiate conversations about group climate or process if they sense tensions brewing
- reflect on the activities and interactions of their group and encourage other group members to do so as well

Watch Video 20.3: *Communicating Effectively*. Closed captioning is available. Click HERE to read a transcript.

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Planning the Project

There are a number of strategies and techniques for effective group project planning to help your group stay on track and meet deadlines. These include identifying and negotiating roles and learning about tools and approaches that can help you plan effectively.

Watch Video 20.4: *Planning the Project*. Closed captioning is available. Click HERE to read a transcript.

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Glossary

Accounting

The process of collecting, recording, classifying, summarizing, reporting, and analyzing financial activities.

Accounts payable

Amounts the firm owes for credit purchases due within a year. This account is the liability counterpart of accounts receivable.

Accounts receivable

Amounts owed to the firm by customers who bought goods or services on credit.

Accrued expenses

Expenses, typically for wages and taxes, that have accumulated and must be paid at a specified future date within the year although the firm has not received a bill.

Acid-test (quick) ratio

The ratio of total current assets excluding inventory to total current liabilities; used to measure a firm's liquidity.

Acquisitive growth

The growth of a company due to takeovers, acquisitions, or mergers.

Activity ratios

Ratios that measure how well a firm uses its assets.

Advertising

Paid communication designed to create an awareness of a product or company.

Angel investors

Wealthy, private individual seeking investment options with a greater potential return than is generally available with traditional publicly traded stocks.

Annual report

A yearly document that describes a firm's financial status.

Arenas

In strategy, where the firm will be active and with how much emphasis.

Assets

Things of value owned by a firm. They may be tangible, such as cash, equipment, and buildings, or intangible, such as a patent or trademarked name.

Attribution theory

The cognitive process by which people interpret the reasons or causes for their behavior.

Auditing

The process of reviewing the records used to prepare financial statements and issuing a formal auditor's opinion indicating whether the statements have been prepared in accordance with accepted accounting rules.

Autocratic leadership

Boss-centered, directive leadership.

Avoidance learning

Learning to behave in a certain way to avoid encountering an undesired or unpleasant consequence.

Balance sheet

A financial statement that summarizes a firm's financial position at a specific point in time.

Basic research

Involves efforts to build knowledge and understand principles and phenomena. It often precedes practical applications and is generally undertaken without immediate commercial goals.

Behavioral segmentation

Dividing consumers by such variables as attitude toward the product, user status, or usage rate.

Benefit corporation

A designation recognized by a majority of U.S. states for a for-profit corporation that is driven by both mission and profit.

Best-cost provider

A combination or hybrid strategy that combines elements of cost leadership and differentiation.

Board of directors

A group of people elected by the stockholders to handle the overall management of a corporation, such as setting major corporate goals and policies, hiring corporate officers, and overseeing the firm's operations and finances.

Bond

Long-term debt obligations (liabilities) issued by corporations and governments.

Bond ratings

Letter grades assigned to bond issues to indicate their quality or level of risk; assigned by rating agencies such as Moody's and Standard & Poor's (S&P).

Bonds

Long-term debt obligations (liabilities) of corporations and governments.

Bounded rationality

The idea that for complex issues, we cannot be completely rational because we cannot fully grasp all the possible alternatives, nor can we understand all the implications of every possible alternative.

Brand

An intangible asset with tangible value; made up of promotion efforts and customer meaning.

Brand equity

Added value generated by favorable consumer experiences with a product.

Brand value

The financial asset associated with a brand.

Breakthrough innovation

Seeks to solve problems that are well defined but exceptionally challenging to solve, often requiring knowledge and insights from seemingly unrelated domains.

Broker market

Consists of national and regional securities exchanges that bring buyers and sellers together through brokers on a centralized trading floor. The NYSE is a broker market.

Business

An organization that provides goods or services to consumers for the purpose of making a profit.

Business model

A plan for how venture will be funded; how the venture creates value for its stakeholders, including customers; how the venture's offerings are made and distributed to the end users; and how income will be generated through this process.

Business model canvas

Developed by Osterwalder and Pigneur, used to develop a business model for a venture, including nine blocks that are mapped out to address customer segments, customer relationships, channels, revenue streams, value propositions, key partners, key activities, key resources, and cost structure.

Business model innovation

Creating, adapting, or fundamentally changing the way a company delivers value to its customers and/or generates revenue/

Business plan

A formal document that typically describes the business and industry, market strategies, sales potential, and competitive analysis, as well as the company's long-term goals and objectives.

Buyer cooperative

A group of cooperative members who unite for combined purchasing power.

C corporation

A conventional or basic form of corporate organization. A corporation is a legal entity with an existence and life separate from its owners, who are not personally liable for the entity's debts. A corporation is chartered by the state in which it is formed and can own property, enter into contracts, sue and be sued, and engage in business operations under the terms of its charter.

Capital budgeting

The process of determining which long-term or fixed assets to acquire in an effort to maximize shareholder value.

Capital expenditures

A major expenditure that requires a large up-front investment and is expected to generate substantial cash inflow in return.

Career readiness

A foundation from which to demonstrate requisite core competencies that broadly prepare college students for success in the workplace and lifelong career management.

Cash

Funds on hand or in a bank.

Cash flow from financing activities

Cash flows related to debt and equity financing.

Cash flow from investment activities

Cash flows related to the purchase and sale of fixed assets.

Cash flow from operating activities

Cash flows related to the production of the firm's goods or services.

Cash flows

The inflows and outflows of cash.

Cash management

Making sure that enough cash is on hand to pay bills as they come due and to meet unexpected expenses.

Centralization

In organizational structure, where decision making is concentrated at the top of the organizational hierarchy.

Certificates of deposit

Savings products offered by banks and credit unions. You generally agree to keep your money in the CD without taking a withdrawal for a specified length of time. Withdrawing money early means paying a penalty fee to the bank.

Certified B Corporation

A certification by B Lab that requires companies to meet rigorous standards for transparency, accountability, and social and environmental performance.

Chain of command

The authority relationships among people working at different levels of the organization.

Channels

One of the nine elements of the business model canvas: how a company communicates with and reaches its customer segments to deliver its value propositions.

Circuit breakers

Procedures for coordinated cross-market trading halts if a severe market price decline reaches levels that may exhaust market liquidity. These procedures, known as market-wide circuit breakers, may halt trading temporarily or, under extreme circumstances, close the markets before the normal close of the trading session.

Clustering

In marketing, combining segmenting criteria.

Coercive power

The power a person has because people believe that the person can punish them by inflicting pain or by withholding or taking away something that they value.

Cohesion

The degree of camaraderie within a team.

Commercial paper

Unsecured short-term debt—an IOU—issued by a financially strong corporation.

Common stock

A security that represents an ownership interest in a corporation.

Compound interest

The continual addition of interest to the original principal sum of a loan or deposit, often referred to as interest on interest.

Compounding

The process that takes a present valuation of money to some point in the future.

Confirmation bias

The tendency to pay more attention to information that confirms our existing beliefs and less attention to information that is contrary to our beliefs.

Convertible bonds

Bonds that allow the bondholder to exchange each bond for a specified number of shares of common stock.

Cooperative corporation

A legal entity typically formed by people with similar interests, such as suppliers or customers, to reduce costs and gain economic power. A cooperative has limited liability, an unlimited life span, an elected board of directors, and an administrative staff; all profits are distributed to the member-owners in proportion to their contributions.

Corporate social responsibility (CSR)

The practice in which a business views itself within a broader context, as a member of society with certain implicit social obligations and responsibility for its own effects on environmental and social well-being.

Cost leadership

A strategy in which the focus is on minimizing costs, which often results using product price as a competitive edge.

Cost of goods sold

The total expense of buying or producing a firm’s goods or services.

Cost structure

One of the nine elements of the business model canvas: costs incurred to operate your business model.

Coupon rate

The amount of annual interest paid by the bond issuer; is multiplied by the face value of a bond to determine annual interest or coupon payment amounts.

Creativity

Generating and developing original ideas.

Current assets

Assets that can or will be converted to cash within the next 12 months.

Current liabilities

Short-term claims that are due within a year of the date of the balance sheet.

Current portion of long-term debt

Any repayment on long-term debt due within the year.

Current ratio

The ratio of total current assets to total current liabilities; used to measure a firm's liquidity.

Customer division

A divisional departmentalization based on customer segments.

Customer relationships

One of the nine elements of the business model canvas: the types of relationships a company establishes with its customer segments.

Customer segments

One of the nine elements of the business model canvas: the different groups of people or organizations a company aims to reach and serve.

Customer-relationship management

A marketing strategy that focuses on using information about current customers to nurture and maintain strong relationships with them.

Dealer markets

In contrast to broker markets, buyers and sellers do not trade securities directly. Instead they work through securities dealers called market makers, who make markets in one or more securities and offer to buy or sell securities at stated prices. A security transaction in the dealer market has two parts: the selling investor sells his or her securities to one dealer, and the buyer purchases the securities from another dealer (or in some cases, the same dealer). The NASDAQ is a dealer market.

Debt financing

Borrowing funds that must be repaid, usually with interest.

Debt ratios

Ratios that measure the degree and effect of a firm's use of borrowed funds (debt) to finance its operations.

Debt-to-equity ratio

The ratio of total liabilities to owners' equity; measures the relationship between the amount of debt financing (borrowing) and the amount of equity financing (owner's funds).

Decentralization

In organizational structure, where decision making is delegated to lower-level employees.

Default risk

The risk that the issuer of a financial security will be unable to make payments as specified in the terms of a financial contract.

Delegation

The process of entrusting work to subordinates.

Demographic segmentation

Divides the market into groups based on such variables as age, marital status, gender, ethnic background, income, occupation, and education.

Departmentalization

Grouping specialized jobs into meaningful units.

Depreciation

The allocation of the asset's original cost to the years in which it is expected to produce revenues.

Design thinking

A technique for creative problem-solving that involves keeping the user at the center of everything and is focused around asking different questions and looking at problems in new ways. It involves empathizing, defining, ideating, prototyping, and testing.

Designated leaders

Leaders who are put into positions of leadership by formal processes; designated leaders also known as formal leaders.

Differentiation

A strategy that involves offering a unique product that is in some way different than other offerings.

Differentiators

In strategy, the things that are unique to a firm.

Discount rate

The interest rate used to determine the present value of future cash inflows; may derive from several sources, such as stated contract rates, costs to borrow, or expected rates of return on investments.

Discounting

The process that takes a future value of money and equates it to present dollar value terms.

Disruptive innovation

"Describes a process by which a product or service initially takes root in simple applications at the bottom of a market—typically by being less expensive and more accessible—and then relentlessly moves upmarket, eventually displacing established competitors."

Christensen Institute. (n.d.) *Disruptive innovation.* Retrieved March 8, 2024, from https://www.christenseninstitute.org/disruptive-innovations/

Distributive justice

One type of organizational justice, which refers to the perceived fairness of outcomes.

Diversifiable risk

Also called unsystematic risk, a risk that can be eliminated without the loss of expected return by holding a portfolio of securities.

Diversification

Holding a variety of assets in a portfolio, in order to manage risk.

Diversity

Identity-based differences among and between people that affect their lives as applicants, employees, and customers.

Dividends

Payments to stockholders from a corporation's profits.

Divisional organization

A form of departmentalization in which each division contains most of the functional areas (production, marketing, accounting, finance, human resources); in other words, divisions are similar to stand-alone companies, and they function relatively autonomously.

Double-entry bookkeeping

A method of accounting in which each transaction is recorded as two entries so that two accounts or records are changed.

Early stage

Company lifecycle stage in which the product or service has begun development.

Earnings per share (EPS)

The ratio of net profit to the number of shares of common stock outstanding; measures the number of dollars earned by each share of stock.

Economic logic

How a firm makes money above its cost of capital.

Economies of scale

A situation where producing more of a product (or service) results in a lower per-unit cost, as a result of fixed costs spread over more units, volume discounts, or both.

Economies of scope

A situation where producing one product (or service) reduces the cost of producing a different product (or service), as a result of sharing resources or operations.

Emergent leaders

Leaders who emerge from the dynamics and processes that unfold within and among a group of individuals as they endeavor to achieve a collective goal.

Emotional intelligence

The capability of individuals to recognize their own emotions and others' emotions.

Empowerment

In individuals, autonomy and discretion to make their own decisions, as well as control over the resources needed to implement those decisions.

Entrepreneur

Someone who identifies and acts on an idea or problem that no one else has identified or acted on in quite the same way.

Entrepreneurial opportunity

The point at which identifiable consumer demand meets the feasibility of satisfying the requested product or service and meets the following conditions: significant market demand, significant market structure and size, significant margins, and resources to support the venture's success.

Equity financing

Funds provided in exchange for a share of ownership in a business.

Equity theory

A theory of motivation that holds that worker satisfaction is influenced by employees' perceptions about how fairly they are treated compared with their coworkers.

Escalation of commitment

The tendency of decision makers to remain committed to poor decision, even when doing so leads to increasingly negative outcomes.

Ethics

Principles or standards of behavior to which we hold ourselves.

Exchange-traded fund (ETF)

A security similar to a mutual fund; holds a broad basket of stocks with a common theme but trades on a stock exchange so that its price changes throughout the day.

Expectancy

In expectancy theory, the link between effort and performance, which refers to the strength of the individual's expectation that a certain amount of effort will lead to a certain level of performance.

Expectancy theory

A theory of motivation that holds that the probability of an individual acting in a particular way depends on the strength of that individual's belief that the act will have a particular outcome and on whether the individual values that outcome.

Expenses

The costs of generating revenues.

Expert power

The power a person has because others believe that the person has and is willing to share expert knowledge that they need.

External locus of control

A tendency for individuals to attribute things that happen to them as being caused by someone or something else.

Externality

Occurs when an exchange between two parties (where a party can be an individual or organization) has an impact on a third party who is not part of the exchange. An externality, which is sometimes also called a spillover, can have a negative or a positive impact on the third party.

Extinction

The principle that suggests that undesired behavior will decline as a result of a lack of positive reinforcement.

Extrinsic rewards

Rewards that come from outside the individual—things like pay raises, promotions, bonuses, and prestigious assignments.

Finance

Planning for, obtaining, and managing a company's funds.

Financial accountants

Responsible for preparing financial statements to help users, both inside and outside the organization, assess the financial strength of the company.

Financial accounting

Accounting that focuses on preparing external financial reports that are used by outsiders such as lenders, suppliers, investors, and government agencies to assess the financial strength of a business.

Financial management

The art and science of managing a firm's money so that it can meet its goals.

Financial risk

The chance that the firm will be unable to make scheduled interest and principal payments.

Financing

Raising money for an intended purpose.

Fixed assets

Long-term assets used by the firm for more than a year.

Fixed costs

Costs that do not change regardless of the level of production.

Flat

In organizational structure, when an organization has only a few layers of management.

Focus group

A small group, typically 8 to 12 people, who are asked several questions by a moderator and encouraged to build upon each other's responses.

Focused differentiation

A strategy in which a differentiated product is marketed to a narrow market.

Focused low-cost

A low-cost, narrowly-focused market strategy in which a company focuses on a specific segment, such as a particular buyer segment or a particular geographic segment.

Formal leadership

A leadership role that is officially recognized.

Forming stage

The first stage of team development—the positive and polite stage.

Fraud

the act of intentionally deceiving a person or organization or misrepresenting a relationship in order to secure some type of benefit, either financial or nonfinancial.

Fraud triangle

The three factors that increase the likelihood of an individual committing fraud, as well as other forms of ethical violations; these factors are pressure, opportunity, and rationalization.

Free-rein leadership

Subordinate-centered, hands-off leadership. Also called laissez-faire leadership.

Frontline managers

Managers at the lowest level of management who report to middle managers; they coordinate activities, supervise employees, and are involved in day-to-day operations.

Functional organization

A form of departmentalization that groups together people who have comparable skills and perform similar tasks.

Fundamental attribution error

The tendency to underestimate the effects of external or situational causes of behavior and to overestimate the effects of internal or personal causes.

Funds

Financial resources for acquiring assets.

Future value (FV)

The value that a current amount will grow to at a given interest rate over a given period of time.

General and administrative expenses

Business expenses that cannot be linked to either cost of goods sold or sales. Examples of general and administrative expenses are salaries of top managers and office support staff; utilities; office supplies; interest expense; fees for accounting, consulting, and legal services; insurance; and rent.

Generally accepted accounting principles (GAAP)

The financial accounting standards followed by accountants in the United States when preparing financial statements.

Generic branding

When the maker attaches no branding information to a product except a description of its contents.

Generic strategies

Strategies that can be applied to any size or form of business: cost leadership and differentiation. These can take either a broad or narrow scope, giving rise to four primary options: cost leadership, focused low cost, broad differentiation, and focused differentiation.

Geographic segmentation

Dividing a market according to such variables as climate, region, and population density (urban, suburban, small-town, or rural).

Geographical division

A divisional departmentalization based on geographical location.

Giving Voice to Values (GVV)

An approach to values-driven leadership development that helps you learn how to effectively act on your values and ethical principles in the context of your professional responsibilities.

Goal-setting theory

A theory of motivation based on the premise that an individual's intention to work toward a goal is a primary source of motivation.

Goods

Tangible items manufactured by businesses.

Greenwashing

Carrying out superficial CSR efforts that merely cover up systemic ethics problems for the sake of public relations.

Gross profit

The amount a company earns after paying to produce or buy its products but before deducting operating expenses.

Gross sales

The total dollar amount of a company's sales.

Ground rules

Basic rules or principles of conduct that govern a situation or endeavor.

Groupthink

The tendency to conform to team pressure in making decisions, while failing to think critically or to consider outside influences.

Growth rate

The percentage increase of a specific variable within a specific time period; synonymous with interest rate in the context of the time value of money.

In-group

A group that we identify with or see ourselves as belonging to.

Income statement

A financial statement that summarizes a firm's revenues and expenses and shows its total profit or loss over a period of time.

Income taxes payable

Taxes owed for the current operating period but not yet paid. Taxes are often shown separately when they are a large amount.

Inflation risk

The risk of reduced purchasing power of goods and services due to rising prices.

Informal leadership

Leadership that is exhibited without an official position.

Informational power

The power a person has because they have access to or control over valuable information.

Initial public offering (IPO)

Process by which a company lists its ownership shares on a public stock exchange.

Innovation

A new idea, product, service, process, or business model, or a change to an existing product, service, process, or business model.

Insider trading

The use of information that is not available to the general public to make profits on securities transactions.

Institutional investors

Investment professionals who are paid to manage other people's money.

Instrumentality

In expectancy theory, the link between performance and outcome, which refers to the strength of the expectation that a certain level of performance will lead to a particular outcome.

Intangible asset

A nonphysical resource that provides advantages.

Intangible assets

Long-term assets with no physical existence, such as patents, copyrights, trademarks, and goodwill.

Interactional justice

One type of organizational justice, which refers to the manner in which an employee is treated.

Interest

The amount of money that is paid by a borrower to a lender for the use of their money, typically calculated from an annualized rate.

Internal locus of control

A tendency for individuals to attribute their successes and failures to their own abilities and efforts.

Intrinsic rewards

Rewards that come from within the individual—things like satisfaction, contentment, sense of accomplishment, confidence, and pride.

Inventory

Stock of goods being held for production or for sale to customers.

Inventory turnover ratio

The ratio of cost of goods sold to average inventory; measures the speed with which inventory moves through a firm and is turned into sales.

Investment bankers

Firms that act as intermediaries, buying securities from corporations and governments and reselling them to the public.

Jargon

Unnecessarily complicated language used to impress, rather than to inform, your audience.

Job satisfaction

The degree to which individuals enjoy their job.

Junk bonds

High-risk, high-return bonds often used by companies whose credit characteristics would not otherwise allow them access to the debt markets.

Key activities

One of the nine elements of the business model canvas: the most important things a company must do to make its business model work.

Key partnerships

One of the nine elements of the business model canvas: the network of suppliers and partners that make the business model work.

Key resources

One of the nine elements of the business model canvas: the most important assets required to make a business model work.

Leadership

The process of guiding and motivating others toward the achievement of organizational goals.

Legal compliance

The extent to which a company conducts its business operations in accordance with applicable regulations, statutes, and laws.

Legitimate power

The power a person has because others believe that the person possesses the "right" to influence them and that they ought to obey.

Liabilities

What a firm owes to its creditors; also called debts.

Limited liability company (LLC)

A hybrid organization that offers the same liability protection as a corporation but may be taxed as either a partnership or a corporation.

Limited liability partnership

Similar to a general partnership except that partners are not held responsible for the business debt and liabilities.

Limited partnership

A partnership with one or more general partners, who have unlimited liability, and one or more limited partners, whose liability is limited to the amount of their investment in the company.

Liquidity

The speed with which assets can be turned into cash.

Liquidity ratios

Ratios that measure a firm's ability to pay its short-term debts as they come due.

Long-term liabilities

Claims that come due more than one year after the date of the balance sheet.

Macro environment

Aspects of a company's external environment that can impact the business but over which the company generally has little direct control, such as the economy and political activity.

Maintenance needs

Needs related to interpersonal interactions and relationships. For instance, a leader attending to maintenance needs may help manage conflict or decision-making by reducing tension and encouraging full participation.

Management

The process of guiding the development, maintenance, and allocation of resources to attain organizational goals.

Managerial accountants

Responsible for preparing information, such as reports on the cost of materials used in the production process, for internal use only.

Managerial Accounting

Accounting that provides financial information that managers inside the organization can use to evaluate and make decisions about current and future operations.

Manufacturer branding

When a company sells products under its own brand names.

Market segments

Groups of potential customers with common characteristics that influence their buying decisions.

Marketable securities

Temporary investments of excess cash that can readily be converted to cash.

Marketing

The process of creating, communicating, and delivering offerings that have value for customers.

Marketing concept

The philosophy that firms should analyze the needs of their customers and then make decisions to satisfy those needs while achieving organizational goals.

Marketing mix

The four key elements—product, price, place, and promotion—that shape the development and execution of marketing objectives to reach a target market.

Marketing research

The process of collecting and analyzing the data that are relevant to a specific marketing situation.

Mass market

A large group of customers with generally similar problems and needs.

Matrix structure

A form of departmentalization that combines elements of functional and divisional structures.

Mature stage

Company lifecycle stage in which the business has reached commercial viability

Middle managers

Managers who report to top management and oversee the activities of frontline managers. Their responsibilities include allocating resources and developing and implementing activities.

Mortgage bonds

Bonds secured by property such as land, buildings, or equipment.

Mortgage loan

A long-term loan made against real estate as collateral.

Motivation

The set of forces that prompt a person to release energy, or exert effort, in a certain direction.

Multi-branding

Assigning different brand names to products covering different segments of the market.

Multiproduct-branding

Selling many products under one brand name.

Municipal bonds

Bonds issued by states, cities, counties, and other state and local government agencies.

Mutual fund

A financial-service company that pools investors' funds to buy a selection of securities that meet its stated investment goals.

Narrow span of control

A span of control with few direct reports.

National Association of Securities Dealers Automated Quotation system (NASDAQ)

The first and largest electronic stock market, which is a sophisticated telecommunications network that links dealers throughout the United States.

Need

The gap between what is and what is required.

Negative reinforcement

Removing an undesirable consequence to encourage desired behavior.

Net loss

The amount obtained by subtracting all of a firm's expenses from its revenues, when the expenses are more than the revenues.

Net profit (or net income)

The amount obtained by subtracting all of a firm's expenses from its revenues, when the revenues are more than the expenses.

Net profit margin

The ratio of net profit to net sales; also called return on sales. It measures the percentage of each sales dollar remaining after all expenses, including taxes, have been deducted.

Net sales

The amount left after deducting sales discounts and returns and allowances from gross sales.

Net working capital

The amount obtained by subtracting total current liabilities from total current assets; used to measure a firm's liquidity.

New York Stock Exchange (NYSE)

The oldest and most prestigious broker market, which has existed since 1792 and is located on Wall Street in downtown New York City.

Niche market

A specific, specialized customer segment with problems or needs that differ from other customer segments.

Non-diversifiable risk

Risk that cannot be eliminated by simply holding a portfolio of securities; also known as systematic risk.

Nonprofit corporations

An organization formed to serve some public purpose rather than for financial gain. Nonprofits whose activity is for charitable, religious, educational, scientific, or literary purposes can be exempt from paying income taxes.

Norming stage

The third stage of team development—when team resolves its differences and begins making progress.

Not-for-profit

An organization that exists to achieve some goal other than the usual business goal of profit.

Notes payable

Formal short-term borrowings usually evidenced by a specific written promise to pay.

Notes receivable

Amounts owed to the firm by customers or others to whom it lent money; typically longer-term than accounts receivable and includes interest.

Open innovation

An approach in which organizations actively seek external insights and ideas.

Operating expenses

The expenses of running a business that are not directly related to producing or buying its products.

Operations management

The business function that designs and oversees the transformation of resources into goods or services.

Organic growth

The growth rate of a company excluding takeovers, acquisitions, or mergers.

Organizational chart

A diagram delineating the interrelationships of positions within the organization.

Organizational justice

Employee perceptions of fairness in the workplace, encompassing three distinct forms of justice: distributive (fair outcomes), procedural (fair process), and interactional (the manner in which a person is treated).

Organizational structure

the various roles within an organizational, which positions report to which, and how an organization will departmentalize its work

Out-group

A group that we don't belong to and that we view as fundamentally different from us.

Owners' equity

The total amount of investment in the firm minus any liabilities; also called net worth.

Par value

Also called face amount or face value. This is equal to the principal amount that the issuer will repay at the end of the bond term or maturity date.

Partnership

An association of two or more individuals who agree to operate a business together for profit.

Performing stage

The fourth stage of team development—when hard work leads to the achievement of the team's goal.

Personal interviews

An interview that happens on an individual level between researcher and respondent.

Personal selling

One-on-one communication with customers or potential customers.

Place

Where a product is purchased.

Plain language

Communication your audience can understand the first time they read or hear it.

Political risk

The risk of local, state, or national governments "changing the rules" and disrupting firm cash flows.

Pooled interdependence

When team members may work independently and simply combine their efforts to create the team's output.

Portfolio

A collection of financial investments, such as stocks, bonds, mutual funds, certificates of deposit, etc.

Positive reinforcement

A desirable consequence that satisfies an active need or that removes a barrier to need satisfaction.

Power

The ability to influence others.

Preferred stock

An equity security for which the dividend amount is set at the time the stock is issued and the dividend must be paid before the company can pay dividends to common stockholders.

Present value (PV)

The current value of a future amount, calculated by discounting the future value back at a known discount or interest rate for a specified period of time.

Price

What a consumer pays in exchange for a product.

Primary data

New information that is collected by the researcher with the current project in mind.

Primary market

The securities market where new securities are sold to the public.

Principal

The amount borrowed by the issuer of a bond; also called par value.

Private accountants

Accountants who are employed to serve one particular organization.

Private branding

When a company makes a product and sells it to a retailer who in turn resells it under its own name.

Procedural justice

One type of organizational justice, which refers to the fairness of the process used to determine outcomes.

Process division

A divisional departmentalization based on distinct stages of the production process.

Process innovation

The implementation of a new or significantly improved production or delivery method.

Product

The good or service that a company provides.

Product division

A divisional departmentalization based on product lines.

Product Innovation

The development of a new product, an improvement in the performance of the existing product, or a new feature to an existing product.

Product-market fit

The degree to which a product satisfies a strong market demand.

Profession

An occupation that involves mastery of complex knowledge and skills through prolonged training, education, or practical experience.

Professionalism

Understanding and demonstrating effective work habits and acting in the interest of the larger community and workplace.

Profit

The money left over after all costs are paid.

Profitability ratios

Ratios that measure how well a firm is using its resources to generate profit and how efficiently it is being managed.

Promotion

Comprised of advertising, sales, and other communication efforts the company utilizes to attract customers.

Promotion mix

Tactics marketers use to communicate with the customer.

Psychographic segmentation

Classifies consumers on the basis of individual lifestyles as they're reflected in people's interests, activities, attitudes, and values.

Public accountants

Independent accountants who serve organizations and individuals on a fee basis.

Public company

A company that is subject to public reporting requirements and whose securities trade on public markets.

Public relations

Any actions that help to create and maintain a favorable public image.

Publicity

Notice or attention given by the media.

Punishment

Anything that decreases a specific behavior.

Ratio analysis

The calculation and interpretation of financial ratios using data taken from the firm's financial statements in order to assess its condition and performance.

Reciprocal interdependence

Occurs when two or more team members depend on one another for inputs.

Referent

Another person, used for comparison purposes.

Referent power

The power a person has because others want to associate with or be accepted by them.

Reinforcement theory

A theory of motivation that holds that people do things because they know that certain consequences will follow.

Restructuring

Altering existing organizational structures to become more competitive once conditions have changed.

Retained earnings

The amounts left over from profitable operations since the firm's beginning; equal to total profits minus all dividends paid to stockholders.

Return

In finance, the opportunity for profit.

Return on equity (ROE)

The ratio of net profit to total owners' equity; measures the return that owners receive on their investment in the firm.

Revenue

The money a company receives by providing services or selling goods to customers.

Revenue streams

One of the nine elements of the business model canvas: the ways a company generates cash from customer segments.

Revenues

The dollar amount of a firm's sales plus any other income it received from sources such as interest, dividends, and rents.

Reward

Anything that increases a specific behavior.

Reward power

The power a person has because people believe that they can bestow rewards or outcomes, such as money or recognition that others desire.

Risk

The potential to lose time and money or otherwise not be able to accomplish an organization's goals.

Risk (finance)

In finance, the potential for loss, or the chance that an investment will not achieve the expected level of return.

Risk-return tradeoff

A basic principle in finance which states that the higher the risk, the greater the return that is required.

S corporation

A hybrid entity that is organized like a corporation, with stockholders, directors, and officers, but taxed like a partnership, with income and losses flowing through to the stockholders and taxed as their personal income.

Sales promotion

Promotion that creates an incentive to purchase; provides for a fairly immediate increase in sales in the short term.

SCAMPER technique

A technique for creative brainstorming that draws on existing products, services, and business models. It involves substituting, combining, adapting, modifying, putting to other uses, eliminating, and/or rearranging.

Secondary data

Any research or data that was completed or collected, within the organization or outside of the organization, for another purpose.

Secondary market

The securities market where old (already issued) securities are bought and sold, or traded, among investors; includes broker markets, dealer markets, the over-the-counter market, and the commodities exchanges.

Secured loans

Loans that require the borrower to pledge specific assets as collateral, or security.

Securities

Investment certificates that represent either equity (ownership in the issuing organization) or debt (a loan to the issuer).

Securities and Exchange Commission (SEC)

The SEC is an independent federal agency, established pursuant to the Securities Exchange Act of 1934, whose mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."

Seed Stage

Company lifecycle stage in which the business is largely still an idea.

Self-fulfilling prophecy

An expectation held by a person that alters their behavior in a way that tends to make it true.

Self-serving bias

The tendency for individuals to attribute their successes to their own actions while attributing their failures to others.

Seller cooperative

A group made up of individual producers who join together to compete more effectively with large producers.

Selling expenses

Related to marketing and distributing the company's products. They include salaries and commissions paid to salespeople and the costs of advertising, sales supplies, delivery, and other items that can be linked to sales activity, such as insurance, telephone and other utilities, and postage.

Sequential interdependence

Exists when the outputs of one team member becomes the inputs for another.

Service innovation

Introducing new services or improving the delivery of existing services.

Services

Intangible offerings of businesses that can't be held, touched, or stored.

Short-term expenses

Outlays used to support current production and selling activities.

Showrooming

The process that occurs when a customer visits a brick-and-mortar store to check out a product in person and then goes home to order it online.

Similar-to-me bias

The tendency to prefer the familiar, specifically people that look and think like us.

Slotting fees

Allowances paid by a manufacturer to a retailer to secure space on store shelves.

Social loafing

The tendency of individuals to put in less effort when working in a group context.

Social media marketing

Using social media platforms, such as Facebook, Instagram, LinkedIn, and TikTok, to deliver content that drives engagement with your brand

Social or (interpersonal) influence

The ability to effect a change in the motivation, attitudes, and/or behaviors of others.

Sole proprietorship

A business that is established, owned, operated, and often financed by one person.

Span of control

The number of people reporting to a particular manager.

Specialization

Organizing activities into clusters of related tasks that can be handled by certain individuals or groups.

Staging and pacing

The sequence and speed of strategic moves.

Stakeholders

Those with a legitimate interest in the success or failure of the business and the policies it adopts; include customers, clients, employees, shareholders, communities, the environment, the government, and the media, among others.

Statement of cash flows

A financial statement that provides a summary of the money flowing into and out of a firm during a certain period, typically one year.

Stereotype

A widely held generalization about a group of people. Stereotyping is a process in which attributes are assigned to people solely on the basis of their class or category. It is particularly likely to occur when one meets new people, since very little is known about them at that time.

Stock dividends

Dividend payments in the form of more stock.

Stockbroker

A person who is licensed to buy and sell securities on behalf of clients.

Storming stage

The second stage of team development—when people are pushing against the boundaries.

Strategy

Making choices about what an organization will and won't do to achieve goals and competitive advantage.

Strategy diamond

A framework for checking and communicating strategy, made up of arenas, differentiators, economic logic, vehicles, and staging and pacing.

Surveys

Also known as a questionnaire, a series of several questions that can collect a variety of qualitative and quantitative data.

Sustainability

The capacity to maintain or improve the state and availability of desirable materials or conditions over the long term.

Sustaining innovation

Also referred to as incremental innovation; involves making small-scale improvements to existing products, services, processes, and business models.

Tall

In organizational structure, when an organization has many layers of management.

Tangible asset

Something of value that physically exists.

Target market

Group of people with some shared characteristics that a company has identified as potential customers for its products.

Task interdependence

In teams, the degree that team members are dependent on one another to get information, support, or materials from other team members to be effective.

Task needs

Needs related to task completion or goal achievement. For instance, a leader attending to task needs may help analyze problems, distribute assignments, gather information, make sure everyone is heard from, keep the group focused, and facilitate the group reaching a consensus or final recommendations.

Term loan

A business loan with a maturity of more than one year.

Time value of money (TVM)

The concept that an amount of money is worth more today than the exact same amount of money at some point in the future.

Top managers

The highest level of management which is responsible for setting objectives; scanning the environment for opportunities and threats; and planning and decision making.

Treasury bills

Short-term debt obligations of one year or less issued by the US government.

Triple bottom line (TBL)

A measure that accounts for an organization's results in terms of its effects on people (social), the planet (environmental), and profits (economic).

Turnover

The rate at which workers who leave an organization and must be replaced.

Underwriting

The process of buying securities from corporations and governments and reselling them to the public; the main activity of investment bankers.

Unity of command

Occurs when each employee reports to only one supervisor.

Unsecured loans

Loans that do not require assets as security and that are are made on the basis of the firm's creditworthiness and the lender's previous experience with the firm.

Valence

In expectancy theory, the outcome, which refers to the degree to which the individual expects the anticipated outcome to satisfy personal needs or wants. Some outcomes have more valence, or value, for individuals than others do.

Valuation

Estimate of a company's worth.

Value proposition

One of the nine elements of the business model canvas: the products and services and their attributes that create value for customer segments.

Variable costs

Costs that increase or decrease based on the level of production.

Vehicles

In strategy, how a company will achieve its objectives; for example, internal development versus acquisitions.

Venture capital

Financing obtained from venture capitalists, investment firms that specialize in financing small, high-growth companies and receive an ownership interest and a voice in management in return for their money.

Venture capitalist

Individual or investment firm that specializes in funding startup companies.

Volatility

Fluctuations in a security or index over time.

Want

The gap between what is and what is desired.

Wide span of control

A span of control with many direct reports.