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INTRODUCTION TO BUSINESS

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Email: studypacks@icap.org.pk
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CHAPTER 1

NATURE OF BUSINESS

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1 Understanding nature of business

SELF-TEST

AT A GLANCE

Understanding the basic structures, organization, and key forces are important for the survival and success of a business.

In a fast-changing environment, the change is the only constant. Those businesses which understand the functioning of major variables influencing its growth and profitability, will succeed in long-run.

This chapter will focus on key elements of understanding the nature of business such as:

- Purpose - profit and not-for-profit
- Vision, mission, goals and objectives
- Factors of productions
- Stakeholders – internal and external

1. UNDERSTANDING NATURE OF BUSINESS

1.1. The nature of business

A business is an organization that strives for **profit** by providing goods and services desired by its customers. Businesses meet the needs of consumers by providing household essentials, clothing, medical care, transportation, banking, communication, and countless other goods and services.

Goods are tangible items, that can be held, touched, or stored, manufactured or traded by businesses, such as laptops.

Services are intangible offerings of businesses that can't be held, touched, or stored. Physicians, lawyers, hairstylists, car washes, and airlines all provide services.

Businesses also sell or serve to other organizations, such as hospitals, retailers, and governments, by providing machinery or goods for resale, computers, and thousands of other items.

Thus, businesses create the goods and services that are the basis of our standard of living. The standard of living of any country is measured by the output of goods and services people can buy with the money they have. This provides a basis for comparing standard of living among different countries.

Businesses play a key role in determining our quality of life by providing jobs and **goods and services** to society. Quality of life refers to the general level of human happiness based on such things as life expectancy, educational standards, health, sanitation, and leisure time. Building a high quality of life is a combined effort of businesses, government, and not-for-profit organizations (explained later). Different places are ranked and compared based on the quality of life standards.

The profitability of a business can be measured through key variables such as revenue, costs, and profit.

Revenue is the money a company receives by providing services or selling goods to customers.

Costs are expenses for rent, salaries, supplies, transportation, and many other items that a company incurs from creating and selling goods and services. For example, some of the costs incurred by Microsoft in developing its software include expenses for salaries, facilities, and advertising. If Microsoft has money left over after it pays all costs, it has a **profit**. A company whose costs are greater than revenues incur a **loss**. There is always a risk that a business may incur a loss by not achieving its goals due to inefficient use of its resources and/or ineffective business strategies to fight against market competition.

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. There is a direct relationship between risks and profit: the greater the risks, the greater the potential for profit (or loss).

Not-for-Profit Organisations

Not all organizations strive to make a profit. A **not-for-profit** organization is an organization that exists to achieve some goal other than the usual business goal of profit. Charities such as the Edhi Foundation and The Citizens Foundation are not-for-profit organizations, as are most hospitals, educational institutes, social work organizations, non-governmental organisations (NGOs), civic groups, and religious organizations.

Like their for-profit counterparts, these groups set goals and require resources to meet those goals. However, their goals are not focused on profits. For example, a not-for-profit organization's goal might be feeding the poor, preserving the environment or advocating for the rights of some underprivileged community.

1.2. Purpose of a business

The primary goal of all businesses is to earn a profit. Businesses have the right to keep and use their profits as they choose—within legal limits—because profit is the reward for the risks business take in providing products (i.e. goods and services). Earning profits contributes to society by providing employment, which in turn provides money that is reinvested in the economy. In addition, profits must be earned in an ethical and socially responsible manner.

To earn a profit, a person or organization needs management skills to plan, organize, and control the activities of the business and to find and develop employees so that it can make products consumers will buy. A business also needs marketing expertise to learn what products consumers need and want and to develop, manufacture, price, promote, and distribute those products. Additionally, a business needs financial resources and skills to fund, maintain, and expand its operations. Other challenges for businesspeople include abiding by laws and government regulations; acting in an ethical and socially responsible manner; and adapting to economic, technological, political, and social changes. Even nonprofit organizations engage in management, marketing, and finance activities to help reach their goals.

To achieve and maintain profitability, businesses have found that they must produce quality products, operate efficiently, and be socially responsible and ethical in dealing with customers, employees, investors, government regulators, and the community. Because these groups have a stake in the success and outcomes of a business, they are sometimes called stakeholders. Many businesses, for example, are concerned about how the production and distribution of their products affect the environment.

As part of a strategic review, management should always re-consider the purpose of the entity that they manage, what it is trying to achieve. In the strategic planning process, goals, objectives and strategies should be decided with the aim of fulfilling the entity's purpose. A business entity should have a hierarchy of aims and plans. A useful way of presenting this is shown below.

Future Outlook	**Vision**
Overall purpose	**Mission**
General overall aims	**Goals**
Specific overall aims	**Objectives**
Detailed longer-term targets	**Strategies and Strategic aims**
Implementation targets and budgets	**Tactical plans and aims**
Action plans and targets	**Operational plans and aims**

An important aspect of managing business is creating purpose and providing clear messaging to stakeholders. This can be done by the creation of a mission statement and a vision statement.

Vision and Vision Statement

A vision statement has more to do with the future and really describes what an organization plans or hopes to be in the future. This is more of an inspirational or motivational statement that is meant to drive employees and also clearly demonstrate an organizations' goals to stakeholders (customers, investors, etc.).

A vision statement shouldn't really discuss the present state of the organization but more what the organization wants to be and how it wants to be viewed. To be effective the message should be clear, optimistic, and of course realistic. An unrealistic vision statement, i.e. a corner store owner saying that in six months the company will be bigger than Walmart, won't be motivating or inspirational but end up being comical.

A well-written vision statement should be short, simple, specific to the business, leave nothing open to interpretation.

- *For example:*

Habib Bank's vision statement:

"Enabling people to advance with confidence and success".

(https://www.hbl.com/about-us/our-brand)

Coca Cola's vision statement:"Our vision serves as the framework for our Roadmap and guides every aspect of our business by describing what we need to accomplish in order to continue achieving sustainable, quality growth.

People: Be a great place to work where people are inspired to be the best they can be.

Portfolio: Bring to the world a portfolio of quality beverage brands that anticipate and satisfy people's desires and needs.

Partners: Nurture a winning network of customers and suppliers, together we create mutual, enduring value.

Planet: Be a responsible citizen that makes a difference by helping build and support sustainable communities.

Profit: Maximize long-term return to shareowners while being mindful of our overall responsibilities.

Productivity: Be a highly effective, lean and fast-moving organization."

(https://www.coca-cola.com.sg/our-company/mission-vision-values)

Mission: A mission is the purpose of an organization and the reason for its existence. Many entities give a formal expression to their mission in a mission statement. A mission statement defines what an organization is, why it exists, its reason for being.

'A mission describes the organization's basic function in society, in terms of the products and services it produces for its customers' (Mintzberg).

A mission statement has a more 'present day' focus and really describes how a company plans on achieving its objectives. This is really a statement to employees, shareholders, and others with an interest in the organization that clearly articulates what an organization is doing, how it's going to do it, and ultimately why it's doing it.

For many small businesses this can seem like a trivial item but large organizations spend countless hours, meetings and dollars considering their mission statement and its significance. Changing a company's mission statement can be a major undertaking with numerous consultations and even external advisors being hired. For any growing business this should underline the significance of creating an effective mission statement, particularly when it's not part of the business model (or not possible) for the owner to personally convey the companies' mission to everyone.

A mission statement should be a clear and short statement. The key questions to answer in a mission statement include:

- What is our business?
- What is our value to the customer?
- What will our business be?
- What should our business be?

Some entities include a statement about the role of their employees in their mission statement, or include a statement on the ethics of the entity.

- *For example:*

  Habib Bank's mission statement:

  "To make our customer prosper, our staff excel and create value for shareholders".

  (https://www.hbl.com/about-us/our-brand)

  Coca Cola's mission statement:

  "Our Roadmap starts with our mission, which is enduring. It declares our purpose as a company and serves as the standard against which we weigh our actions and decisions.

  To refresh the world...

  To inspire moments of optimism and happiness...

  To create value and make a difference."

  (https://www.coca-cola.com.sg/our-company/mission-vision-values)

- *Example:*

  The World Bank – Mission statement

  - 'Our dream is a world free of poverty
  - To fight poverty with passion and professionalism for lasting results.
  - To help poor people help themselves and their environment, by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors.
  - To be an excellent institution able to attract, excite and nurture diverse and committed staff with exceptional skills who know how to listen and learn.'

Commercial entities also often emphasize the ethical aspects of their mission, perhaps as a method of motivating employees.

The relevance of the mission statement

A mission statement can have several different purposes:

- to provide a basis for consistent strategic planning decisions
- to assist with translating broad intentions and purposes into corporate objectives
- to provide a common purpose for all groups and individuals within the organization
- to inspire employees
- to establish goals and ethics for the organization
- to improve the understanding and support for the organization from external stakeholder groups and the public in general.

Mission Statement vs. Vision Statement

When considering a mission statement vs. a vision statement the key aspect to remember is the current vs. future context. A mission statement is where you are and why you do it, a vision statement is where you are going to be and how you want to get there. While these may seem like soft topics it can be very important to ensure that the mission and vision of an organization or company's leadership is clearly conveyed to the people who need to know it. Employees, shareholders, and other stakeholders can be provided with quick answers to how an organization views itself and where it plans on being in the future. Conveying this message to them in two well thought out statements can be a very useful communication and governance tool.

Ultimately, the mission statement reflects the purpose, value and action. In any business, the goals and objectives should clearly support the organization's mission statement.

For example, Twitter's mission statement has three parts such as the purpose, value, and action:

- Mission: Give everyone the power to create and share ideas and information instantly, without barriers.
- Values: We believe in free expression and think every voice has the power to impact the world.
- Strategy: Reach the largest daily audience in the world by connecting everyone to their world via our information sharing and distribution platform products and be one of the top revenue generating Internet companies in the world.

Accordingly, Twitter combines its mission and values to fulfill its goals and objectives through a well-defined strategy.

Goals and objectives

There is some confusion about the meaning of goals and objectives, and the terms might be used to mean different things.

However, it is useful to think of goals and objectives as follows:

- Goals are aims for the entity to achieve, expressed in narrative terms. They are broad intentions. For example, an entity might have the goal of maximizing the wealth of its shareholders, or the goal of being the world's leading business entity in one or more markets.
- Objectives are derived from the goals of an entity, and are aims expressed in a form that can be measured, and there should be a specific time by which the objectives should be achieved.

The objectives should be **SMART**:

- Specific/stated clearly
- Measurable
- Agreed
- Realistic
- Time-bound (clear and specific targets should be set for achievement of objective)

A company might have a goal of maximizing the wealth of its shareholders. Its objective might therefore be to double the share price within the next ten years.

Objectives might be expressed as a hierarchy of corporate and strategic objectives:

- A corporate objective might be to double the share price within the next ten years. This is the overall objective for the entity.

In order to achieve the corporate objective, it is necessary to set strategic objectives for key aspects of strategy. Examples of strategic objectives might be:

- to increase the annual profit after tax by 125% in the next ten years
- to introduce an average of three new products each year for the next ten years
- to become the market leader in four market segments within the next ten years, an improvement in each case from the current position of second-largest competitor in each of these market segments.

Some strategic objectives are more important than others, and there is a hierarchy of strategic objectives. However, the main strategic objectives might be identified as critical success factors, for which there are key performance indicators.

Goals and objectives can therefore be used to convert an entity's mission into specific strategies with strategic targets for achievement within a strategic planning period.

Who decides mission, goals and objectives?

When an entity states its mission in a mission statement, the statement is issued by the leaders of the entity. For a company this is the board of directors. Similarly, the formal goals and objectives of an entity are stated by its leaders.

However, the decisions by a board of directors about the goals and objectives of an entity are influenced by the way in which the company is governed and the expectations of other stakeholders in the company.

How to set effective goals

Techniques for setting effective goals include:

- Participate in the goal-setting process
- Ensure that the goals include intrinsically motivating work
- Ensure there is a system that can provide feedback on the achievement of goals
- Goals must be SMART (see above)
- Align personal and commercial goals
- When recording goals, state them in a positive statement
- Set priorities

Problems created by goals

The most effective and motivating goals are those that are challenging yet remain achievable. The extremes either side are likely to be demotivating whether they are:

- unrealistically challenging – result is the employee simply gives up
- too easy – resulting in the employee slacking off, feeling under-utilized and lacking inspiration.

Other problems that are perceived to be caused by setting goals include:

- goals create inflexibility and can lead to a narrow focus. This means that an opportunity that falls outside the scope of recorded and stated goals is potentially overlooked as time spent on the opportunity will not help achieve the previously agreed goals.
- goals may generate stress through a constant pressure and reference to needing to constantly perform at the highest levels in order to achieve or exceed stated goals. This can detract from taking enjoyment and interest from the task.

▶ *Example*

The board of OT Limited (OTL) is currently formulating strategy for achieving its business goals during the next four years. The board is of the opinion that the level of business activity in the country would increase significantly and OTL should achieve a fair share of the envisaged growth.

The board of OTL should keep the following important matters in perspective while establishing its goals for the next four years:

i. The goals should be based on realistic growth parameters and pose reasonable challenges for the employees. Over-ambitious goals or internal/external constraints may frustrate the employees. On the other hand, if the goals are too easy to achieve, the employees may adopt a complacent or laid back attitude and not put in their best efforts.

ii. The employees should participate in the goal-setting process because their input and involvement would self-motivate them to make extra efforts to achieve the goals.

iii. The commercial goals of OTL should be aligned with the personal goals of the employees. OTL should study the types of rewards and incentives which would motivate the employees to put in their best efforts and design the compensation packages to elicit optimum efforts from the employees.

iv. OTL should be able to generate adequate resources to meet the goals and also ensure that the resources are allocated according to the requirements in order to achieve optimum utilization of the available resources.

v. The goals should be flexible so that any new opportunities which are not envisaged in the original goal plan are also recognized and targeted.

vi. A performance monitoring system should be implemented to ensure that the performance is in line with the goals/ targets and timely corrective measures are taken to rectify any unfavorable variances from the set goals.

vii. A system of employees training and development should be implemented to enhance their work skills and ensure that they are fully conversant with the prevailing regulations.

▶ *Example*

Fancy Apparel Company

Fancy Apparel Company Limited is a garments' manufacturing concern; operating in the local market producing apparels for the middle-class segment of the market. The company has ambitious plans to enter in the high-fashion ladies garment business. To achieve effective coordination, the management is of the opinion that various departments should be assigned specific goals of performance for the next two years in order to meet stringent delivery schedules. This is particularly important because a large number of new employees will be recruited who would work in a team environment with the existing work force.

The new aim of the company will be achieved by introducing and implementing a formal goal setting system. The company will achieve competitive advantage through clear vision of goal achievement. The other advantages for the company are as follows:

- All the departmental heads and their subordinates would be fully aware of their responsibilities and duties which they would have to perform during the next two years.
- The goal setting system would strengthen the departmental head and subordinate relationship because it would promote an environment of team effort and the manager would not be considered as an arbitrary decision maker.
- The goal setting system would have self-correcting characteristics as any slippages in performance would be identified immediately and corrective measures taken.
- The goal-setting system would help to identify worker deficiencies and lead to development of training needs in the organization.
- All individuals in the organization would know in advance the basis of their performance appraisal.
- The goal setting system would help to closely monitor the market trends and adapt to the changes in the market tastes and preferences.
- The goal setting system would help to achieve greater departmental coordination and lead to achievement of overall organizational goals.

Examples of Goals and Objectives:

Variables	Goal	Objective
Growth and Profitability	Increasing net profit by 15% by increasing revenue while limiting expenses	▪ Increasing annual sales by 25% ▪ Adding five new customers each month ▪ Reducing the annual utility bills by 5%
Customer Care	Reducing customer complaints by 30% and improving resolution time by one day	▪ Adding two new customer service employees next 12 months ▪ Reply to customer complaints within two business days
Staff Retention	Improving staff retention – less than three employees leaving in six months	▪ Training for new employees within first 90 days on the job ▪ Bi-weekly meetings one-on-one basis
Efficiency	Increasing shipping times from five to two days	▪ Adding new shipper ▪ Improving production time by two hours

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1.3. Factors of Production: The Building Blocks of Business

To provide goods and services, regardless of whether they operate in the for-profit or not-for-profit sector, organizations require inputs in the form of resources called factors of production. Four traditional factors of production are common to all productive activity: Natural Resources, human resources (labour), capital, and enterprise. Many experts now include knowledge as a fifth factor, acknowledging its key role in business success. By using the factors of production efficiently, a company can produce more goods and services with the same resources.

Natural Resources

Natural resources include any resources or commodities that can be used in their natural form. They include farmland, forests, mineral and oil deposits, and water. Sometimes natural resources are simply called land, although, as you can see, the term means more than just land. Companies use natural resources in different ways. A paper manufacturing company uses wood pulp to make paper, and a utility distribution company use water, oil, or coal to produce electricity.

Land remains the most obvious natural resource that is commonly used by businesses to produce goods and services. Agricultural businesses rely on land to grow crops. Other businesses rely on land to establish a site for production of their goods and services.

Human Resources (Labor)

Human resources are the people who are able to perform work for a business. They may contribute to production by using their physical abilities, such as working in a factory to construct a product. Alternatively, they may contribute by using their mental abilities, such as proposing a change in the existing production process or motivating other workers.

Capital

The tools, machinery, equipment, and buildings used to produce goods and services and get them to the consumer are known as capital. Sometimes the term capital is also used to mean the money that buys machinery, factories, and other production and distribution facilities. However, because money itself produces nothing, it is not one of the basic inputs. Instead, it is a means of acquiring the inputs. Therefore, in this context, capital does not include money.

Physical facilities are typically necessary to produce many goods and services. Especially in recent years, technology has enabled businesses to use their capital more effectively.

Entrepreneurship

Entrepreneurs are the people who combine the inputs of natural resources, labor, and capital to produce goods or services with the intention of making a profit or accomplishing a not-for-profit goal. These people make the decisions that set the course for their businesses; they create products and production processes or develop services.

Entrepreneurship involves the creation of business ideas and the willingness to accept risk. Entrepreneurs attempt to identify business opportunities. When they find one, they invest some of their own resources to create a business with the expectation that they will earn adequate profits as a reward for their efforts. However, they also face the risk that the profits of the business may not be as high as expected. In fact, if expenses exceed revenue, the profits may be negative and the business could fail.

In a free market economy, many businesses may be created within an established industry, which results in intense competition. In this situation, a firm that charges too high a price for its product may fail because customers will switch to its competitors. Similarly, a firm that is not well managed may fail because its expenses are too high. This risk of failure can reduce the motive to create a business.

Entrepreneurs should realize that if they overestimate the potential profitability of a business or manage the business poorly, they will lose the money.

1.4. Key Stakeholders in a Business

Every business involves transactions with people. Those people are affected by the business and therefore have a stake in it. They are referred to as stakeholders, or people who have an interest (or stake) in the business.

In business, a stakeholder is any individual, group, or community that has an interest in an organization and the outcomes of its operation. Common examples of stakeholders include employees, customers, shareholders, suppliers, communities, and governments. Different stakeholders have different interests, and companies often face trade-offs in trying to please all of them. Therefore, businesses would set priorities while playing a balancing act in serving all of its stakeholders, e.g. in a highly regulated business environment the top priority of the business would be to operate within all boundaries set by the government and ensuring that no laws are being compromised. Another example would be of a service related business where customers are an important stakeholder and the business would include satisfaction of its customers in its vital strategy.

A stakeholder in an organisation is a person who has an interest (or 'stake') in what the organisation does, and who might therefore try to influence the decisions and actions of the organisation.

Stakeholders are individuals and other organisations, but they may often have a common interest. It is therefore possible to categorise some stakeholders into groups of people with a similar interest.

Stakeholders can be either:

a) people or groups within the organisation (internal stakeholders), or
b) people, groups or other entities that are external to the organisation (external stakeholders).

A 'power-interest matrix' can be used to categorise stakeholders based on their power or influence and interest in a project or entity. This should begin with a list of all possible stakeholders involved in a project. Relevant stakeholders can be identified by reviewing corporate documentation, holding workshops, and discussions with management.

1.4.1 Internal stakeholders

Within a business organisation, internal stakeholders can be categorised into groups as follows:

a) shareholders/owners
b) executive directors and senior managers
c) other managers and employees

It might be appropriate to divide management and employees into sub-categories, where there are groups with differing interests and concerns.

Owners

Every business begins as a result of ideas about a product or service by one or more entrepreneurs. As explained earlier, entrepreneurship is the act of creating, organizing, and managing a business. Today, a lot of businesses are a result of initiatives by individuals who take the risk of becoming entrepreneurs. Entrepreneurs are critical to the development of new business because they create new products (or improve existing products) desired by consumers.

People will be willing to create a business only if they expect to be rewarded for their efforts. The rewards of owning a business come in various forms. Some people are motivated by the chance to earn a large income. Others desire to be their own boss rather than work for someone else. Many people enjoy the challenge or the prestige associated with owning a business. Most business owners would agree that all of these characteristics motivated them to start their own business.

Many firms have grown by issuing shares or stock to other investors; that is, they essentially sell a portion of the ownership to these investors. The stock received by investors is a certificate representing ownership of the specific business. The investors who purchase stock are called stockholders (or shareholders) of those firms. The funds received by a firm that issues stock can be used to expand the business. Large firms such as Unilever, Lucky Group of Companies and General Tyres now have millions of stockholders, but when they were created, they were small businesses.

Stakeholder vs Shareholder

This is an important distinction to make. A stakeholder is anyone who has *any type of stake* (interest) in a business, while a shareholder is someone who owns *shares* (stock) in a business and thereby has an equity interest.

In large companies, the main shareholders are not usually involved in the day-to-day management (although there are some exceptions). Shareholders in a large company are usually investors, seeking to earn a return on their investment in the form of dividends and a higher share price.

Shareholders leave the management of their company to the board of directors and executive management team. However, they might become more closely involved in the company, and try to influence the decisions of the directors, when they feel that their interests are threatened. For example, shareholders might express their concerns about any of the following:

a) Falling profits and a falling share price
b) Lower dividend payments
c) A proposal to invest in a major project where the business risk is high
d) A proposed takeover bid for another company or from another company.

When shareholders feel that their interests are threatened, they might try to become more actively involved in the company. Major shareholders can discuss their concerns with the company chairman and other senior directors.

A company might have a majority shareholder, who owns enough shares in the company that the shareholder is able to control the composition of the board and the decisions that the company's directors make. When there is a majority shareholder, the interests of this shareholder might differ from those of the minority shareholders owning the remainder of the shares. (In other words, the majority shareholder and the minority shareholders might be different stakeholder groups.)

Employees

Employees have a direct stake in the company in that they earn an income to support themselves, along with other benefits (both monetary and non-monetary). Depending on the nature of the business, employees may also have a health and safety interest (for example, in the industries of transportation, mining, oil and gas, construction, etc.)

Firms hire employees to conduct their business operations. Some firms have only a few employees; others, such as General Motors and IBM, may have more than 200,000 employees spread across the globe running their operations in different regions.

Employees or human resource is one of the most important stakeholders of the business and can significantly affect the performance of the business. Companies invest a great deal of time and commitment on the process of hiring good quality of human resource and then retain them by offering competitive benefits as incentive. Employees also make the decision to work for a company after careful thought as they are directly affected by the business, its policies and its success or failure.

Executive directors and senior managers

A board of directors might consist of executive directors and non-executive directors. Executive directors are usually full-time employees of the company (whereas non-executives are not).

As executives and full-time employees, executive directors are involved in the management of the company. Their interests are therefore often similar to the interests of other senior executives, who do not have a position on the board of directors.

The interests of executive directors and senior managers are affected by matters such as:

a) their remuneration, which consists of basic salary, pension rights, cash bonuses and share incentive schemes

b) power and status
c) career prospects
d) job security.

Executive directors and other senior managers often want their company to grow in size, because in a larger company, they expect larger remuneration, more power and status and better career prospects. However, growing the company is not necessarily in the best interests of shareholders, who are more concerned about profitability, dividends and the share price.

Other managers and employees

Managers in the middle and junior ranks of a management hierarchy might have ambitions to become senior managers. However, their interests and concerns are different. Often, junior managers and other employees share common interests, such as:

a) pay
b) working conditions
c) job security
d) job satisfaction
e) quality of life.

1.5. External stakeholders

Business organisations, particularly large organisations, have a large number of external stakeholders. These include:

a) lenders
b) suppliers
c) government
d) customers
e) local communities
f) the general public, including special interest groups and pressure groups
g) non-executive directors.

Lenders and Creditors

Firms typically require financial support beyond the capital injected by the owners or their personal assets being used in the business. When a firm is initially created, it incurs expenses before it starts selling a single product or service. For example, it may have to acquire machinery and equipment, purchase or rent a facility or premises, and hire workers before it can generate any revenue. In the first several months, its costs incurred may exceed its revenue. Therefore, the firm cannot solely rely on money made from sales to cover its expenses. The owners of a new business may initially have to rely on borrowed funds or credit.

Many firms that need funds borrow from financial institutions or individuals called creditors, who provide loans. Creditors may include friends and family at first and banks which may be willing to provide money when a business is been running for some time with a stable financial history and market conditions. The amount taken from these creditors represents the debt or liability of a business which the business will return on agreed terms with the lender.

Creditors will lend funds to a firm only if they believe the firm will perform well enough to pay the interest on the loans and the principal (amount borrowed) in the future. The firm must convince the creditors that the business will be able to generate sufficient profits to make the interest and principal payments of the loan.

Lenders to a company include banks and bondholders. (Companies might issue bonds or debentures in order to raise finance. Interest is paid on the bonds, which represent a debt that the company must eventually repay.) The main concerns of lenders are that the borrower should be able to repay the debt, with interest, on schedule.

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Lenders might therefore be concerned about heavy borrowing by a business organisation, because when a borrower gets into heavy debt, the risks increase that it will not be able to meet all the claims for interest and debt repayment, especially if profitability falls.

Suppliers

Businesses commonly use materials to produce their goods and services. For example, automobile manufacturers use steel to make automobiles, while home builders need cement, wood siding, and many other materials. Firms cannot complete the production process if they cannot obtain the materials. Therefore, their performance is partially dependent on the ability of their suppliers to deliver the materials on schedule.

Business organisations also buy goods and services from their suppliers. Suppliers will usually agree to allow their customers some credit (time to pay) but their main interests are that:

a) a customer will pay what is owed and will not become a bad debt
b) customers will continue to buy from them
c) customers will treat them fairly, and deal with them in an ethical way.

Government

Governments can also be considered a major stakeholder in a business, as they collect taxes from the company (corporate income taxes), as well as from all the people it employs (payroll taxes) and from other spending the company incurs (sales taxes). Governments benefit from the overall Gross Domestic Product (GDP) that companies contribute to.

Governments of free-market economies recognize the advantages of allowing businesses to be set up. Not only do businesses serve consumers, but by creating work for the business owners and employees, they also reduce the country's unemployment which is an important goal of the government.

Firms rely on entrepreneurs (owners) to create business ideas and possibly to provide some financial support. They rely on other owners and creditors to provide additional financial support. They rely on employees (including managers) to produce and sell their products or services. They rely on suppliers to provide the materials needed for production. They rely on customers to purchase the products or services they produce.

The government has an interest in all business organisations, but especially large organisations, for a wide range of reasons.

a) Businesses pay tax on profits, so government has an interest in company profitability.
b) The government want to create and maintain a strong economy. This depends partly (or largely) on new investments by businesses. Government might therefore want to encourage business investments.
c) The government want to achieve low levels of unemployment. Businesses are major employers.
d) The government regulates many different aspects of business activity: employment law, environmental law, health and safety regulations and company law are just a few examples.

The government might be a significant external stakeholder in a business because of its power to introduce new laws and regulations, or amend existing laws.

Customers

Customers have a stake in a business organisation because they expect to obtain value from the goods or services that they buy.

A business cannot survive without customers. To attract customers, a firm must provide a desired product or service at a reasonable price. It must also ensure that the products or services produced are of adequate quality so that customers are satisfied. If a firm cannot provide a product or service at the quality and price that customers desire, customers will switch to the firm's competitors. Apple and Samsung's cell phone manufacturing divisions attribute most of their recent success to recognizing the types of products and features that consumers want. These firms also are committed to a certain standard of quality and price their products in a manner that matches the expectations of their customers.

Local communities

In some cases, local communities might be stakeholders in a business organisation, especially when the organisation is a major employer in the area and the local economy depends on the work and business activity that the organisation brings to the area.

The concerns of a local community might be very strong when a business organisation proposes to close down operations in the area, and make its employees redundant. Business shut down by a major employer in an area has a knock-on effect for other businesses, which will lose trade and income.

The general public

The general public might consider that it has a stake or interest in major companies, because the actions of these companies can affect society as a whole. Public concerns might be expressed by action groups or pressure groups. Areas of public concern might include:

a) public health, especially in the case of food manufacturers and manufacturers of drugs and medicines
b) protection of the environment, reducing pollution, and creating 'sustainable businesses'
c) corruption in business practices (such as bribery)
d) the exploitation of the consumer through mis-selling and misleading descriptions of goods
e) the monopolisation of a market by one or a small number of companies. (In the UK for example there is public concern about the dominance of supermarket chains in the retail market, and the shift of retailing from town centres to out-of-town locations.)

Non-executive directors

Oddly, perhaps, non-executive directors are external stakeholders in a company. Although they are members of the board of directors, they are not full-time employees, and they are usually appointed to a company's board because:

a) they bring experience and knowledge to the board that they have gained outside the company, and which executive directors often do not have
b) their interests are different from those of executive directors and senior executives: they are not affected by concerns about remuneration (bonuses and performance incentives), power and status or job security.

Appointing independent non-executive directors to the board of directors of a company is good corporate governance practice, because independent NEDs can help to prevent a company from being dominated by the personal interests of the executive directors.

The main stakeholders

The main stakeholders in a business organisation, internal or external, are those who exercise the greatest influence.

The most influential stakeholders in a company are usually the board of directors, and possibly also senior executives below board level. These are the individuals with the power to make most of the decisions for the company.

The directors will often be influenced by the opinions of their shareholders, especially their largest shareholders, because shareholders can take some action against the directors if they are dissatisfied. For example, shareholders can vote against the re-election of directors (and in extreme cases can vote to have a director removed from office).

Connected stakeholders

Other stakeholder groups, other than the directors, senior management and the shareholders, might influence the decisions that directors and senior management make. The term 'connected stakeholder' means a stakeholder who:

a) is not a decision-maker, or
b) is not a part of the permanent (full-time) infrastructure of the organisation, but
c) is nevertheless very influential in shaping the future of the organisation and the decisions of its leaders.

The main connected stakeholders in a company are usually:

a) non-executive directors
b) employees
c) key suppliers
d) key customers

The main connected stakeholders in a business organisation must have some power that they are able to use to influence decisions. Some sources of power, and the stakeholders who might have them, are listed below:

Source of power: External	**Example**
Legal rights	Shareholders have some legal voting rights under company law. Lenders have legal rights under the terms of their lending agreements: for example a lender has a right to take action in the event of default by a borrower.
Publicity, and ability to influence customers or legislators	Pressure groups and protest groups might be influential. These include environmental protection groups, human rights protection groups, and animal welfare activists.
Control over key resources	A major supplier could exert influence by controlling the supply of a key resource to the organisation. This results in a 'supplier or vendor risk' for a business.
Buying power	Customers can exert influence collectively through their buying power. If they do not like what a business organisation is doing, they can switch to buying from competitors. This results in a 'customer concentration risk' for a business.
Source of power: Internal	**Example**
Position power	Individual employees might be in a position of power within the organisation, perhaps because of special expertise that they possess. Top consultants and investment bankers are examples. This results in a 'key person risk' for a business.
Claim on resources	Power might arise from a claim or control that exists over particular resources of the business. For example the power of employees or trade union representatives might come from their ability to withhold labour in the event of a dispute with management.
Personal charisma or influence	Some individuals might exercise considerable influence through their personal qualities and charisma.

Power Interest Matrix

Power-interest matrix is used to categorise relevant stakeholders based on their power or influence and level of interest in a project or an entity.

Based on the above categorisation, strategies can be developed to manage all stakeholders effectively and to develop a communication plan accordingly for their consultation and engagement. This may further result in applying RASCI (Responsible, Accountable, Supporting, Consulted, and Informed) based strategy to identify the roles and responsibilities of each relevant stakeholder.

Once the stakeholders are identified, they are plotted on a grid in relation to the power and interest as follows:

Grid	Strategy
• High power / High interest	Managed closely with regular engagement
• High power / Low interest	Keep satisfied with active consultation
• Low power / High interest	Keep informed
• Low power / Low interest	Monitor only

SELF-TEST

For the following questions select the best answer.

1. A business is an organization that strives for __________ by providing goods and services desired by its customers. Which of the following completes the statement:?
   a. Profit
   b. Satisfaction
   c. Efficiency
   d. All of the above

2. The Board of Directors are the most powerful decision makers of a business. If this is true, what factor can influence the decision of the Board of directors. Choose the best answer from the following:
   a. Opinion of customers
   b. Knowledge of the business
   c. Employee feedback
   d. Opinion of shareholders

3. Which of the following are not considered as External Stakeholders of a company:
   a. lenders
   b. non-executive directors
   c. local communities and pressure groups
   d. competitors

4. TRUE OR FALSE: The general public has a stake or interest in major companies, because the actions of these companies can affect society as a whole.
   a. TRUE
   b. FALSE

5. Which of the following is a reason why the government has an interest in all business organisations,
   a. Businesses pay tax on profits, so government has an interest in company profitability.
   b. Government wants to encourage business investments.
   c. The government is interested in regulating business activity
   d. All of the above

6. Business organisations buy goods and services from suppliers. Suppliers will usually agree to allow their customers some credit only if:
   a. a customer will pay what is owed and will not become a bad debt
   b. supplier has customer's personal information
   c. The government allows sales on credit.
   d. The government gives a guarantee that it will provide subsidy on credit sales

7. Firms typically require financial support beyond the capital injected by the owners or their personal assets being used in the business. Which stakeholder could be a source of funding for a new business?

   a. Lenders and creditors

   b. Suppliers

   c. Customers

   d. Government

8. Which of the following are the advantages that a government of a free-market economy would recognize and allow businesses to be set up?

   a. businesses serve consumers

   b. businesses create work for the business owners and employees

   c. businesses reduce the country's unemployment

   d. All of the above

9. Which of the following is a goal of the government fulfilled by encouraging new businesses to set up?

   a. Earning profit

   b. businesses reduce the country's unemployment

   c. Paying salaries of government employees

   d. Investment in country's infrastructure

10. TRUE or FALSE: A stakeholder is anyone who has *any type of stake* in a business, while a shareholder is someone who owns *shares* (stock) in a business and thereby has an equity interest.

    a. TRUE

    b. FALSE

    c. More information is needed to answer

    d. None of the above

11. Which of the following are the main concerns of shareholders in a business?

    a. Falling profits and a falling share price

    b. A proposal to invest in a major project where the business risk is high

    c. A proposed takeover bid for another company or from another company

    d. All of the above

12. Managers in the middle and junior ranks of a management hierarchy might have ambitions to become senior managers. However, their interests and concerns are different. Which of the following may be the interests of junior managers and other employees?

    a. pay and working conditions

    b. job security and satisfaction

    c. quality of life.

    d. A, B and C

13. Within a business organisation, internal stakeholders can be categorised into groups. Which of the following are NOT internal stakeholders?
    a. Mr. Masood who owns 20% shares of the company
    b. executive directors and senior managers
    c. finance managers
    d. M/s AM Tech – supplier of machinery

14. By using the ______________efficiently, a company can produce more goods and services with the same resources. Fill in the blank to complete the sentence.
    a. Machinery
    b. Human resources
    c. Factory space
    d. Factors of production

15. TRUE OR FALSE: A mission describes the organization's basic function in society, in terms of the products and services it produces for its customers.
    a. TRUE
    b. FALSE

16. TRUE OR FALSE: A vision statement has more to do with the future and really describes what an organization plans or hopes to be in the future.
    a. TRUE
    b. FALSE

17. What is the key question to answer when developing a mission statement?
    a. What is our business?
    b. What is our value to the customer?
    c. What will our business be?
    d. All of the above

18. ____________ are the people who combine the inputs of natural resources, labor, and capital to produce goods or services with the intention of making a profit or accomplishing a not-for-profit goal. Fill in the blank to complete the statement.
    a. Factory labour
    b. Employees
    c. Directors
    d. Entrepreneurs

19. What is the single element that sets a mission statement apart from a vision statement?
    a. When considering a mission statement vs. a vision statement the key aspect to remember is the current vs. future context
    b. Mission statement is longer than a vision statement
    c. Mission statement is shorter than a vision statement
    d. Vision statements are considered to be more important than mission statements

AT A GLANCE
SPOTLIGHT

ANSWERS TO SELF-TEST

1	A
2	D
3	B
4	A
5	D
6	A
7	A
8	D
9	B
10	A
11	D
12	D
13	D
14	D
15	A
16	A
17	D
18	D
19	A

CHAPTER 2

OWNERSHIP OF BUSINESS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Organization of business
2. Types of business organizations
3. Laws governing business organisations

SELF-TEST

AT A GLANCE

To achieve the goals and objectives of a business in an effective and efficient manner, the first step of owner(s) is to decide on the type of business organization which means the form of business ownership such as sole proprietorship, partnership, or a limited liability company.

1. ORGANIZATION OF BUSINESS

Definition of Organization

In general, an Organization is a tool to arrange individual or combined resources for a particular purpose in an efficient and effective manner. Working independently may not allow to achieve the required purpose.

A business organization is an entity formed for the purpose of carrying on required activities to achieve its goals and objectives. It can be seen as the process of dividing up activities in an efficient and effective manner to enable a system of co-operative activities of two or more persons. These activities would collectively lead to the completion of common goals and objectives of an entity operated by an individual or group of people.

Since people from different backgrounds come to work together, organizations are strongly influenced by the people that form them. Their personalities, attitudes, perceptions, behaviors, and expectations significantly affect the functioning of an organization.

2. TYPES OF BUSINESS ORGANIZATIONS

When entrepreneurs establish a business, they must decide on the form of business ownership. There are three basic forms of business ownership: (i) sole proprietorship, (ii) partnership, and (iii) corporation or the limited liability company. The form that is chosen can affect the growth, profitability, risk, and value of the firm.

The basic design features of an organization depend on the type of organization, the environment it operates in and its nature of business. For example, there are certain regulatory requirements to follow to form a bank or an insurance company. Each type of organization has features that distinguish one from the other.

a) **Purpose**. They have different purposes. Business organizations exist to make a profit. Public sector organizations exist to provide a benefit to the public, such as good government or key services such as health, education, a police force, national defense, and so on.

b) **Ownership**. They have different types of owners. Companies are owned by their shareholders, whereas public sector organizations are owned by the government (as the representative of the general public). Co-operatives are owned by the members.

c) **Funding**. Business organizations obtain the funds they need to operate from a variety of sources. A stock market company, for example, obtains its long-term funds from a mixture of reinvesting profits in the business, issuing new shares and borrowing from the lenders. Charities rely on a mixture of government grants and private donations for the funds they need. Public sector organizations obtain their funds from the government, which in turn raises through the taxation.

d) **Accountability**. The management of an organization is accountable to its owners for the goals and objectives of the organization. The directors of a company, for example, are accountable to the shareholders for the financial performance of the company. This is the main reason why companies produce their annual report and accounts.

Broadly speaking, organizations can be classified in two broad categories:

- Business organizations, and
- Not-for-profit organizations

2.1 Business organizations:

This type of organization engages in commercial activities, with the purpose of making a profit.

The main types of business organization are:

2.1.1 Sole Proprietorships

A sole proprietor is an individual who owns and operates his or her own business, but might employ a small number of people. There are no legal formalities needed to set up as a sole proprietor. Any profit made after tax belongs to the owner. The owner is in complete control and is free to make decisions. The independence is one of the key attractions of running a business as a sole proprietor.

Typical examples of sole proprietorships include a local restaurant, a local construction firm, a barber shop, a laundry service, and a local clothing store.

Sole proprietors must be willing to accept full responsibility for the business's performance. The pressure of this responsibility can be much greater than any employee's responsibility. Sole proprietors must also be willing to work flexible hours. They are on call at all times and may even have to substitute for a sick employee. Their responsibility for the success of the business encourages them to continually monitor business operations. They must exhibit strong leadership skills, be well organized, and communicate well with employees.

Many successful sole proprietors had previous work experience in the market in which they are competing, perhaps as an employee in a competitor's firm. For example, restaurant managers commonly establish their own restaurants. Prior experience is critical to understanding the competition and the behavior of customers in a particular market.

AT A GLANCE

SPOTLIGHT

Advantages of Sole Proprietorships

Ease and Low Cost of Formation. Forming a sole proprietorship is relatively easy and inexpensive. In some cases, creating a sole proprietorship involves merely announcing the new business in the local newspaper. The legal requirements are minimal. A sole proprietorship need not establish a separate legal entity. The owner may also need to apply for an occupational license to conduct a particular type of business. The specific license requirements vary with the province and even the city where the business is located.

Secrecy. Sole proprietorships make possible the greatest degree of secrecy. The proprietor, unlike the owners of a partnership or corporation, does not have to discuss his or her operating plans with other partners or public, minimizing the possibility that competitors can obtain trade secrets. Financial reports need not be disclosed, as do the financial reports of publicly owned corporations.

Distribution and Use of Profits. All profits from a sole proprietorship belong exclusively to the owner. He or she does not have to share them with any partners or stockholders. The owner decides how to use the funds—for expansion of the business, or salary increases, for travel to purchase additional inventory, or to find new customers.

Greater Flexibility and Direct Control. The sole proprietor has complete control over the business and can make decisions on the spot without anyone else's approval. This control allows the owner to respond quickly to competitive business conditions or to changes in the economy. The ability to quickly change prices or products can provide a competitive advantage for the business.

Ease of Government Regulations. Sole proprietorships have the most freedom from government regulation. Many government regulations – federal or provincial- apply only to businesses that have a certain number of employees, and securities laws apply only to corporations that issue stock. Nonetheless, sole proprietors must ensure that they follow all laws that do apply to their business. For example, sole proprietorships must be careful to obey labour laws and food safety regulation in case of food related businesses.

Lower Taxation. Profits from sole proprietorships are considered personal income and are taxed at individual tax rates than imposed on some other forms of business ownership. The owner, therefore, pays one income tax that includes the business and individual income. Sole proprietorships do not pay special franchise or corporate taxes. Profits are taxed as personal income as reported on the owner's individual tax return.

Ease of dissolution. A sole proprietorship can be dissolved easily. No approval of co-owners or partners is necessary. The only legal condition is that all financial obligations must be paid or resolved.

Disadvantages of Sole Proprietorships

Along with its advantages, the sole proprietorship has the following disadvantages:

Unlimited Liability. The sole proprietor has unlimited liability in meeting the debts of the business. In other words, if the business cannot pay its creditors, the owner may be forced to use personal, nonbusiness holdings such as a car or a home to pay off the debts under the bankruptcy laws. The more wealth an individual has, the greater is the disadvantage of unlimited liability.

Difficulty in raising funds. Among the relatively few sources of money available to the sole proprietorship are banks, friends and family, or his or her own funds. The owner's personal financial condition determines his or her credit standing. Additionally, sole proprietorships may have to pay higher interest rates on funds borrowed from banks than do large corporations because they are considered greater risk of default.

Often, the only way a sole proprietor can borrow for business purposes is to pledge a car, house, other real estate, or other personal assets to guarantee the loan. If the business fails, the owner may lose the personal assets as well as the business. Publicly owned corporations, in contrast, can not only obtain funds from commercial banks but can sell stocks and bonds to the public to raise money. If a public company goes out of business, the owners do not lose personal assets as their liability is limited to their shareholding.

Limited skills. The sole proprietor must be able to perform many functions and possess skills in diverse fields such as management, marketing, finance, accounting, bookkeeping, and personnel management. Specialized professionals, such as accountants or attorneys, can be hired by businesses for help or advice. Sometimes, sole proprietors need assistance with certain business functions.

Lack of Continuity. The life expectancy of a sole proprietorship is directly linked to that of the owner and his or her ability to work. The serious illness of the owner could result in failure of the business if competent help cannot be found. It is difficult to arrange for the sale of a proprietorship and at the same time assure customers that the business will continue to meet their needs. This results in 'key person' risk.

Difficulty in finding qualified Employees. It is usually difficult for a small sole proprietorship to match the wages and benefits offered by a large competing corporation because the proprietorship's profits may not be as high. In addition, there is little room for advancement within a sole proprietorship, so the owner may have difficulty attracting and retaining qualified employees.

Taxation. Although we listed taxation as an advantage for sole proprietorships, it can also be a disadvantage, depending on the proprietor's income and the marginal tax rate of corporations. However, sole proprietorships avoid the double taxation that occurs with corporations. The tax effect often determines whether a sole proprietor chooses to incorporate his or her business.

2.1.2 Partnerships

A partnership exists when the ownership of a business is shared by at least two people. In most cases, the maximum number of partners is 20, although there are some exceptions, e.g. accountants and solicitors.

A business that is co-owned by two or more people is referred to as a partnership. The co-owners of the business are called partners and they collectively form the 'firm'.

The parties agree, either orally or ideally in writing, to share in the profits and losses of a joint enterprise. A written partnership agreement, spelling out the terms and conditions of the partnership, is recommended to prevent later conflicts between the partners. Such agreements typically include the name of the partnership, its purpose, and the contributions of each partner (financial, asset, skill/talent, etc.). It also outlines the responsibilities and duties of each partner and their compensation structure (salary, profit and loss sharing, etc.). It should contain provisions for the addition of new partners, the sale of partnership interests, and procedures for resolving conflicts, dissolving the business, and distributing the assets.

There are two basic types of partnership: general partnership and limited partnership. A general partnership involves a complete sharing in the management of a business. In a general partnership, each partner has unlimited liability for the debts of the business. Professionals such as lawyers, accountants, and architects often join together in general partnerships.

A limited partnership has at least one general partner, who assumes unlimited liability, and at least one limited partner, whose liability is limited to his or her investment in the business. Limited partnerships exist for risky investment projects where the chance of loss is great. The general partners accept the risk of loss; the limited partners' losses are limited to their initial investment. Limited partners do not participate in the management of the business but share in the profits in accordance with the terms of a partnership agreement. Usually the general partner receives a larger share of the profits after the limited partners have received their initial investment back. Popular examples are oil-drilling partnerships and real estate partnerships.

There are also limited liability partnerships (LLP), which are similar to a general partnership except that partners are not held responsible for the business debt and liabilities.

Advantages of Partnerships

Ease of formation. Like sole proprietorships, partnerships are easy to form. The partners agree to do business together and draw up a partnership agreement. For most partnerships, applicable laws are not complex.

Higher availability to raise funds. Partnerships have the benefit of a combination of talents and skills and pooled financial resources. Therefore, partnerships can raise funds more easily for operating expenses and business expansion. The partners' combined financial strength also increases the firm's ability to raise funds from outside sources due to enhanced credibility.

Combined Knowledge and Skills. Partners share the responsibilities of managing and operating the business. Combining partners skills to set goals, manage the overall direction of the firm, and solve problems increases the chances for the partnership's success. The diversity of skills in a partnership makes it possible for the business to be run by a management team of specialists instead of by a generalist sole proprietor. With their respective specializations, a wide variety of customers can be served. For example, an accounting firm may have one partner who specializes in personal taxes for individuals and another who specializes in corporate taxes for firms. A medical practice partnership may have doctors with various types of expertise.

Flexibility of decision making. Partnerships can react more quickly to changes in the business environment than can large corporations. Such fast reactions are possible because the partners are involved in day-to-day operations and can make quick decisions after consultation.

Less Regulatory Control. Like a sole proprietorship, a partnership has fewer regulatory controls affecting its activities than does a corporation. A partnership does not have to file public financial statements with government agencies or send out quarterly financial statements to several thousand owners, as the corporations do such as Unilever and Pakistan State Oil. A partnership does, however, have to abide by all laws relevant to the industry or profession in which it operates as well as provincial and federal laws relating to labour, safety, environment, and so on, just as the sole proprietorship does.

Disadvantages of Partnerships

Unlimited Liability. All general partners have unlimited liability for the debts of the business. In fact, any one partner can be held personally liable for all partnership debts and legal judgments (such as malpractice)—regardless of who caused them. As with sole proprietorships, business failure can lead to a loss of the general partners' personal assets. To overcome this problem, many countries now allow the formation of *limited liability partnerships (LLPs),* which protect each individual partner from responsibility for the acts of other partners and limit their liability to harm resulting from their own actions.

Sharing of profits. Any profits that the partnership generates must be shared among all partners. As a result, higher the number of total partners, smaller the share of each individual partner. Sharing the profits is relatively easy if all partners contribute equal amounts of time, expertise, and capital. But if one partner puts in more money and others more time, it might be more difficult to arrive at a fair profit-sharing formula.

Difference of opinion. In contrast of combined knowledge and skills, diversity of partners may result in serious disagreements for key business decisions such as how to run their business, which employees to hire, how to allocate responsibilities, and when to expand. Such diversity in personalities and work styles can cause clashes or breakdowns in communication, sometimes requiring outside intervention to save the business.

Dissolution of partnerships. As a rule, partnerships are easier to form than to leave. When one partner wants to leave, the value of their share must be calculated. It is always difficult to decide who is going to acquire the shares of a leaving partner, and if that person is acceptable to other partners. If a partner who owns more than 50 percent of the entity withdraws, dies, or becomes disabled, the partnership must reorganize or end. To avoid these problems, most partnership agreements include specific guidelines for transferring partnership interests and buy–sell agreements that make provision for surviving partners to buy a deceased partner's interest.

2.1.3 Limited Companies or corporations

The main feature of a limited company is that it has a separate legal identity from that of its owners. All owners of a company have limited liability. If the company collapses, they cannot be forced to use personal funds to pay off business debts. They only lose the amount that they originally invested in the company.

A company, also known as a corporation, is a legal entity, created under the government regulations, whose assets and liabilities are separate from its owners. As a legal entity, a corporation has many of the rights, duties, and powers of a person, such as the right to receive, own, and transfer property. Corporations can enter into contracts with individuals or with other legal entities, and they can sue and be sued in court of law. As a limited company has a separate legal identity, all owners have limited liability. If the company collapses, they cannot be forced to use personal funds to pay off business debts. They only lose the amount that they originally invested in the company.

People become owners of a company by purchasing shares of stock. Many small companies are privately held, meaning that ownership is restricted to a small group of investors, and are called **private limited companies**.

Most large corporations are publicly held, meaning that shares can be easily purchased or sold by investors. These companies are called **public limited companies**. Stockholders of publicly held companies can sell their shares of stock when they need money, are disappointed with the performance of the company, or simply expect that the stock price will not rise in the future. Their stock can be sold to some other investor who wants to invest in that company.

A private limited company that needs more money to expand or to take advantage of opportunities may have to obtain financing by "going public" through an **initial public offering** (IPO), that is, becoming a public limited company by selling stock so that it can be traded in public markets.

Publicly held companies can obtain additional funds by issuing new common stock. This means that either their existing stockholders can purchase more stock, or other investors can become stockholders by purchasing the company's stock. By issuing new stock, companies may obtain whatever funds are needed to support any business expansion.

Structure of a company / corporation

A company is created or incorporated through a charter or article of incorporation. The organizational structure has three key components: stockholders, directors, and management.

Stockholders (or shareholders) are the owners of a corporation, holding shares of stock that provide them with certain rights. They may receive a portion of the corporation's profits in the form of dividends, and they can sell or transfer their ownership in the corporation (represented by their shares of stock) at any time. Stockholders can attend annual meetings, elect the board of directors, and vote on matters that affect the corporation in accordance with its charter and bylaws. Each share of stock generally carries one vote.

The stockholders elect a **board of directors** to govern and handle the overall management of the corporation. The directors set major corporate goals and policies, hire corporate officers, and oversee the firm's operations and finances. Small firms may have as few as 3 directors, whereas large corporations usually have 10 to 15 directors. The boards of large corporations typically include both corporate executives and outside directors (not employed by the organization) chosen for their professional and personal expertise. Outside directors often bring a fresh view to the corporation's activities because they are independent of the company.

Hired by the board, the *executives/officers* of a corporation are its top management and include the president and chief executive officer (CEO), chief financial officer (CFO), vice presidents, treasurer, and secretary, who are responsible for achieving corporate goals and policies. Officers may also be board members and stockholders.

Advantages of Companies

Combination of resources and economies of scale. The corporate structure allows companies to merge financial and human resources into enterprises with great potential for growth and profits.

Limited liability. A key advantage of companies is that they are separate legal entities that exist apart from their owners. Owners' (stockholders') liability for the obligations of the firm is limited to the amount of the stock they own. If the corporation goes bankrupt, creditors can look only to the assets of the corporation for payment.

Ease of transferring ownership. Stockholders of public companies can sell their shares at any time without affecting the status of the corporation.

Unlimited life. The life of a corporation is unlimited. Because the company is an entity separate from its owners, the death or withdrawal of an owner does not affect its existence, unlike a sole proprietorship or partnership.

Tax deductions. Companies are allowed certain tax deductions, such as operating expenses, which reduces their taxable income.

Ability to attract financing. Companies can raise money by selling new shares of stock. Dividing ownership into smaller units makes it affordable to more investors, who can purchase one or several thousand shares. The large size and stability of companies also helps them get bank financing. All these financial resources allow companies to invest in facilities and human resources and expand beyond the scope of sole proprietorships or partnerships. It would be impossible for a sole proprietorship or partnership to make automobiles, provide nationwide telecommunications, or build oil or chemical refineries.

Disadvantages of Companies

Double taxation of profits. Companies must pay income taxes on their profits. In addition, any profits (dividends) paid to stockholders are taxed as personal income, although at a somewhat reduced rate.

Cost and complexity of formation. As outlined earlier, forming a corporation involves several steps, and costs can run into thousands of rupees, including registration, and license fees, as well as the cost of attorneys and accountants.

Increased government restrictions. Unlike sole proprietorships and partnerships, companies are subject to many regulations and reporting requirements. For example, companies must also register with the Securities and Exchange Commission of Pakistan (SECP) before selling stock to the public. Unless it is closely held (owned by a small group of stockholders), a company must publish financial reports on a regular basis and file other special reports with the SEC and other regulatory agencies. These reporting requirements can impose substantial costs, and published information on corporate operations may also give competitors an advantage.

2.1.4 Summary of Advantages and Disadvantages of Major Types of Business Organization

Sole Proprietorship	Partnership	Corporation
Advantages:		
Ease and low cost of formation	Ease of formation with relatively low organizational cost	Limited liability of owners
Secrecy	Higher ability to raise funds due to more owners	Ease of transferring ownership
Distribution and use of profits solely by owner	Combined knowledge and managerial skills	Unlimited life - continuity due to lack of owner dependency
Greater flexibility and direct control	Flexibility of decision making	Tax benefits and deuctions
Ease of government regulations	Ease of regulatory control	Ability to attract funds allows growth
Lower taxation	Business income taxed as personal income of each partner	Ability to attract employees with specialized skills
Ease of dissolution		
Disadvantages:		
Unlimited liability of owner for all business losses and liabilities	Unlimited liability of owners for sharing of business losses and liabilities	Higher cost and complexity of formation
Difficulty in raising funds inhibit growth	Complexity of profit and loss sharing	Double taxation of corporate profits and dividend
Limited skills and management expertise	Difficulty in exiting or dissolution	Higher regulatory control
Lack of continuity	Potential for conflicts among partners	
Difficulty in finding qualified employees due to limited long-term opportunities	Limitation of growth	

2.2 Not-for-profit organizations

These type of organizations do not seek to make a profit, although they must operate within the limits of the funding and financial resources that is available to them. They can be divided into the following main types:

i. Public sector organizations: These are government organizations that are funded by the government to achieve social indicators of the country. Examples are quality education to all, availability of basic health facility, ensuring clean drinking water for all citizens, etc.

ii. Non-government organizations: These are not-for-profit organizations that are partly or wholly funded from non-government sources. Examples are charities, clubs and societies.

iii. Clubs and societies: These non-profit making organizations, e.g. sports and social clubs, exist because their members are drawn together by a common interest. The assets of clubs and societies are the property of the members and most income comes from member's subscriptions. Clubs and societies produce income and expenditure accounts, rather than profit and loss accounts which show either a surplus or deficit of income over expenditure, as they do not aim to make a profit.

iv. Cooperatives: These are association of persons, usually of limited means, who voluntarily come together to achieve a common economic end through the formation of a controlled business organization making equitable contributions to raise capital and accepting a fair share of risks and benefits. A cooperative is not formed with profit as the guiding objective but to render services to society and its members.

3. LAWS GOVERNING BUSINESS ORGANISATIONS

The laws and regulations affecting an entity, and the possibility of major new laws or regulations in the future has an impact on how businesses operate.

Laws and regulations vary between different countries, although international regulation is accepted in certain areas of commercial activity, such as banking.

Strategic decisions by an entity might be affected by legal considerations. For example:

- an international company might locate some operations, for tax reasons, in a country with a favourable tax system
- decisions to relocate operations from one country to another could be affected by the differences in employment law in the two countries, or by new employment legislation
- in many industries, companies are faced with environmental legislation or health and safety legislation, affecting the ways in which they operate, as well as the design of the products they make and sell.

1.1 Companies law

In Pakistan, if a business set-up intends to form a public or private company, it is required to complete the requirements for incorporation, management, operations and winding up of companies, provided in the Companies Act, 2017 (the Act), issued by the Securities and Exchange Commission of Pakistan (SECP). In addition to this principal law, there are other corporate laws and regulation that are applicable on companies.

The Act regulates companies for protecting interests of shareholders, creditors, other stakeholders and general public and inculcate principles of good governance.

Companies are required to comply with the requirements of the Act, for which they will be required to incur certain cost, with respect to incorporation, human resources, audit of financial statements, holding of annual general meetings, record keeping etc. The companies which do non-compliance with the requirements of the Act will be subject to penalties imposed for the relevant offence. For a business manager, the cost of having a company and risk of non-compliance must be in sight.

1.2. Partnership law

The law relating to partnership businesses in Pakistan is the Partnership Act, 1932. The Partnership Act includes the procedure of registration and dissolution of a firms, rights and duties of partners etc.

In comparison to companies, partnership firms have ease of doing business as the requirements applicable on companies for annual filing of returns, audit of financial statements, holding of annual general meeting etc are not applicable on partnership firms. However, doing business as partnership requires understanding of partners rights and duties of partners.

SELF-TEST

For the following questions select the best answer.

1. An entrepreneurial organization is an entity that is managed by its entrepreneurial owner. Which one of the following can be a feature of an entrepreneurial organisation:
   (a) the Board of Directors take all the main decisions and does not delegate decision-making to anyone else
   (b) there is a formal management structure
   (c) operations and processes are likely to be complex and there is too much to handle for a single owner
   (d) None of the above

2. _____________ can be seen as the process of dividing up activities in an efficient and effective manner to enable a system of co-operative activities of two or more persons. Fill in the blank.
   (a) Business
   (b) A company
   (c) Process
   (d) Organisation

3. There are no legal formalities needed to set up a business. This statement is true about which of the following?
   (a) Sole Proprietor
   (b) Partnership
   (c) Private Limited Company
   (d) None of the above

4. There are many advantages of setting up business as a sole-trader. Which of the following CANNOT be an advantage of a sole trader business?
   (a) Low cost of setting up
   (b) Combined Knowledge and Skills
   (c) Greater flexibility
   (d) A and C

5. Clubs and societies, Non-governmental organisations, Cooperatives and Public sector organisations fall in the same type of organisations. What is a term used to refer to these type of organisations?
   (a) Social Organisations
   (b) Not-for-Profit Organisations
   (c) Revenue Organisations
   (d) Social sector Organisations

6. Which of the following is a disadvantage of single-owner business organisations?
   (a) Unlimited Life
   (b) Limited Liability
   (c) Unlimited Liability
   (d) Limited interaction

7. A business that is co-owned by two or more people is referred to as a __________. The co-owners of the business are called partners and they collectively form the ______. Fill in the blanks to complete the sentence.
   (a) Firm, partnership
   (b) Partnership, firm
   (c) Partnership, Shareholders
   (d) Firm, proprietors

8. Professionals such as lawyers, accountants, and architects often join together in **general partnerships**. What is one distinctive feature of a general partnership over limited partnerships?
   (a) All partners are owners of the firm
   (b) Assets of the firm are divided as per the agreement between partners
   (c) All partners in a general partnership have unlimited liability
   (d) All of the above

9. The stockholders elect a _______________ to govern and handle the overall management of the corporation. Fill in the blank.
   (a) Board of Directors
   (b) Board of Stakeholders
   (c) Council
   (d) Committee

10. TRUE or FALSE: Limited partners do not participate in the management of the business but share in the profits in accordance with the terms of a partnership agreement.
   (a) TRUE
   (b) FALSE

11. TRUE or FALSE: The main feature of a limited company is that it has a separate legal identity from that of its owners.
   (a) TRUE
   (b) FALSE

12. Companies must pay income taxes on their profits. In addition, any profits (dividends) paid to stockholders are taxed as personal income. Which of the following terms explains this regulation on companies?
   (a) Double regulation
   (b) Double taxation
   (c) Unlimited taxation
   (d) Unlimited liability

ANSWERS TO SELF-TEST

1	D
2	D
3	A
4	B
5	B
6	C
7	B
8	C
9	A
10	A
11	A
12	B

CHAPTER 3

ORGANIZATION OF BUSINESS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Organisational structures
2. Types of Organizational Struture
3. Key elements of Organizational Structure

SELF-TEST

AT A GLANCE

An organisational structure is a formal arrangement of activities that bring efficiency and effectiveness for the achievement of business/organisational goals.

An organizational structure is based on several key elements such as specialization, levels of management, chain of command, spans of control, and chain of command. A formal structure, whether based on traditional or contemporary approaches, bring order, discipline, and control in overall decision-making process and help creating the shape of an organization such as tall or flat.

1 ORGANISATIONAL STRUCTURES

An organizational structure is the formal arrangement within an organization that defines how activities and tasks are formally divided and how processes and information would flow within this structure in order to achieve the goals and objective of an organization.

The purpose of having an organizational structure is that it:

- Divides work to be done into specific jobs and departments.
- Assigns tasks and responsibilities associated with individual jobs.
- Coordinates diverse organizational tasks.
- Clusters jobs into units.
- Establishes relationships among individuals, groups, and departments.
- Establishes formal lines of authority.
- Allocates and deploys organizational resources.

To put it in the simplest terms possible, an organizational structure describes how a company, division, team, or other organization is built; how all of its various components fit together.

An organizational structure consists of activities such as task allocation, coordination and supervision, which are directed towards the achievement of organizational aims in an effective and efficient manner.

Importance of Management Structure

Choosing the correct management structure ensures an organization's continued growth, content employees and profitable returns for the shareholders. Choosing the wrong structure creates tensions between employees and managers, allows inefficient work practices to flourish and reduces company profitability. In the worst case an incorrect management structure can lead to company closure.

Unfortunately, many managers take it for granted that their organization's management structure is correct, static and never requires changing. However, such assumptions are naïve and as the pace of change increases, there is a need to continually assess the suitability of a company's management structure. A dynamic management structure makes it easier providing a flexible and ready means for growth.

2 TYPES OF ORGANIZATIONAL STRUCTURES

Organizational structures differ between entities. The organizational structure of an entity should be appropriate for the size of the entity, the nature of its operations, and what it is trying to achieve. Most importantly, the organizational structure must enable the entity to develop plans and implement them effectively and efficiently.

There are several different types of organizational structure. Within a single entity, particularly in a large entity, there might be a mixture of different organizational structures, with different structures in different parts of the entity.

An organizational structure could be based on following approaches:

- Nature of work such as Skilled, Unskilled, Specialized, Management, etc.
- Traditional departmentalization such as Functional (finance, operations, marketing, etc.), Product (credit cards, mortgages, auto loans, etc.), Process (assembly, shipping, etc.), Customer (auto, airline, military, etc.), and Geographic (Europe, USA, Canada, etc.) are more rigid.
- Contemporary and team-based such as Matrix (also known as project management approach) and Committee (e.g. executive risk committee, business continuity committee, audit committee, etc) are more dynamic and assemble employees to respond quickly to dynamic business environments.
- Outsourcing of non-core activities to specialized vendors such as accounting or IT functions.
- Virtual network of independent companies including suppliers, customers, etc. linking through IT platforms is the new trend.

Following are the basic organizational structures that might exist within any entity or part of an entity:

a) an entrepreneurial structure
b) a functional structure
c) a divisional structure
d) a matrix organization.

Entrepreneurial organizations

An entrepreneurial organization is an entity that is managed by its entrepreneurial owner. The main features of an entrepreneurial organization are usually that:

a) the entrepreneur takes all the main decisions and does not delegate decision-making to anyone else.
b) the entity is therefore organized around the entrepreneur and there is no formal management structure.
c) operations and processes are likely to be simple, and the entity will probably sell just a small number of products or services.

An entrepreneurial organizational structure is appropriate when an entity is in the early phase of its life. The entrepreneur has a direct connection with its employees. As it grows larger, however, an entrepreneurial structure will become inefficient, and a formal management structure is needed.

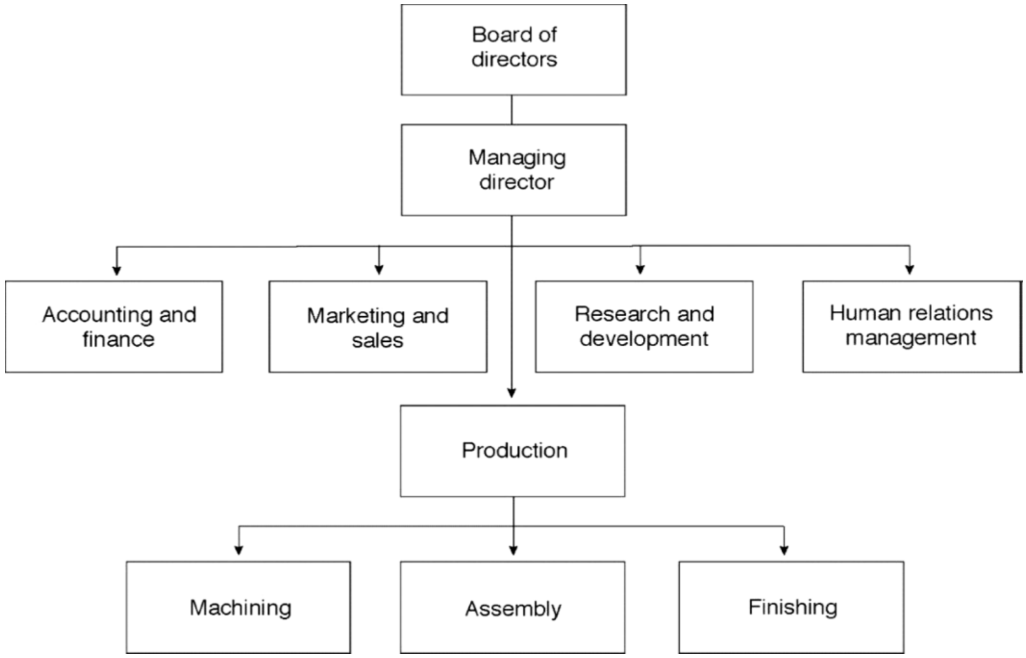
Functional organizations

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. Also, business colleges will often organize according to functions found in a business.

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.

AT A GLANCE
SPOTLIGHT

Each function has its own management structure and its own staff. An organization chart showing a simple functional structure is shown below.



Divisional organizations

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

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

Customer Division: Some companies prefer a customer division structure because it enables them to better serve their various categories of customers. Thus, Johnson & Johnson's two hundred or so operating companies are grouped into three customer-based business segments: consumer business (personal-care and hygiene products sold to the general public), pharmaceuticals (prescription drugs sold to pharmacies), and professional business (medical devices and diagnostics products used by physicians, optometrists, hospitals, laboratories, and clinics).

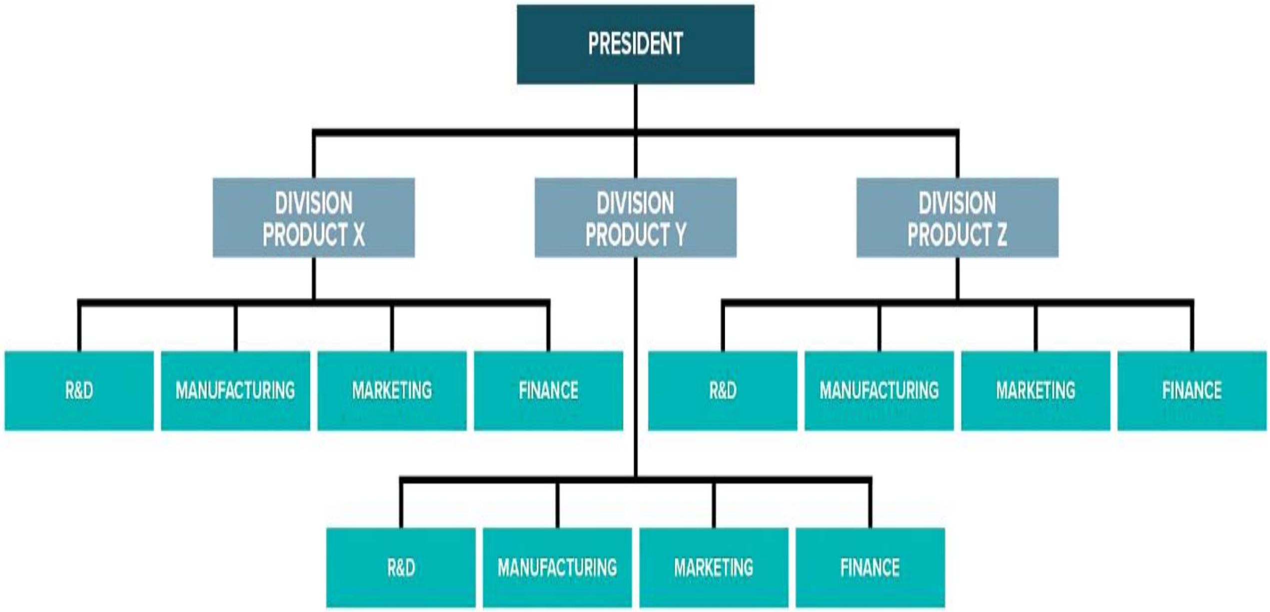
Process Division: If goods move through several steps during production, a company might opt for a process division structure. This form works well at Bowater Thunder Bay, a Canadian company that harvests trees and processes wood into newsprint and pulp. The first step in the production process is harvesting and stripping trees. Then, large logs are sold to lumber mills and smaller logs are chopped up and sent to Bowater's mills. At the mill, wood chips are chemically converted into pulp. About 90 percent is sold to other manufacturers (as raw material for home and office products), and the remaining 10 percent is further processed into newspaper print. Bowater, then, has three divisions: tree cutting, chemical processing, and finishing (which makes newsprint).

Geographical Division: It 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. They have eight different regions and each one reports its performance separately in their annual reports.

Summing Up Divisional Organizations

There are advantages and disadvantages associated with divisional organizations. 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.

A divisionalized organization with two divisions, where IT and Research and Development (R&D) are head office support functions is shown below.



Note: There could be a Corporate or Head Office function providing shared services to all divisions.

- *Example:*

Unilever's Organizational Structure for Product Innovation (By Panmore Institute and Justin Young)

Unilever maintains a structure that addresses corporate needs in terms of managing product types across the world. As a leading consumer goods firm, Unilever has an organizational structure that suitably supports diversified global operations and adapts to changes in the consumer goods industry and global market.

Features of Unilever's Organizational Structure

Unilever has a ***product type divisional*** organizational structure. The organization is divided into components based on their product focus. For example, the company has a division for personal care products and another division for home care products. The following are the main characteristics of Unilever's organizational structure:

1. Product type divisions (most significant feature)
2. Corporate executive teams
3. Geographic divisions (least significant feature)

Product Type Divisions. A product type division functions as a unit that enables Unilever to manage the development, manufacturing, distribution and sale of its consumer goods. For example, corporate managers use this feature of the organizational structure to match markets needs with appropriate products.

An advantage of this structural characteristic is its facilitation of the company's efforts to apply product differentiation, which is Unilever's generic strategy for competitive advantage. This corporate structure is beneficial, especially because the company already has a diverse portfolio of products. Unilever maintains the following product type divisions in its organizational structure:

1. Personal Care
2. Foods
3. Home Care
4. Refreshment

Corporate Executive Teams. Corporate teams are a secondary characteristic of Unilever's organizational structure. This structural feature is based on business functions.

For example, Unilever has a team for finance and another team for marketing communications. These teams make up the Unilever Leadership Executive (ULE) group.

Geographic Divisions. Geographic divisions are a minor feature of Unilever's organizational structure. The company uses this structural characteristic to support regional strategies. For example, Unilever's marketing strategies for Europe are different from strategies applied for Asian consumer goods markets.

Also, this corporate structure feature is used to analyze the company's financial performance. The following geographic divisions are maintained in Unilever's organizational structure:

1. Asia/Africa, Middle East, Turkey/ Russia, Ukraine, Belarus)
2. America
3. Europe

Unilever's Corporate Structure – Implications, Advantages & Disadvantages

An advantage of Unilever's organizational structure is its support for product development and innovation. For example, each product type division has its semi-autonomous capabilities to develop products that directly suit the needs in consumer goods market segments. This corporate structure is also advantageous because it enables Unilever to differentiate its products despite the large size of its global operations.

A disadvantage of Unilever's organizational structure is its minimal support for regional strategic implementation. Even though geographic divisions are one of its structural features, the company focuses more on product type divisions. As a result, there is limited support for market-specific or regional strategic reforms. Thus, to improve this organizational structure, Unilever must increase its emphasis on geographic divisions to empower regional managerial teams. Such structural change improves strategic effectiveness in regional consumer goods markets.

Matrix organizations

A matrix organization has been defined as: 'any organization that employs a multiple command system that includes not only a multiple command structure but also related support mechanisms and an associated organizational culture and behavior pattern' (Davis and Lawrence 1977).

Unlike the other structures we've looked at so far, a matrix organizational structure doesn't follow the traditional, hierarchal model. Instead, all employees have dual reporting relationships.

The matrix organization is also called the project management approach of organizational structure. It combines functional and product departmentalization, complementing their strengths and weaknesses, which brings together people from different functional areas of the organization (such as manufacturing, finance, and marketing) to work on a special project. Each employee has two direct supervisors: the line manager from her or his specific functional area and the project manager.

Matrix organization and project organization structures were both first used in the defense and aerospace industries, where companies were required to carry out major projects for customers, such as building a quantity of aircraft for a government customer.

The challenge was to complete projects on time and on budget. However, the traditional functional structure within the construction companies meant that no one was responsible for the project as a whole. A matrix organization or project management organization was introduced to overcome the problem.

- Project managers were appointed with overall responsibility for individual projects. Project managers had to organize the efforts of individuals in all the different functions.
- At the same time, functional managers such as management of engineering, production and sales and marketing, retained their decision-making authority.

In this way, a dual command structure was created. In a matrix organization, the traditional vertical command structure has an overlay of horizontal authority or influence.

CEO / President			
	Head of Production	**Head of Sales & Marketing**	**Head of Finance & Admin**
Project Manager A	Production Supervisor A	Sales Reresentative A	Manager Finance A
Project Manager B	Production Supervisor B	Sales Reresentative A	Manager Finance B
Project Manager C	Production Supervisor C	Sales Reresentative A	Manager Finance C

The difference between a matrix organization structure and a project organization is that with a project organization, the project management comes to an end when the project ends. With matrix organization, the matrix structure of authority and command is permanent.

Overall, matrix structures should:

- encourage communication
- place emphasis on 'getting the job done' rather than each manager defending his or her own position.

▶ *Examples of matrix organizations are as follows.*

- A large company in which there are:
  - divisional managers responsible for a geographical market or a particular product, and for the profitability of the market or the product, and in addition
  - functional managers at head office responsible for the major functions across the entire entity – for production, marketing and sales, human resources management and so on.
- A university in which there is a traditional command structure based on heads of faculty and heads of department, but in addition a course-based management structure in which individual lecturers are responsible for all aspects of particular courses or degree programs (for example, obtaining and managing the teachers from different faculties or departments, finding the lecture rooms, marking the examinations, and so on).

AT A GLANCE

SPOTLIGHT

- *Example:*

Starbucks Corporation's Organizational Structure Type and Characteristics

Starbucks has a ***matrix organizational structure***, which is a hybrid mixture of different features from the basic types of organizational structure (Koehn, 2002). In this case, the structural design involves intersections among various components of the business (Sakhartov, 2016; Lee, Kozlenkova & Palmatier, 2015). For example, the company's product-based divisions intersect with functional groups and geographic divisions, which in turn intersect with other parts of the organization ("Starbucks Coffee's Organizational Structure & Its Characteristics - Panmore Institute," n.d.).

The following are the main features of Starbucks Coffee's corporate structure:

1. Functional hierarchy
2. Geographic divisions
3. Product-based divisions
4. Teams

Functional Hierarchy. The functional hierarchy feature of Starbucks Coffee's organizational structure refers to grouping based on business function.

For example, the company has an HR department, a finance department and a marketing department. These departments are most pronounced at the top levels of Starbucks's corporate structure, such as at the corporate headquarters. This characteristic is hierarchical. For example, the corporate HR department implements policies applicable to all of the company's cafés. The functional hierarchy of the corporate structure facilitates top-down monitoring and control, with the CEO at the top.

Functional groups are responsible for the organization-wide development and implementation of Starbucks Corporation's generic competitive strategy and intensive growth strategies.

Geographic Divisions. Starbucks Coffee's corporate structure involves geographic divisions, which are based on physical location of operations. The company has three regional divisions for the global market: (1) America, (2) China and Asia-Pacific, (3) Europe, Middle East, and Africa.

Each geographic division has a senior executive. In this way, each local manager reports to at least two superiors: the geographic head (e.g. President of Europe, Middle East, and Africa Operations) and the functional head (e.g. Corporate HR Manager). This feature of Starbucks's corporate structure enables closer managerial support for geographic needs. Each division head is given flexibility in adjusting strategies and policies to suit specific market conditions.

Product-based Divisions. Starbucks has product-based divisions in its organizational structure. These divisions address product lines. For example, the company has a division for coffee and related products, another division for baked goods, and another division for merchandise like mugs. This feature of the corporate structure enables Starbucks to focus on product development. In this way, the company develops and innovates its products with support through its organizational structure.

Teams. Teams are used in different parts of Starbucks Coffee's organizational structure. However, teams are most visible at the lowest organizational levels, particularly at the coffeehouses. For example, in each café, the company has teams organized to deliver goods and service to customers. This feature of Starbucks's corporate structure enables the business to provide effective and efficient service to consumers. Team effectiveness is a major determinant of the financial performance of franchised locations and company-owned coffeehouses. Starbucks's corporate culture influences how such team effectiveness is achieved. The company's development depends on team-based factors and associated human resource management strategies.

Starbucks Corporation's organizational structure has many characteristics. However, the ones enumerated above are the most significant in shaping strategic management decisions in the business.

- *Example:*

TJ Limited (TJL) was established 10 years ago as a small scale manufacturing concern. At that time the total number of employees was 18. Most of the employees were directly reporting to the CEO. With the growth in business, number of employees has increased to 55 but no significant change has been made in the reporting structure.

a) In this scenario, TJL's growth has made it compulsory for the CEO to delegate some responsibilities to other staff so that he can focus on core business activities.

Functional/Mechanistic organizational structure seems most appropriate in the given situation. The functional structure would organize TJL according to the HR, IT, Accounting, Sales, Marketing and Administration functions. Each function will have its own management structure and its own staff. The individual employees who perform function-specific activities would report to the functional managers and functional managers will report to CEO. Because of the functional orientation, employees and the managers would gain specialized knowledge and experience of their respective functions.

In addition to the above, the delegation of authority would allow the CEO to focus his attention on core business functions, formulation and implementation of the company's business strategy, policies and procedures.

b) CEO is of the view that with the passage of time, some of the activities would have to be outsourced.

Considering the situation, TJL may outsource its Accounting / IT / HR / Administration functions.

Following are the possible benefits due to which CEO of TJL may outsource accounting function:

i. Outsourcing can help TJL to shift its focus from non-core activities to core activities.

ii. Mostly middle and small scale firms can't afford to match the in-house support that larger companies maintain. Outsourcing can help TJL to act "big" by giving it access to equally efficient and expert resources that are available to large companies.

iii. Outsourcing may lead to cost saving.

TJL may face the following problems due to outsourcing of Accounting Function:

i. When TJL will outsource its accounting function; it will turn the control of accounting function to another company.

ii. The vendor may not be driven by the same standards which are followed by TJL.

iii. Permanent employees usually work with more sense of responsibility as compared to outsourced staff.

iv. There is a risk that all information and confidential data will be available to the vendor and may be misused.

v. Vendor's staff may be frequently changed by vendor which may extend the learning curve and TJL may never be able to get the efficiency of a fully maintained team.

vi. TJL may become extremely dependent on the vendor. There is a risk to business continuity of TJL on account of either any dispute with the vendor or if the vendor goes out of business.

Note: Recent technological advancements have resulted in new types of organizational structures such as virtual, outsourcing, sharing-economy, etc.

The Virtual organizations

The virtual company or virtual organization does not have an identifiable physical existence, in the sense that it does not have a head office or operational premises. It might not have any employees or assets.

AT A GLANCE

SPOTLIGHT

A virtual organization is operated by means of:

a) IT systems and communications networks – normally telephone and e-mail

b) Specialized business partners for outsourcing key operations.

Many small businesses operate as virtual organizations. For example, a house builder might operate his business from his home. When asked to build a new house, he can hire all the labor – skilled and unskilled – that he needs to do the work, supervise it and check it. He can employ a firm of accountants to deal with the invoicing and payments. The builder does not need an office, or full-time employees. His core competence is his personal skill and experience, which he should use to give his firm its competitive advantage over rival house builders.

In the same way, there is no reason why a larger business should not be operated as a virtual company. For example, a company that sells branded footwear could operate as a virtual company, using its brand name as its major core competence. It could outsource all its value chain and support activities. Manufacture could be outsourced to producers in developing countries; warehousing companies could be used to hold inventories. A network of self-employed sales representatives might be used to sell the footwear into retail organizations, and marketing activities might be outsourced to an external agency.

One person, or a small number of individuals, can operate a virtual organization and indirectly control the actions of many 'external' entities and individuals.

A key to a successful virtual organization is the effective management of all the different external relationships, and co-ordination of their activities.

▶ *Example*

ABC Limited has shown poor performance during the preceding five years in spite of the fact that the company owns substantial physical assets, including modern machinery for manufacture of a wide range of products. All the assets of the company are in good working condition and marketing prospects for the products are also promising. However, the company's organizational structure is designed inappropriately and therefore has serious shortcomings and weaknesses which create impediments in its operations and are responsible for the company's unsatisfactory performance.

The characteristics which would be apparent in the working of ABC Limited because of its inappropriately designed organizational structure are as follows:

i. Conflicts and lack of coordination: Lack of clarity of goals and individuals working at cross-purposes give rise to conflicts and a non-conducive team environment resulting in poor coordination between the planning and actual operational levels.

ii. Delays and inappropriate decisions: Lack of proper and timely communication of information to the relevant individuals on account of insufficient delegation of authorities and inappropriate reporting channels resulting in delays and inappropriate decisions.

iii. Low motivation and morale: Low level of motivation and poor morale amongst the employees due to lack of clarity of job descriptions and inappropriate or complex reporting lines.

iv. Rising costs: Tall hierarchal structures at management positions and excessive red-tape at the expense of genuine productive work resulting in high operating costs.

v. Inability to seize business opportunities: Lack of coordination and communication among the various operating and planning and research departments resulting in failure to identify and seize new business opportunities as they emerge from time to time.

vi. Inability to adapt to external changes in business environment: Lack of coordination among the key management and the various departments which prevents the company from foreseeing the changes in business environment and utilize its physical assets at optimum levels.

3 KEY ELEMENTS OF ORGANIZATIONAL STRUCTURE

In this section, we'll be looking at the vital components or building blocks that you can pull and arrange in order to build an organizational structure.

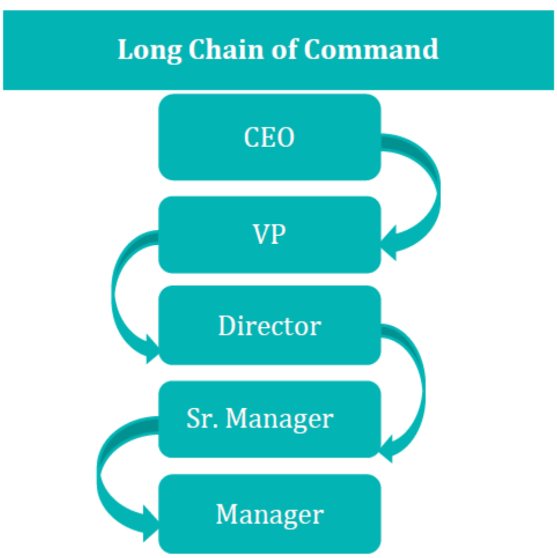
Following are different elements generally considered in building an organizational structure:

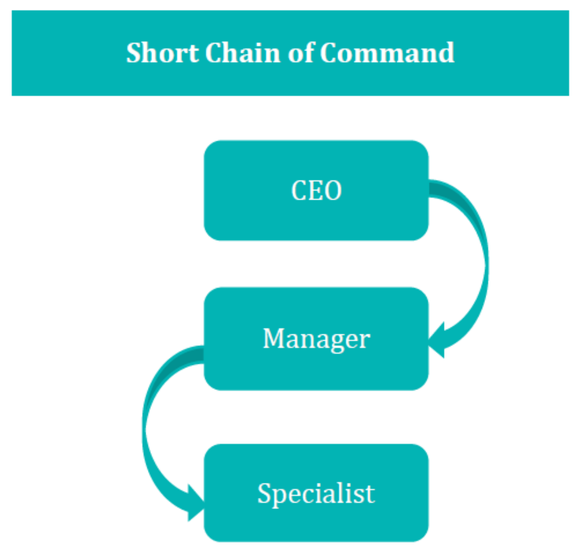
- departmentalization,
- chain of command,
- span of control,
- levels of management,
- centralization or decentralization of decision making, and
- work specialization

As explained below, some of the elements such as chain of command, span of control, and centralized or decentralized decision-making process are very basic and applicable to every type of organization.

4.1 Chain of Command

One of the most basic elements of an organizational structure, chain of command is exactly what it sounds like: an unbroken line of authority that extends from the top of the organization (e.g. a CEO) all the way down to the bottom. Chain of command clarifies who reports to whom within the organization.





4.2 Span of Control

Span of control refers to the number of subordinates a superior can effectively manage. The higher the ratio of subordinates to superiors, the wider the span of control.

Span of control depends on:

- Managers capabilities (physical & mental limitations)
- Nature of manager's workload
- Nature of work undertaken (how routine it is)
- Geographical dispersion of subordinates
- Level of cohesiveness within the team.

There can be a tall-narrow or wide-flat span of control

a) **Tall-narrow**. In this type of structure, each manager has a small number of subordinates reporting directly to him. As a result, in a large organization, there are many layers of management from the top down to supervisor level. The span of control is narrow, and the shape of the organization structure is tall, because of the many layers of management.

b) **Wide-flat**. In this type of structure each manager has a large number of subordinates reporting directly to him. As a result, even in a large organization, there are only a few layers of management from the top down to supervisor level. The span of control is wide, and the shape of the organization structure is flat, because of the small number of management levels.

4.3 Centralization and Decentralization

Who makes the decisions in an organization? If decision-making power is concentrated at a single point, the organizational structure is centralized. If decision-making power is spread out, the structure is decentralized. In many situations, junior ('local') managers have much better knowledge than senior management about operational conditions.

Tactical and operational decisions are probably better when taken by local management, particularly in a large organization. Giving authority to managers at divisional level and below helps to motivate the management team.

Decisions by management are more likely to be taken with regard for the corporate objectives of the entity as a whole. There is a very strong argument in favor of making strategic decisions centrally. Decisions by management should be coordinated more effectively if all the key decisions are taken centrally. In a crisis, it is easier to make important decisions centrally.

By level of decision-making:

- Centralized – decisions are made by senior management (e.g. functional, entrepreneurial).
- Decentralized – decision-making is delegated to lower levels (e.g. matrix, geographical).

a) In a centralized organization, senior management retain most (or all) of the authority to make the important decisions.

b) In a decentralized organization, the authority to take major decisions is delegated to the management of units at lower levels in the organization structure, such as strategic business units (SBU) managers, and divisional managers.

The choice between a centralized and a decentralized organization depends to some extent on the preference of senior management. However, the size and complexity of the entity also influence the extent to which decision-making, planning and control are centralized or decentralize ('devolved'). It is difficult to control a large and complex entity from head office, without delegating substantial amounts of authority to divisional managers.

Advantages of centralization

Advantages of centralization are as follows.

- Decisions by management are more likely to be taken with regard for the corporate objectives of the entity as a whole. There is a very strong argument in favor of making strategic decisions centrally.
- Decisions by management should be coordinated more effectively if all the key decisions are taken centrally.
- In a crisis, it is easier to make important decisions centrally.

Advantages of decentralization/devolution of authority

Advantages of decentralization are as follows.

- In many situations, junior ('local') managers have much better knowledge than senior management about operational conditions. Tactical and operational decisions are probably better when taken by local management, particularly in a large organization.

- Giving authority to managers at divisional level and below helps to motivate the management team.
- Decisions can be taken more quickly at a local level, because they do not have to be referred to head office.
- In a large and complex organization, many decisions have to be made – probably too many for senior management at head office.

The appropriate amount of centralization or decentralization for an entity will depend on the circumstances.

Based on the above key elements an organizational structure could be classified as tall (mechanistic) or flat (organic) as follows:

Key Elements	Tall	Flat
Work specialization	High degree	Low degree
Departmentalization	Rigid (more traditional structure)	Loose (more contemporary dtructure)
Management layers	Many levels	Few levels
Spans of control	Narrow	Wide
Decision-making	Centralized	Decentralized
Chain of command	Long	Short

For example, armed forces are typical Tall in its organization, whereas universities are Flat.

In reality, most organizations fall somewhere in the middle of these two classifications. An organizational structure also depends on the entity's overall goals and objectives. In addition, the size of the organization and the stability of its external environment play a key role in building an organizational structure.

SELF-TEST

For the following questions select the best answer.

1. Any organization that employs a multiple command system and related support mechanisms including an associated organizational culture is a:
   (a) Factory organisation
   (b) Functional organisation
   (c) Matrix organisation
   (d) All of the above

2. ______________refers to the number of subordinates a superior can effectively manage. Fill in the blank.
   (a) Span of control
   (b) Tall structure
   (c) Short structure
   (d) Control ratio

3. TRUE OR FALSE: Tactical and operational decisions should be centralized at the local management level, particularly in a large organization.
   (a) TRUE
   (b) FALSE

4. One World Limited has an organizational structure focused on its different line of businesses such as Consumer Products, Industrial Consumers, Retail Business and Customer Services. What type of structure below best describes One World Limited's structure?
   (a) Matrix Organisation
   (b) Narrow Organisation
   (c) Functional Organisation
   (d) Divisional Organisation

5. Which of the following is true for a Centralised decision making?
   (a) Decisions by management are more likely to be taken with regard for the corporate objectives of the entity as a whole. There is a very strong argument in favor of making strategic decisions centrally.
   (b) Decisions by management should be coordinated more effectively if all the key decisions are taken centrally.
   (c) In a crisis, it is easier to make important decisions centrally
   (d) All of the Above

6. Which of the following can be an advantage of centralized decision making in an organisation?
   (a) Decisions by senior management are always correct junior management cannot be trusted.
   (b) Decisions by management could be coordinated more effectively if all the key decisions are taken centrally.
   (c) In a crisis, the management will have no-one to answer to.
   (d) All of the Above

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7. Which of the following, if any, can be a feature of a decentralized organization structure?
   (a) In many situations, junior ('local') managers have much better knowledge than senior management about operational conditions.
   (b) Giving authority to managers at divisional level and below helps to motivate the management team.
   (c) Decisions can be taken more quickly at a local level, because they do not have to be referred to head office.
   (d) All of the above

8. ________________an unbroken line of authority that extends from the top of the organization (e.g. a CEO) all the way down to the bottom. Fill in the blank.
   (a) Chain reaction
   (b) Chain of command
   (c) Hierarchy
   (d) Span of control

9. Which of the following stands true about the Chain of Command?
   (a) Chain of command makes an organisation too complex
   (b) Chain of command cannot exist in a functional organization
   (c) Chain of command clarifies who reports to whom within the organization.
   (d) All of the above

10. The span of control is wide, and the shape of the organization structure is flat, because of the small number of management levels. This statement is true for:
   (a) Wide-flat structure
   (b) Tall-narrow structure
   (c) Tall-flat structure
   (d) Wide-short structure

11. A ________________organization groups together people who have comparable skills and perform similar tasks. Fill in the blank.
   (a) Matrix
   (b) Functional
   (c) Geographic
   (d) Complex

12. The English Food Co. has organized its workforce based on their expertise. Which organizational structure does the company follow?
   (a) Divisional Organisation
   (b) Functional Organisation
   (c) Matrix Organisation
   (d) Cannot be determined from the given information

13. TRUE or FALSE: The size and complexity of the entity influence the extent to which decision-making, planning and control are centralized or decentralized.
   (a) TRUE
   (b) FALSE

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ANSWERS TO SELF-TEST

1	C
2	A
3	A
4	D
5	D
6	B
7	D
8	B
9	C
10	A
11	B
12	B
13	A

SOURCES OF BUSINESS FINANCE

IN THIS CHAPTER:

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1. Financial Management
2. Sources of Short-term Financing
3. Sources of Long-term Financing
4. Debt Versus Equity Financing

SELF-TEST

AT A GLANCE

To achieve the goals and objectives of a business, financial management is critical to decide which type of financing is required to maximize shareholders' value. This could be achieved through a mix of debt or equity, or short-term and long-term financing. The ultimate financing decision should be based on optimal capital structure and value maximization for shareholders.

Any company, whether it's a small grocery shop or a large fast moving consumer goods company, needs money (funds) to operate. To make money (funds inflow) through sales, a company must first spend money (funds outflow) 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 optimal management of a company's finances is just as much a key to the company's success. Accordingly, the role of financial manager is also critical for the overall success of a company

1. FINANCIAL MANAGEMENT

Financial management is the art and science of managing a company's funds so that it can meet its goals and objectives. The science part belongs to analyzing data and cash flows. The art part belongs to optimum use of resources. All business decisions have financial consequences. Managers in all departments must work closely with finance 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 IT department will need to justify any requests for new computer systems or employee laptops. Therefore, all stakeholders, directly or indirectly, are part of the financial management of a company. It is just not the responsibility of finance department.

Knowledge of accounting and finance plays a critical part in understanding the concept of financial management. A company's financial statements such as Balance Sheet, Income Statement, and Cash Flow Statements are a key source of information for financial management, which are mostly prepared by professional accountants. Financial managers focus on financial planning and cash flow management.

Following is a basic structure of a Balance Sheet, in a report format, which shows how the sources of finances (liabilities and shareholders' equity) and the uses of finances (assets) of a company are summarized on a specific date such as at the year-end:

Balance Sheet As at 31 December 20XX	
Assets	**Liabilities and Shareholders' Equity**
Current assets (short-term): which are convertible into cash within one year	Current liabilities (short-term): obligations due within one year
Non-current assets (long-term); which are of a more permanent nature	Non-current liabilities (long-term): obligations due within one year
	Total liabilities
	Shareholders' equity (permanent): including capital and retained earnings
Total assets	**Total liabilities and Shareholders' equity**

An important aspect of financial management is the choice of financing methods for a company's assets. Companies use a variety of sources of finance and the aim should be to achieve an efficient capital structure that provides:

- A suitable balance between short-term and long-term funding
- Availability of adequate cash for day to day expenses
- A suitable balance between equity (funds raised through the sale of ownership in the business) and from debt (borrowed funds) in the long-term capital structure.

1.1 Role of a Financial Manager

In today's fast-paced global economy, managing a company's finances is more complex than ever. For financial managers, a thorough command of traditional finance activities - financial planning, investing money, and raising funds - is only part of the job. Financial managers are more than number crunchers. As part of the top management team, chief financial officers (CFOs) need a broad understanding of their company's business and industry, as well as leadership ability and creativity. They must never lose sight of the **primary goal of the financial manager**: **to maximize the value of the company to its owners**, measured by the share price or value of stocks.

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. A widely used concept is risk-return trade-off to ensure optimum use of company's resources, which means that the higher the risk (that an investment will not achieve the expected return), the greater the return that is required. There are many factors which may result in a potential risk such as changing pattern of market demand, interest rates, general economic and market conditions, etc. A scenario-analysis based on risk-return trade-off is an important tool to analyze risk-return trade-off.

The key activities of the financial manager, to achieve their primary goal, are:

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

1.2 Sources of Finance

Corporations are often required to raise external funding or capital to expand their businesses into new markets or locations, to invest in research & development, or to spend on campaigns to deal in a competitive market. And, while organisations do aim to use the available revenues and profits from ongoing business operations to fund such projects, it is often more appropriate to seek external lenders or investors. Despite all the differences among the thousands of companies in the world across various industry sectors, there are only a few sources of funds available to all organisations.

Debt Capital (financing)

Like individuals, organisations can also borrow money. This can be done privately through bank loans, or it can be done publicly through a debt issue. These debt issues are known as corporate bonds, which allow a wide number of investors to become lenders (or creditors) to the organisation. The drawback of borrowing money is the interest that must be paid to the lender, where a failure to pay interest or repay the principal can result in default or bankruptcy. But, the interest paid on debt is typically tax-deductible and costs less than other sources of capital.

Equity Capital (financing)

An organisation can also raise capital by selling its ownership in the form of shares to interested investors, existing or new, which is known as equity funding. The benefit of this type of capital is that investors do not require interest payments like bondholders do. The drawback is that further profits are divided among all shareholders (including new ones) in the form of dividends. Furthermore, shareholders have voting rights on important matters of the organisation, which means that the company's management control is weak or forfeited, due to increase in shareholders. Another way of equity financing is through retaining earnings in the business by not fully distributing the profits to shareholders as dividends.

Sources of finance can also be classified based on time-duration or maturity. This results in two types of financing:

- Short-term Financing
- Long-term Financing

2. SHORT-TERM FINANCING

Short term finance refers to financing needs for a small period normally less than a year. In businesses, it is also known as working capital financing. Short-term financing is shown as a current liability on the balance sheet. It is used to finance current assets and support operations.

Financing may be secured or unsecured, which is on the basis of the firm's creditworthiness and the lender's previous experience with the firm. This type of financing is normally needed because of uneven flow of cash into the business, the seasonal pattern of business, etc. In most cases, it is used to finance all types of inventory, accounts receivables etc. At times, only specific one time orders of business are financed.

2.1 Short-term Financing options

Few examples of short term financing are as follows:

- Trade Credit: Accounts Payable
- Bank Loans
- Committed lines of credit
- Operating leases
- Factoring / discounting of receivables

Trade Credit: Accounts Payable

Accounts Payable are amounts due to vendors or suppliers for goods or services received but have not yet been paid. Generally, an unsecured mode of financing. An organisation should try to negotiate favourable credit terms from its suppliers. Trade credit from suppliers has no cost, and is therefore an attractive method of short-term finance. However, an organisation is expected to honour its credit arrangements and pay its suppliers on time at the end of the agreed credit period. It's not a good strategy for any organisation to increase the amount of its trade payables by taking excess credit and making late payments.

Advantages

- It allows the organisation to keep a smooth flow of the manufacturing process without any shortages of the material.
- It gives increased purchasing power to the organisation.
- The organisation does not have to pay interest cost.
- Generally, no specific collateral is required.

Disadvantages

- Obtaining goods on credit may become a habit for the organisation and accumulate its debts. It may also discredit the company's reputation in market.
- The organisation may lose any discount incentives which are available for buying on cash
- The organisation will have to incur additional costs to manage its accounts payable personnel and record keeping.

Bank Loans

Short-term bank loans might be arranged for a specific purpose, for example to finance the purchase of specific items. Unlike an overdraft facility, a bank loan is for a specific period of time, and there is a repayment schedule.

Several different types of business loans are generally available. The specific type of loan that a organisation obtains may depend on its reasons for funding need or the length of time the funds are required.

Another type of business loan is a term loan, which is used to finance the purchase of fixed assets such as machinery. The maturity on a term loan may typically be between 3 and 10 years. Such loans are considered long-term loans and can be secured or unsecured.

Advantages

- Bank loans provide you the flexibility to spend the money as per company's requirements.
- The company does not have to give up with rights for control and ownership to get the finance.

Disadvantages

- There is an interest cost involved in obtaining bank loan.
- The process of obtaining a bank loan is very time consuming as well as requires excessive paperwork and some kind of collateral to keep the rates lower.

Committed lines of credit

A committed credit line is a legal agreement between a financial institution and a borrower setting out the conditions of a credit line. Once signed, the agreement requires the financial institution to lend money to the borrower, provided that the borrower does not break the conditions.

This allows the organisation to borrow up to a specified amount of money within a specified period of time. For example, a line of credit may allow an organisation to borrow up to Rs1,000,000, but it would have to pay off the credit within one year. A line of credit is especially useful when an organisation expects that it will need funding in the future, but does not know exactly when it will need funds or how much it will need.

Advantages

- It gives the flexibility to the organisation to borrow money when the need arises
- There is less paperwork involved at each drawdown of funds
- The interest is only paid on amounts borrowed

Disadvantages

- The facility cannot be used for large borrowings
- The rates of interest are generally higher than bank loans
- The bank can change or withdraw limit at any time or may ask for repayment earlier than the expected date
- The facility may be secured against assets of the organisation and there is a risk that assets may be confiscated if the company does not to make timely payments.

Operating leases

A lease is a contractual agreement whereby one party that is the owner of an asset grants the other party the right to use the asset in return for a periodic payment. In simpler terms, leasing is renting an asset of the organisation for a specified period.

In some cases, operating leases might be an alternative to obtaining short-term finance. Operating leases are similar to rental agreements for the use of non-current assets, although they might have a longer term. (Rental agreements are usually very short term).

Advantages of Lease Finance

- Lease rentals paid by the lessee (lease holder) are deducted from taxable profits.
- Leasing provides finance without diluting the ownership of the asset.
- It enables the lessee to obtain the asset with a lower price rather than owning it.
- Easy documentation makes it simpler to finance assets.
- The lessor carries the risk of obsolescence. This allows flexibility to the lessee to replace the asset.

Disadvantages of Lease Finance

- It may result in higher payout obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement.
- Financial activities of business may be affected in case the lease is not renewed.
- There are chances that a lease arrangement might impose certain restrictions on the use of assets. For example, it may not allow the lessee to make any modification in the asset.
- The lessee never becomes the owner of the asset.

Factoring / Discounting of Receivables

In discounting, a firm sells its accounts receivable outright to a factor, which is a financial institution (often a commercial bank or commercial finance company) that buys accounts receivable at a discount. Discounting is more expensive than a bank loan, however, because the factor buys the receivables at a discount from their actual value, but provide quick access to funds.

For businesses with steady flow of orders but a lack of funds to make payroll or other immediate payments, discounting is a popular way to obtain financing by selling its invoices to a third-party..

2.2 Advantages of Short-term finance

There may be a number of benefits of using short-term sources of finance.

- **Less Interest Amount:** As these are to be paid off in a very short period within about a year, the total amount of interest cost under it will be least as compared to long term loans which take many years to be paid off. The long term loan total interest cost might be more than the principal amount.
- **Disbursed Quickly:** The risk involved in defaulting of the loan payment is lesser than that of the long term loan as they are having a long maturity date. As a result, it takes lesser time to get sanctioned the short term loan as their maturity date will be shorter. Thus one can get the loan sanctioned and fund disbursed very quickly.
- **Less Documentation:** As it is less risky, the documents required for the same will also be not too much making it an option for all to approach for short term loan.

2.3 Disadvantages of Short-term finance

- **Smaller size of facility and installment**: The main disadvantage of the short term finance is that one can get a smaller amount of loan only and that too with shorter maturity date so that the borrower won't get burdened with bigger installments. It is fixed that the period of loan will be less than 1 year and if a high amount of loan is sanctioned, the monthly installment will come very high resulting in an increase in the chance of default in repayment of loan which will affect the credit score adversely.
- **High Rate of Interest**: Another limitation of short-term finance is that there is generally a higher interest rate associated with short-term loans as opposed to long-term loans. However, it is acknowledged in most circumstances that a short-term loan is only an interim measure to refinance a more traditional long-term loan.
- **Debt Trap**: It can leave the business with no other option than to come into the trap of the cycle to borrow in which one continues borrowing to repay the previous unpaid loan. In this cycle, the interest rate keeps on increasing and can terribly affect the business and its liquidity.

The short-term financing might not be adequate and, for businesses that are already stretched, there might not be additional sources of funds available.

- **Asset-Liability Mismatch**: Funding long-term assets with short-term liabilities on the assumption of frequent renewals of short-term debts creates high risk of default due to sudden illiquid market conditions, as resulted in 2008 financial crisis.

3. SOURCES OF LONG-TERM FINANCING

The funds which are paid back after a period of one year are referred to as long term finance. Certain long term finance options directly form a part of the permanent capital of the organisation, where an obligation does not even arise. The primary purpose of obtaining long-term funds is to finance capital projects and carry out operations on an expansionary scale e.g. modernization, expansion, diversification and development of business operations. Such funds are normally invested into avenues from which greater economic benefits are expected to arise in future.

Generally, the companies resort to the sources of long-term finance when they have an inadequate cash balance and need funds to carry out its operation for a longer period of time. Some objectives of long-term finance may be to:

- purchase new asset or equipment
- finance the permanent part of the working capital
- enhance the cash flow in the company
- invest in R&D operations
- construct or build new construction projects
- develop a new product
- design marketing strategies or increase facilities
- expand business operations

The long term financing could be done internally, i.e. within the organization (equity) or externally (debt), i.e. from outside the organization

3.1 Types of Long-term Financing options

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.

The types of long-term financing are as follows:

- Debt financing
- Equity financing

3.2 Debt Financing

The term 'debt finance' is used to describe a type of finance where the borrower:

- receives funds, either for a specific period of time or possibly in perpetuity.
- acknowledges an obligation to pay interest on the debt for as long as the debt remains outstanding; and
- agrees to repay the amount borrowed when the debt matures (reaches the end of the borrowing period).

Few examples of debt financing are as follows:

- Term loans
- Bonds
- Finance lease

Term Loans

For Term Loans, refer to the section on Bank Loans.

Bonds

Bonds are long-term debt instruments involving two parties- the borrower (issuer) and the lender (buyer or investor). The borrower can be the government, a local body or a corporation. They generally provide fixed interest payments at periodic intervals and are redeemable at a predetermined date in future. The issuer of a

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bond must pay the buyer a fixed amount of money called interest, stated as the coupon rate on a regular schedule. The issuer must also pay the bondholder the amount borrowed called the principal, or par value at the bond's maturity date (due date). A bond certificate is issued as proof of the obligation. Bonds are normally issued against collateral and are therefore a highly secured form of long term finance.

Advantages

- Fixed-rate bond pays a regular interest rate or coupon rate return to investors, therefore, provide a predicated form of cash out flow needs for an issuer.
- Considered less risky comparing to equity (stocks) mode of financing due to specific maturity period of bonds.
- Most bonds are universally rated by credit rated agencies providing an independent source of analysis.
- Convertible bonds can be converted to equity shares after a specified period, making them more appealing to investors.
- In the event of a corporation's bankruptcy, the bond is paid before common stock shareholders. Further many bonds are secured through some form of collateral. Therefore, bonds are considered less risky compared to stocks.
- Provide a medium and long term source of financing avoiding short-term refinancing risk.
- Cheaper form of financing comparing to bank debts for higher credit rating issuers.

Disadvantages

- Fixed-rate bonds may have interest rate risk exposure in environments where the market interest rate is rising.
- Creditworthiness is important when considering the chance of default risk from the underlying issuer's financial viability.
- Bonds may have inflationary risk if the coupon rate does not keep up with the rate of inflation.
- Creates a commitment of cash payments – interest and principal – therefore a liquidity risk.
- Requires to maintain certain financial and non-financial caveats such as maintaining certain ratios.

Finance Lease

A finance lease is another way of providing finance, where effectively a leasing company (the lessor or owner) buys the asset for the user (usually called the hirer or lessee) and rents it to them for an agreed period.

Simply, the finance lease is the type of lease wherein the lessor transfers all the risks and rewards (control) associated with the asset to the lessee before the lease agreement expires. The ownership could be transferred at the expiry of the lease agreement with mutually agreed terms.

Finance Lease is more widespread in the acquisition of assets as computers and electronic equipment which become obsolete quicker because of rapid development in technology in the sector. It is very important while making the leasing decision to compare the cost of leasing the asset with the cost of owning the same.

Advantages of Finance Lease:

- **Liquidity**: The lessee can use the asset without investing company funds in the asset. The cost is spread over monthly instalments rather a large upfront investment.
- **Fixed cost**: The rental cost is fixed over a specific period, even if interest rate rise.
- **Tax advantage**: Lease rentals are deducted from taxable profits.
- **Flexibility**: Customized repayment structures are available, tailored to match a company's cash flow patterns.

Disadvantages of Finance Lease:

- **Repossession**: Lease agreement is secured against the asset. In case of non-payment, the asset may be repossessed.
- **Credit Rating**: Non-payment can negatively affect the credit rating of both the business and guarantor.
- **Ownership**: The legal ownership remains with the finance company (lessor).
- **Conditions**: There are certain caveats which needs to followed for finance lease such as maintaining certain mileage for an auto, overall maintenance of the leased asset, current ratio, etc.

Difference between Finance and Operating Lease

- Title: Once the finance lease is expired, the lessee can purchase an asset at a bargain price. In operating lease, generally, the ownership is retained by the lessor during and after the lease term.
- Term / period of use: Generally, extended period for finance lease, and brief period for operating lease.
- Accounting Treatment: Finance lease is included as an asset on the balance sheet of the lessee. Whereas, operating lease is treated as an off-balance sheet item. Accounting standards provide some quantitative criteria to classify a lease between operating or finance lease as follows:
  - The finance lease term is at least 75% of the estimated economic life of the asset. However, in operating lease, the lease term is considerably less than the economic life of the equipment.
  - The present value of finance lease payment is at least 90% of the asset's value.
- **Termination**: The lessee can terminate the operating lease even at the short notice and without any significant penalty, subject to the lease agreement. Usually, finance lease is difficult to be terminated.
- **Running costs & administration**: In Finance lease, the lessee is responsible for insuring and maintaining the equipment, in addition to the periodic lease installment. Whereas, in operating lease, the cost of insurance and maintenance of the equipment is included in the periodic lease installment within the designated term and usage.

Advantages of Long-term Debt Financing

The benefits offered by long-term financing compared to short term, mostly relate to their difference in maturities. Long-term financing offers longer maturities, at a natural fixed rate over the course of the loan. The key benefits of long-term vs. short term financing are as follows:

i. **Coincides with Long-Term Strategy**: Long-term financing enables a company to align its capital structure with its long-term strategic goals, affording the business more time to realize a return on an investment. Similarly, long-term finance can help a business in building synergies. Overall, long-term finance can help in the growth and expansion of a business.

ii. **Matches Duration of Asset Base with Duration of Liabilities**: The maturity associated with long-term financing better coordinates with the typical lifespan of assets purchased.

iii. **Long-Term Support from Investor**: A company can benefit from having a long-term relationship with the same investor throughout the life of the financing. With the right investor, companies stand to gain from a long-term relationship and partnership, in addition to ongoing support. Being that the financing is long term, a company will not have to repeatedly bring in new financing partners who may not understand the business as well, which can often happen with short-term financing.

iv. **Limits Company's Exposure to Interest Rate Risk**: Long-term, fixed-rate financing minimizes the refinancing risk that comes with shorter-term debt maturities, due to its fixed interest rate, thus decreasing a company's interest rate and balance sheet risk.

v. **Diversifies Capital Portfolio**: Long-term financing provides greater flexibility and resources to fund various capital needs, and reduces dependence on any one capital source. It also enables companies to spread out their debt maturities.

vi. **Lower Cost:** Generally, long-term financing has relatively lower interest rate, comparing to short-term financing.

vii. **Flexibility of Repayment**: Generally, long-term finance comes with flexible repayment options, which allows them to repay them in a controlled manner.

Disadvantages of Long-term Debt Financing

The main disadvantages of long-term debt finance are as follows:

i. **Caveats**: Long-term finance may come with certain conditions or regulations such as maintaining certain mix of capital structure, and level of current ratios.

ii. **Additional Monitoring and Controls**: Due to the higher finance and regulations involved, long-term finance may also need additional monitoring and control to ensure proper operations.

iii. **Fixed Rate of Return for Lender**: In a rising market rates expectation, finding long-term fixed rate financing at a cheaper rate is difficult.

- **Additional Legal Documentation and Collateral**: Long-term financing may require additional efforts on paperwork, and collateral to avoid default risk.

Short-term Financing vs. Long-term Financing

Businesses can obtain short- or long-term finance to fund their operations. Ultimately, which type of finance a business uses depends on its requirements.

Comparison of short-term finance and long-term finance

A comparison of Short-term and Long-term Finance	Short-Term Finance	Long-Term Finance
Duration (maturity)	Typically repayable within one year or less.	Have a longer time span varying from 1 to 30 years.
Requirements	Obtained to fund temporary shortfall in the working capital, repayment of current liabilities etc.	Obtained to fund the growth, purchase of property, plant and equipment, or capital projects on a wide scale.
Collaterals	Do not create a charge on the assets of the company.	Collaterals are the most primary condition for the furnishing of long term finance.
Terms of loan	Interest rates are unstable and are vulnerable to inflationary forces. Terms of loans are not very flexible.	Interest rates are stable and the terms of the loan offer flexibility such as prepayment options, re-negotiation of interests upon improvement in credit rating etc.
Volume of funds	Used to raise funds in limited amount since they are repayable in the near future.	A large volume of funds can be obtained. However the same is restricted to the nature of securities furnished, the credit rating of borrower, etc.
Examples	Overdraft, Credit Cards, Line of Credit.	Leasing, Term Loans, Public Deposits, Bonds.

	Short-term Financing	Long-term Financing
Approval Process / Chances	Simple and fast process with higher chances of approval – less to verify	Complex and slow process with slightly harder chances of approval – more to verify
Repayment Schedule	Lower flexibility	Higher flexibility
Financing Cost	Higher interest rate	Lower interest rate
Selection Criteria	Short-term financing preferable if borrower in a liquidity crunch and need funds quickly to bridge the timing of cash flows.	Long-term financing preferable if borrower is stable and need funds for strategic goals at best interest rate due to better credit position.

3.3 Equity Financing

Equity refers to the owners' investment in the business. In corporations, the preferred and common stockholders are the owners. A company obtains equity financing by selling new ownership shares (external financing) or by retaining earnings (internal financing).

Few examples of equity financing are as follows:

- Retained earnings
- Issuing shares for cash
- Preferred stock

Retained Earnings

The **Retained Earnings** represent that portion of the equity earnings (left after deducting the tax and preference dividends), which is sacrificed by the equity shareholders and is ploughed back into the company to reinvest these in the core business operations, such as paying off the debt obligations or purchasing capital assets.

A company can obtain equity financing by retaining earnings rather than by distributing the earnings to its owners. The board of directors of each company decides how much of the company's earnings should be retained (reinvested in the company) versus distributed as dividends to owners. **Dividends** are payments to stockholders from a corporation's profits. Dividends can be paid in cash or in stock.

When companies retain profits in the business, the increase in retained profits adds to equity reserves. The retained capital, in principle, is reinvested in the business and contributes towards further growth in profits.

Increasing long-term capital by retaining profits has several major benefits for companies.

- When new equity is raised by issuing shares, there are large expenses associated with the costs of the issue. When equity is increased through retained earnings, there are no issue costs because no new shares are issued.
- The finance is readily-available, without having to present a case to a bank or new shareholders. Shareholder approval is not required for the retention of earnings.

However, there may be a limit to the amount of earnings available for retention. There are three main reasons for this.

- The company might not earn large profits. Earnings can only be retained if the company is profitable.
- Earnings are either retained or paid out to shareholders as dividends. By retaining earnings, a company is therefore withholding dividends from its shareholders. Therefore, retained earnings must be used efficiently, to provide a suitable return on investment. Unless retained earnings contribute to future growth in earnings and dividends, shareholders will demand higher dividends and lower earnings retention.

Advantages of Retained Earnings

- These earnings are readily available, and the company is not required to seek help from the shareholders or lenders in case of urgency of funds.
- Retained earnings enhance the financial position of a business. This further helps the business to attract equity and debt finance investors. For example, a business with a strong financial position can easily obtain a loan from the bank as compared to a business with a weak financial position.
- Retained earnings are a cheaper alternative to other sources of finance (debt or equity) for a company because it is internally generated. When a business raises equity or debt finance, it has to bear certain costs, which is not the case with retained earnings. Furthermore, businesses don't need to meet any credit rating or security requirements to use retained earnings, unlike debt finance.
- The use of retained earnings reduces the cost of issuing the external equity and also eliminates the losses incurred on underpricing.
- There will be no dilution of control and ownership, in case the company relies on the retained earnings.
- If a company chooses not to pay dividends and retain all its earnings, it still generates wealth for its stockholders through appreciation in its net worth and the value of stocks.
- Generally, the stock market views the equity issue as doubtful and therefore, these earnings do not carry a negative connotation.

Disadvantages of Retained Earnings

- The amount raised through the accrual earnings could be limited and also it tends to be highly variable because certain companies follow a stable dividend policy.
- The retained earnings, in some cases, may not necessarily match with the cash flows, forcing the company to still borrow the funds.
- The opportunity cost of these earnings is relatively high because it shows that amount of earnings, which have been foregone by the equity shareholders.
- Some companies do not give much importance to the opportunity cost of these earnings and invest these into sub-marginal projects that have negative NPV, which me reduce the shareholders' value.

Issuing Shares for cash

Companies can raise equity capital externally by issuing new shares for cash, but the opportunity to do so is much more restricted for private companies than for public companies.

The main difference between a private vs public company is that the shares of a public company are traded on a stock exchange, while a private company's shares are not. Accordingly, the worth of ownership is measured by the share price (for public companies) or value of stocks (for private companies).

Private companies cannot offer their shares for sale to the general investing public, and shares in private companies cannot be traded on a stock market. They can sell shares privately to investors but it is usually difficult to find investors who are willing to put cash into equity investments in private companies. The existing owners of a company might not have enough personal capital to buy more shares in their company. Existing shareholders are therefore a limited source of new capital.

Public companies may offer their shares to the general public. Many public companies arrange for their shares to be traded on a stock market. The stock market can be used both as a market for issuing new shares for cash, and also a secondary market where investors can buy or sell existing shares of the company.

There are three main methods of issuing new shares for cash:

- Issuing new shares for purchase by the general investing public: this is called an **initial public offer** or an IPO
- Issuing new shares to a relatively small number of selected investors: this is called a **placing or private placement of shares.**
- Issuing new shares to existing shareholders in a **rights issue**.

There are mainly two types of shares that a company may issue to raise equity. These are known as Common Stock and Preferred Stock.

Advantages

- There is no commitment to pay back the funds raised through share issuance (i.e. capital). When the company obtain debts, it has to pay high interest and make a commitment for fixed periodic payments. On the other hand, the company has flexibility to pay dividend to shareholders.
- The company can use the funds obtained through share capital in any manner, however, for debts there may be conditions imposed by the creditors to use it for specific purpose.
- Investors find companies financed through shares more attractive than companies financed with debts. It signals market confidence on company's growth strategies and management leadership.
- Even for lenders, a higher share capital is considered a buffer to mitigate default risk.
- Shareholders cannot force a company into bankruptcy if it fails to make payments, however, the creditors may do so if the company fails to repay interest.
- For issuance of shares to employees, it aligns company's goal of achieving profitability with staff's goal of being financially rewarded, resulting in a workforce of high morale and hard-working culture, transforming a good company into a great one.

Disadvantages

- The company's ownership is diluted and it will be required to share its future growth and profits with other shareholders.
- The company's control is diluted and it will be required to get the consent of its majority shareholders for many important matters of the company. This may slow down the decision-making process on critical matters, where a quick solution is required.
- The company will be required to make compliance with the relevant laws in place otherwise it may face huge consequences. This results in a higher regulatory risk.
- Selling shares is a lengthy, time-consuming process, with lot of uncertainties and cost.
- Public companies require to provide lot of information publicly, which is a costly process.

Preferred Stock (Preference Shares)

Another form of issuing new shares as form of equity is **preferred stock**. While both preferred shares and common shares give shareholders ownership in a company, they come with different shareholder rights. Preference shares, also known as preferred shares, have the advantage of a higher priority claim to the assets of a corporation in case of insolvency and receive a fixed dividend distribution. These shares often do not have voting rights and can be converted into common shares.

The basic features of preference shares are as follows:

- Most preference shares are issued with a fixed rate of annual dividend.
- Preference dividends are paid out of after-tax profits.
- Preference shareholders will be entitled to receive dividends out of profits before any remaining profit can be distributed to ordinary shareholders as equity dividends.
- If the company goes into liquidation, preference shareholders rank ahead of equity shareholders, but after providers of debt finance, in the right to payment out of the proceeds from sale of the company's assets.
- Preference shares are fairly uncommon with a few exceptions.

For the issuing firm, preferred stock is more expensive than debt because its dividends are not tax-deductible, and its claims are secondary to those of debtholders but less expensive than common stock.

The advantages of preference shares for companies are that:

- The annual dividend is fixed, and so predictable (with the possible exception of participating preference shares).
- Dividends do not have to be paid unless the company can afford to pay them, and failure to pay preference dividends, unlike failure to pay interest on time, is not an event of default.
- Issuing preference shares is easy, in the case where the company has undergone an IPO and has Authorized Share Capital.
- The amount that is raised by selling preference shares does not have to be repaid back by the company. So, such funds may be used for company's long-term growth strategy.
- Since Preference Shares do not have voting rights, they do not have control over the operational affairs in the company. Therefore, issuing preference shares does not affect the decision-making ownership structure of the company.
- Investors like preference shares due to their priority over common shares.
- Preference shares provide flexibility of financing for long-term and short-term purposes. There is a natural alignment with long-term objectives of the company. However, the redemption (or Callable) features can be used for short-term financing needs.
- Preference Shareholders need to be paid on a high priority basis (before common shareholders) in the case of liquidation. (Note: This is an advantage for preferred shareholders, but a disadvantage for the common shareholders)

The disadvantages of preference shares for companies are that:

- Dividends are not an allowable cost for tax purposes.
- As the annual dividend is fixed dividend, it needs to be paid, similar to the interest on debts, regardless of the volume of profit that the company has generated in the given year. So, it increases the financial risk of the firm.
- It is costly in the longer term comparing to long-term debt instruments, as the dividend charge is higher than rate of interest and not tax deductible.
- 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.
- In the case of cumulative preference shares (which are the most commonly used preference shares), if the company is unable to pay dividends for one particular year, the dividend accumulates and is carried forward to the next year. Therefore, this means that it might be a burden for the company to settle the dividend payments in the years where they were not able to make substantial profits.
- Only public limited companies can sell shares to the general public on the stock exchange. Therefore, this option is only available to medium and large organizations that are formally listed on the Stock Exchange.

4. DEBT VERSUS EQUITY FINANCING

As per the 'pecking-order theory', a company should prefer to finance itself in the following order:

i. First internally through retained earnings, which signals to market that the company is performing strong.

ii. Second through debt, which signals to market that management is confident that the company can meet its obligations.

iii. Finally, and as a last resort, through the issuing of new equity, which is normally a negative signal that the company is overvalued and it seeks money prior to its share price falling.

However, the ultimate financing decision should always be based on optimal capital structure and value maximization for shareholders.

- *Example:*

  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 financing 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 and cash out flow. In addition, there is no loss of ownership. The major drawback is financial risk: the chance that the company 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 company. The company 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 decision-making. Equity is costlier than debt. Unlike the interest on debt, dividends to owners are not tax-deductible expenses.

A summary of major differences between Debt and Equity financing is shown in the table below:

Major Differences between Debt and Equity Financing

Areas	Debt Financing	Equity Financing
Have a say in Management	Creditors typically have none, unless the borrower defaults on payments. Creditors may be able to place restraints on management in event of default. **Financial caveats can also be added to debt agreements such as maintaining minimum current and quick ratios.**	Common stockholders have voting rights.
Have a right to income and assets	Debt holders rank ahead of equity holders. Payment of interest and principal is a contractual obligation of the company.	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.

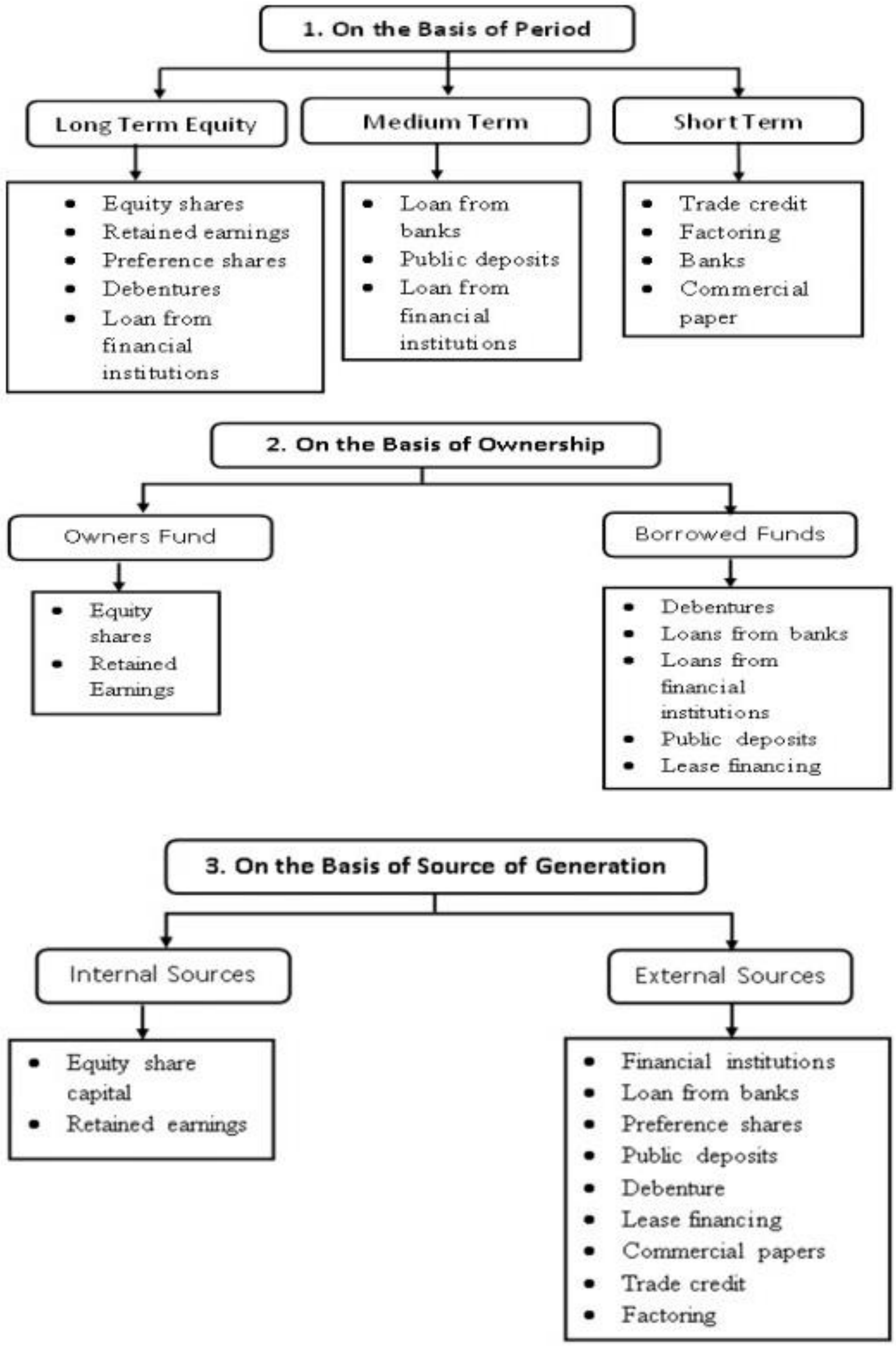


Figure - **CLASSIFICATION OF SOURCES OF FINANCE**

SELF-TEST

For the following questions select the best answer.

1. ________________ management is the art and science of managing a company's funds so that it can meet its goals. Which of the following completes the statement?
   a. People
   b. Revenue
   c. Financial
   d. Data

2. Which of the following is/are features of an efficient capital structure?
   i. A suitable balance between short-term and long-term funding
   ii. Availability of adequate cash for day to day expenses
   iii. A suitable balance between equity and debt in the long-term
   a. I only
   b. I and III only
   c. II only
   d. I, II and III

3. Which of the following is the best summary about the role of a financial manager?
   a. To maximize the value of the business for its shareholders
   b. To organize the finance department
   c. To manage salaries and overheads of the business
   d. None of the above

4. Revenues from sales of product or services should be the primary source of funding. But funds from sales doesn't always come in when required. TRUE or FALSE?
   a. TRUE
   b. FALSE

5. Corporations are often required to raise external funding, or capital. Which of the following may be reasons for requirement of additional funding?
   a. to expand their businesses into new markets or locations,
   b. to invest in research & development,
   c. to spend on competitive market campaigns.
   d. All of the above

6. Sources of finance can also be classified based on time duration. TRUE or FALSE?
   a. TRUE
   b. FALSE

7. What are the key activities of the financial manager?
   a. Preparing the financial plan, which projects revenues, expenditures, and financing needs over a given period.
   b. Investing the company's funds in projects and securities that provide high returns in relation to their risks.

   c. Obtaining timely funding for the company's operations and investments and seeking the best balance between debt and equity
   d. a, b and c

8. Preference shares often do not have voting rights and can be converted into common shares. TRUE or FALSE?
   a. TRUE
   b. FALSE

9. Which of the following is NOT a feature of preference shares?
   a. Most preference shares are issued with a fixed rate of annual dividend.
   b. Preference dividends are paid out of after-tax profits.
   c. Preference shareholders will be entitled to receive dividends out of profits before any remaining profit can be distributed to equity shareholders.
   d. If the company goes into liquidation, preference shareholders are paid after equity shareholders.

10. Which of the following is a feature of preference shares?
   a. Most preference shares are issued with a variable rate of annual dividend.
   b. Preference dividends are paid out of after-tax profits.
   c. Preference shareholders will not be entitled to receive dividends.
   d. a and c

ANSWERS TO SELF-TEST

1	C
2	D
3	A
4	A
5	D
6	A
7	D
8	A
9	D
10	B

CHAPTER 5

INFORMATION SYSTEMS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Role of Information Systems
2. General System Concepts of Information Technology
3. Key Elements of Information Systems
4. Types of Information Systems
5. Levels of Information Systems

SELF-TEST

AT A GLANCE

- In an increasingly technological world, every business faces new opportunities as well as unique challenges.
- Information is critical for effective and efficient decision-making, and to achieve the goals and objectives of a business.
- This chapter focuses on the use of Information Systems (IS) in a business organization including its role, types, and levels.
- The overall objective of this chapter is to equip the students with the basic understanding of IT based management information system and enable them to understand:
- Basic computer hardware i.e., input, output, storage of information and network
- The concepts of information technology and information systems
- Role and types of information systems in business
- Key elements of information system:
  - Data
  - Data entry – batch, online, real-time
  - Database
  - Database Management System
  - Networks
  - Integration
  - Security and privacy
- Use of information systems at different levels of management – operational, middle, senior

1 ROLE OF INFORMATION SYSTEMS

We are living in an increasingly technological world, which brings not only opportunities but challenges as well. Any business can create a competitive advantage by the effective use of Information Technology (IT). This may be achieved through efficient business processes (for instance; purchasing, selling, human resource), and obtaining information for optimal decision-making, which result in substantial operational and cost benefits.

The information is used in day-to-day decision-making to perform multiple tasks such as planning, acquiring, searching, analysing, organizing, storing, programming, producing, distributing, marketing, or selling functions. In order to know how to gather and use information from the many resources available to us, an understanding of information systems is critical. Broadly, it includes users, hardware, and software that support decision-making.

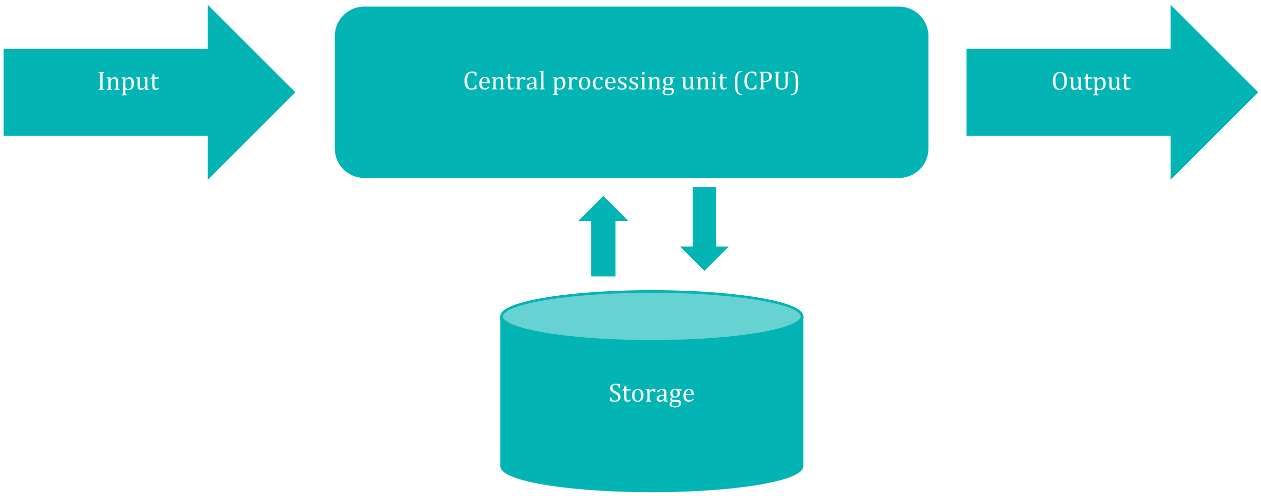
An information system (IS) collects and processes data into information that is provided to users for use in strategic planning, decision making, performance monitoring, and production. These systems give both companies and consumers access to vast amounts of information and also facilitate communication between management, and staff as well as all internal and external stakeholders. Consequently, they can help company to increase their revenue and reduce their expenses through optimisation of time and money. They have also enabled new companies to compete in geographically dispersed product markets. Virtually all companies use some type of IS to store, access and analyse information; improve communication with customers; and improve communication among employees.

If a company determines how to use information technology to improve its efficiency, it can reduce its expenses and increase its earnings. If it can use information technology to attract more customers or offer additional products, it can increase revenue and increase its earnings. Investing in information systems can be expensive for companies, therefore, it is important to carry out a cost-benefit analysis of investing in technologies that will (not) provide a net positive return on investment within their relatively short useful lives as technology experiences fast paced change.

2 GENERAL SYSTEM CONCEPTS OF INFORMATION TECHNOLOGY

2.1 Computer systems

A computer system comprises four key components:



Input devices facilitate the introduction of data and information into the system. Examples might include a keyboard, scanner, mouse or barcode reader.

Output devices facilitate the extraction of processed information from the system. Examples would include a printer, speaker or screen (visual display unit).

The **central processing unit** is the 'brain' of the computer that takes the inputs, processes them and then outputs the results.

Finally, some type of storage facility is useful to enable data to be saved for future use.

2.2 Computer hardware

Computer hardware consists of the computers themselves plus all the peripheral equipment connected to a computer for input, output and storage of data (such as printers and stand-alone disc drives).

The computers used in IT systems range from the very large supercomputers to the very small hand-held computers. In many organizations, different computers are connected to each other to form a network.

The globalisation of the business environment has resulted in much more widespread use of portable laptop computers. Laptops can typically be connected to the organisation's computer network or to the Internet from remote locations via a data connection such as Wi-Fi or a phone line. This means, for example, that a manager can access his e-mails or the organisation's Intranet system (a system that looks and feels like the internet but is only available to employees) from anywhere in the world.

2.3 Input devices

As we saw in section 2.1 above computer systems have four key components – input, CPU, storage and output. In this section we take a brief look at some of the many input devices commonly used in computer systems.

Keyboards

Keyboards are the most common input device and are part of virtually all computer systems. Keyboards can be stand-alone and connected to the computer with a cable or through a wireless connection, or they might be integrated into the computer itself, such as with a laptop or notebook.

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Touch-sensitive screens and touch pads

A recent trend has been towards integrating the keyboard into touch-sensitive screens and touch pads. Both these devices involve the user touching an area of a screen, for example a picture of a keyboard, to simulate the pressing of a physical key such as on a regular keyboard.

Examples of touch-sensitive screens include automated payment booths used to buy train or bus tickets and bank ATM machines.

Magnetic ink character recognition (MICR)

Magnetic ink character recognition (MICR) requires the input media to be formed of specially formatted characters printed in magnetic ink. These characters are then read automatically using a specialised reading device called MICR reader.

The most common example of MICR is in the banking industry with the use of cheques and deposit slips.

Optical mark reading (OMR)

Optical mark reading (OMR) is similar to MICR in that it is an automated input method. OMR involves marking a pre-printed form with a pen or typed line (or cross) in an appropriate box. The card is then read by an OMR device which senses the mark in each box.

Uses can include national lottery entry forms and ballot voting slips.

Scanners and optical character recognition (OCR)

Scanners read text or illustrations printed on paper and translate the information into a format the computer can use. The resolution (number of pixels recorded for each image – pixels are minute areas of illumination on a display screen which taken together form the image) can normally be adjusted to reflect how sharp the users need their image on the computer.

Mice, trackballs and similar devices

Mice and trackball devices are hand-operated devices with internal sensors pick up the motion and convert it into electronic signals which instruct the cursor (pointer) on screen to move.

Touch sensitive pads and joysticks that similarly control the cursor are also now commonly found in the centre of the keyboard. Most current laptops and notebooks incorporate a pad or joystick.

Voice date entry (VDE)

Many computers can now accept voice input via a microphone and voice data entry (VDE) software. One particularly useful application is found in language translation programs that support simultaneous translation. Another example might be in a smartphone where you can enter commands aurally rather than by typing, for example with an instruction such as "Call Office".

Barcodes and QR (quick response) codes, EPOS

Barcodes are the groups of black and white marks with variable spacing and thickness found on product labels such as those at the supermarket. Each code is unique and can be read automatically by an electronic barcode reader.

QR codes are matrix, or two-dimensional, barcodes. Originally popular in the automotive industry they have seen a recent rise in popularity elsewhere given their fast readability and greater storage capacity than standard barcodes.

EPOS stands for *electronic point of sale* which is normally integrated with barcode readers. EPOS allows credit and debit cards to be read for instant payment for goods.

A recent development of EPOS has seen the growth of technology that supports mobile phones being used in a similar way to credit and debit cards. A phone signal rather than the magnetic strip on a credit card is used to identify the purchaser.

Digital cameras

Digital cameras can be found in the form of stand-alone units or they may be integrated into other technology such as smartphones and tablet computers. Digital cameras capture images and videos in digital form and allow easy transfer to a computer where they can be manipulated by software.

Digital cameras are used in many situations whether it is for the development of marketing material, recording of crime scenes by the police, or by an auditor on a year-end inventory count.

Benefits and limitations

The following table presents some of the benefits and limitations of each of the input methods described above.

Input method	Benefits	Limitations
Keyboards	Common, simple and cheap	Labour-intensive and slow. Prone to error.
Touch-sensitive screens and touch pads	Saves space. Integrated graphical user interfaces are very user-friendly and intuitive.	Can be difficult to grasp the techniques for accurate data entry. Labour intensive and slow. Expensive.
Magnetic ink character recognition (MICR)	Speed and accuracy	MICR documents are expensive to produce.
Optical mark reading (OMR)	Speed and accuracy	OMR documents can be expensive to produce. Also a risk of 'spoilt' documents (marks made outside the allotted boxes).
Scanners and optical character recognition (OCR)	Excellent for inputting graphics and text quickly	Can be slow to scan multiple images. File sizes might be large for very high quality scans. OCR can be somewhat inaccurate if input image is low quality.
Mice and trackball devices	Easy to use and very common. Cheap and simple.	Slow and can be prone to error.
Voice data entry (VDE)	Convenient and simple.	Can be inaccurate and affected by external interference (noise)
Barcodes and EPOS	Very common. Accurate. Quick.	Damaged barcodes are impossible to read. Incompatibility issues if different types of barcodes are received by the organization.
Digital cameras	Versatile, quick, accurate. Widevariety of high quality image editing software now available.	Higher quality means larger file size which can become expensive and difficult to manage.

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SPOTLIGHT

2.4 Output devices

Output devices

An output device is the part of a computer system that receives the processed data from the computer and presents it in some way.

Output devices are distinct from input devices which are the parts of the computer that provide data and instructions. However, technology has advanced to the stage where some devices are a combination of both input and output such as a touch-sensitive screen.

Output devices come in a number of forms:

Output device	Description
Monitor (display)	A monitor is a bit like a television screen – it provides visual output from the computer for text and graphics. Note though that monitors only offer temporary output as the image is lost when power removed.
Printers	A printer is a device that prints output to a page (on paper). Printing can be in colour or 'black and white' depending on the printer type. A number of different types of printers exist
Speakers and headsets	Speakers are attached to computers for the output of sound. The sound output is produced by a sound card. Headsets are a combination of speakers and microphones and are commonly used by gamers.
Storage devices	Output may be made to some kind of storage device such as a DVD or CD-ROM, flash memory (USB flash disk or key), blu-ray drive or external hard disk drive.
Projector	A projector can be thought of as a variation of monitor in that it translates the digital output into a visual display projected onto a screen. Think of some of the lectures you attended and how common it is for a computer to be connected to a projector to output the presentation slides.

2.5 Storage devices

Storage devices

We have already seen how the CPU is the brain of the computer taking inputs from various devices such as keyboards, mice and scanners then outputting to devices such as speakers, printers and monitors. However, computers need somewhere to store all the data such as music, videos, pictures, documents, spreadsheets, presentations, emails and so on.

The different types of storage devices found within a computer system include the following:

Storage type	Description
Primary storage (internal memory)	Internal temporary store directly accessible by the CPU that allows it to process data. Volatile by nature as it is erased when power is turned off. Much smaller than secondary or tertiary storage but much quicker to access (as it has no mechanical parts). Examples include RAM and ROM (see 1.2 above) plus the CPU's cache memory (temporary store of instructions repeatedly required to run programs – typically up to 2MB (megabytes) in size).

Storage type	Description
Secondary storage (external memory)	Secondary storage is used for data not currently being processed but which may need to be accessed at a later stage, for example the operating system, documents, music files and emails. Non-volatile as data remains intact even when powered off. Examples include: • Flash memory (USB flash drives or keys) • Floppy disks • CD • DVD • Blu-ray drive • Magnetic tape • Cloud drive
Tertiary storage	Tertiary storage typically involves a robotic mechanism that mounts (inserts) and dismounts removable mass storage media into a storage device. Often used for archiving rarely accessed information as it is much slower than secondary storage.
Offline storage	Offline storage describes any type of data storage that is not under the control of a processing unit. The medium is typically recorded on a secondary or tertiary storage device which is physically removed or disconnected. Off-line storage therefore needs human intervention to re-connect for subsequent access. For example keeping a copy of all your important files offline in a separate building.

2.6 Information technology and information systems

Information technology

Information technology describes the application of computers and telecommunications equipment to store, retrieve, transmit and manipulate data.

The term is typically associated with computers and computer networks. However, the full definition includes other information distribution technology such as television, telephone and radio.

Information system

Information system describes complementary networks of software and hardware that people and organizations use to collect, filter, process, create and distribute data and information.

Within organisations, information systems support operations, management and decision making.

The term 'information system' is broader than 'information technology' as it incorporates the way in which people interact with the technology in support of business processes, as well as the information and communication technology (hardware and software) itself.

In summary:

- System – a set of interacting components that operate together to accomplish a purpose
- Business system – a collection of people, machines and methods organised to accomplish a set of specific functions
- Information system – all systems and procedures involved in the collection, storage, production and distribution of information
- Information technology – the equipment used to capture, store, transmit and present information

Information management – planning, the environment, control and technology

Elements of a system

The elements of a system include:

- Goals
- Inputs
- Processes
- Outputs
- The environment
- Boundary (this limits the system from its environment)

Open and closed systems

Closed systems - the environment has no effect on the system and the system has no effect on the environment. Examples in the real world are rare and business examples even rarer; one useful example is that of a scientific experiment.

Open systems - do interact therefore the environment will affect the system and the system will affect the environment. All businesses, social and information systems are examples of open systems.

System adaptation

Open systems will adapt to their environment with varying degrees of extremity. Examples include:

- Deterministic systems
  - Use predetermined rules
  - Therefore have predicted operations
  - Giving predictable outputs
  - Examples include machines and computer programs
  - These systems will follow a standard and often have a rule book.

- Probabilistic systems
  - Assign a probability to future events
  - Their behaviour is less easy to predict
  - Most businesses are examples of probabilistic systems
  - When a business sales forecasts it will try to predict sales based on past evidence.
  - In effect the business tries to change before the event has occurred.

- Self-organising or cybernetic systems
  - Most complex type of system
  - Continually changing
  - Adapts to the environment
  - Example trade union negotiations
  - These types of systems are the least likely to be computerised
  - Rely heavily on interaction from people

Control systems

Control is important in any information system. The two main types of control are open and closed loop control.

- **Closed loop control** has inbuilt control very much like a thermostat in a heating system, they are not responsive to changes in the environment. A business example which has inbuilt control is a stock or a credit control system where the system automatically checks responses.

Closed loop control is most suitable for the type of system which is stable. Systems which exist in a relatively dynamic environment are not suitable for this type of control.

- **Open loop control** systems do not have inbuilt control as it comes from the outside the system - no thermostat.

A business example would be the whole organisation. Open control systems are responsive to the environment and they often involve interaction from users.

The elements of a control system include:

- input, process, output
- sensor - measures the output from the system and determines a new value
- comparator - compares the new value with that of the standard
- standard - the predetermined limit set within the system
- effector - effects the feedback into the system can be positive or negative.

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3 KEY ELEMENTS OF INFORMATION SYSTEMS

The key elements of IS are as follows:

- Data (raw, unorganized data processed into meaningful and useful information for specific use)
- Database (an electronic filing system to collect and organize data and information)
- Database Management System – DBMS (a software to enter, store, organize, select, and retrieve data in a database)
- Networks
- Integration (provides an holistic view of data and information available within an organization under different areas and functions)
- Security and Privacy

Data:

Data are a set of values of qualitative or quantitative variables about one or more persons or objects. It can exist in various forms: as numbers or text recorded on paper, as bits or bytes stored in electronic memory, or as facts living in a person's mind. Business data is all the information that is related to a company, such as sales data, customer contact information, and even website traffic statistics.

Such data is processed into meaningful and useful information, which is then used for specific purposes, such as business analysis, control, and decision-making.

Database:

Database is an electronic filing system that collects and organizes data and information. It is the core of business information systems. Key users tap into databases to access the information they need, whether for placing inventory orders, scheduling production, or preparing long-range forecasts.

For example, a customer database containing name, address, payment method, products ordered, price, order history, and similar data provides information to many departments. Big size companies use very large databases called data warehouses and data marts.

DBMS:

DBMS is a software called a database management system, which is used to quickly and easily enter, store, organize, select, and retrieve data in a database. DBMS software primarily functions as an interface between the end user and the database, simultaneously managing the data, the database engine, and the database schema in order to facilitate the organization and manipulation of data. There are different types of databases and DBMS available depending upon the needs of a business organization.

The main types of DBMS are:

- Hierarchical database
- Network database
- Relational database
- Object-Oriented database

Popular DBMS examples include cloud-based database management systems, in-memory database management systems (IMDBMS), columnar database management systems (CDBMS), and NoSQL in DBMS.

Networks:

Most businesses use networks to deliver information to employees, suppliers, and customers. A computer network is a group of two or more computer systems linked together by communications channels to share data and information. Today's networks often link thousands of users and can transmit audio and video as well as data. The best-known computer network is the internet.

Computer networks support a vast range of uses including:

- The world wide web (internet)
- Sharing software applications such as databases and Worksheets
- Email
- Sharing devices such as printers, fax machines and scanners
- Online booking systems
- Instant messaging
- Internet-based communication such as Skype

System architectures:

The term system architecture refers to the way in which the components of a computer system such as printers, PCs and storage devices are linked together and how they interact.

A **centralised** architecture involves all processing being performed on a single central computer.

Decentralised architectures spread the processing power throughout the organisation at several different locations. This is typical of the modern workplace given the significant processing power of modern PCs.

Typical network configurations include star networks, ring networks, bus networks and tree networks.

Client-server computing:

Client-server computing describes one level of interaction found between computers in systems architecture.

The client is the application that runs on a personal computer or workstation. It relies on a server that manages network resources or performs special tasks such as storing files, managing one or more printers, or processing database queries. Any user on the network can access the server's capabilities.

A **server** is a machine that is dedicated to providing a particular function or service requested by a **client** within a network system.

Servers can range in power from 'top-end' super servers, capable of driving thousands of network users, to 'low-end' servers which are typically a powerful personal computer (PC). Different types of servers might include file servers, network servers, print servers, e-mail servers and fax servers.

File servers manage the data files that are accessible to users of the network. All the shared data files for the system are held on a file server or are accessible through a file server.

Network servers route messages from terminals and other equipment in the network to other parts of the network. In other words, network servers manage and control the routing of messages within computer networks.

The basic types of networks companies use to transmit data—local area networks and wide area networks—and popular networking applications such as intranets and virtual private networks.

- **Local Area Network (LAN)**:

  A LAN is a computer network covering a small geographic area such as a home, office, group of buildings or school.

  LAN offers a more cost-effective way to link computers than linking terminals to a mainframe computer. The most common uses of LANs at small businesses, for example, are office automation, accounting, and information management. LANs can be set up with wired or wireless connections.

A LAN's distinguishing features include:

- Due to its localised nature, the data transfer speeds are high
- Typically owned, controlled and managed by one person or a single organization

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- Low cost maintenance
- Relatively low data transmission errors
- One LAN can be connected to another LAN over any distance via telephone lines and radio waves

Wide Area Network (WAN):

A WAN is a computer network that covers a broad area i.e. a network that communicates across regional, metropolitan or national boundaries over a long distance.

A WAN connects computers at different sites via telecommunications media such as phone lines, satellites, and microwaves. A modem connects the computer or a terminal to the telephone line and transmits data almost instantly, in less than a second. The internet is essentially a worldwide WAN. Companies also connect LANs at various locations into WANs. Several forms of WANs are intranets, virtual private networks (VPN), and extranets. WANs can be set up with wired or wireless connections.

A WAN's distinguishing features include:

- Data transfer speeds are much lower than with LANs due to the greater distance that information must travel.
- WANs exist under collective or distributed ownership and management covering long distances.
- Setup costs are typically higher due to the need to connect to remote areas. Furthermore, maintaining a WAN is more difficult (and expensive) than maintaining a LAN due to its wider coverage.
- In contrast to LANs, the data transmission error rate tends to be significantly higher.

Intranet:

Like LANs, intranets are private corporate networks. Intranets operate behind a firewall that prevents unauthorized access. They are also considerably less expensive to install and maintain than other network types. Intranets have many applications, from human resource (HR) administration to logistics.

Virtual Private Network (VPN):

Many companies use VPN to connect two or more private networks (such as LANs) over a public network, such as the internet. VPNs include strong security measures to allow only authorized users to access the network and its sensitive corporate information. Companies with widespread offices may find that a VPN is a more cost-effective option than creating a network using purchased networking equipment and leasing expensive private lines.

Integration:

Companies are discovering that they can't operate well with a series of separate information systems geared to solving specific departmental problems. It takes a team effort to integrate the systems described and involves employees throughout the firm. Company-wide enterprise resource planning (ERP) systems that bring together human resources, operations, and technology are becoming an integral part of business strategy. So is managing the collective knowledge contained in an organization, using data warehouses and other technology tools.

An integrated IT system describes the scenario where all modules of the system are linked and function together as a system in a coordinated fashion.

For example, an integrated finance system would link a number of underlying modules such as

- Accounts payable control
- Accounts receivable control
- Accruals and prepayments
- Bank and cash
- Inventory
- Purchases
- Sales

So, for example a new sales order would be simultaneously reflected in the accounts receivable, sales and inventory modules.

Advantages of integrated systems

- Offers a more complete view
- Enables better informed decisions
- Should ultimately lead to a more efficient operation
- Which would lead to greater customer satisfaction and hence profitability

Disadvantages of integrated systems

- Greater risk that if one module fails the whole system could fail
- More complex and therefore prone to error
- More expensive than standalone systems
- May require a greater level of support as the system is likely to need to be bespoke (tailored) specifically to the organisation

Security and Privacy:

Unauthorized access into a company's computer systems can be expensive, and not just in monetary terms but as a reputational risk also. The costliest categories of threats include worms, viruses, and Trojan horses; computer theft; financial fraud; and unauthorized network access.

Computer crooks are becoming more sophisticated all the time, finding new ways to get into ultra-secure sites. Whereas early cybercrooks were typically amateur hackers working alone, the new ones are more professional and often work in gangs to commit large-scale internet crimes for large financial rewards. The internet, where criminals can hide behind anonymous screen names, has increased the stakes and expanded the realm of opportunities to commit identity theft and similar crimes. Working remotely also increase cyber security concerns.

Firms are taking steps to prevent these costly computer crimes and problems, which fall into several major categories:

- Unauthorized access and security breaches.
- Computer viruses, worms, and Trojan horses.
- Deliberate damage to equipment or information.
- Spam
- Software and media piracy

Creating formal written information security policies to set standards and provide the basis for enforcement is the first step in a company's security strategy. Without information security strategies in place, companies spend too much time in a reactive mode—responding to crises—and don't focus enough on prevention.

Another recent concern is about privacy of individuals challenged through collection of personal information at various forums. The challenge to companies is to find a balance between collecting the information they need while at the same time protecting individual consumer rights. Many companies now state in their privacy policies that they will not abuse the information they collect. Regulators are taking action against companies that fail to respect consumer privacy.

4 TYPES OF INFORMATION SYSTEMS

As discussed earlier, IS collect and store the company's key data and produce the information users (e.g., managers) need for analysis, control, and decision-making.

IS are used, for example, in factories to automate production processes and order and monitor inventory. Most companies use them to process customer orders and handle billing and vendor payments. Banks use a variety of IS to process transactions such as deposits, ATM withdrawals, and loan payments.

There are several types of IS such as:

- Transaction Processing System (TPS)
- Management Support System (MSS)
- Decision Support System (DSS)
- Executive Information System (EIS)
- Expert System (ES)
- Office automation systems to improve the flow of communication.

Each type of information system serves a particular level of decision-making: operational, tactical, and strategic.

Transaction Processing System (TPS)

TPS is the starting point of an integrated information system. The TPS receives raw data from internal and external sources and prepares these data for storage in a database similar to a microcomputer database but vastly larger. In fact, all the company's key data are stored in a single huge database that becomes the company's central information resource. The DBMS tracks the data and allows users to query the database for the information they need.

TPS automate routine and tedious back-office processes such as accounting, order processing, and financial reporting. They reduce clerical expenses and provide basic operational information quickly.

Data could be entered manually by a person keying the information in. Some systems are more advanced and support technology-based data entry such as optical character recognition or magnetic ink character recognition.

Data entry describes any of the techniques used to initially record data into a system. A few examples of data include:

- Sales information
- Purchase information
- New employee details
- Updates to existing employee details

There are following two ways database can be updated (i) Batch processing, and (ii) Online, or real-time processing.

Batch processing:

Batch processing is the collection of a group of similar transactions over a period of time, and their processing at a single time as a batch. This is an efficient method to update the database periodically for applications such as monthly payroll processing.

This type of processing has been associated with mainframe centralised type systems. The method has been reduced in importance with the development of more advanced types of processing. It still remains an important form of processing as many systems used now, are based on batch processed systems.

- Advantages
  - Relatively easy to develop
  - Less processing power is required as deals with similar updates
  - Checks in place as part of the systems run
  - Less hardware required, therefore cheaper.
- Disadvantages
  - Often delays between when a transaction is made and when the master file is updated and the output generated.
  - Management information is often incomplete due to out of date data.
  - Often master files kept off line therefore access may not always be available.

Online processing:

Online processing refers to equipment that operates under control of the central computer but typically from a different location through some kind of terminal.

Examples include:

- An ATM machine for a bank – the ATM is linked to the bank's central computer system and updates the user's account immediately
- Flight booking system at a travel agency

If a service is no longer online (available) it is described as being offline. When a system is offline its services are no longer available.

You may have experienced something similar when browsing the internet. For example when you have a Wi-Fi connection your web-browser is considered to be 'online' and will update. However, if there is no Wi-Fi signal and hence no connection the browser is considered to be 'offline'. In this case you will not be able to download any new information to the computer.

Real-time processing:

Real time processing is the processing of individual transactions as they occur without the need for batching them together.

This type of processing allows the user to update the master files immediately. It is an expansive method to update the database in real-time for applications such as airline's information system.

- Advantages
  - Information more up to date therefore providing better management information.
  - Increased ability for data to be online.
- Disadvantages
  - Increase in expense as the system becomes more complex to run and to develop.
  - Increased hardware capacity which increases costs.

▶ ***Examples of TPS:***

Finance and accounting TPS

The major functions would typically include:

- Budgeting
- The nominal ledger
- Invoicing
- Management accounting

The system might be split into a number of modules including:

- Nominal ledger
- Accounts payable
- Accounts receivable
- Budgeting
- Treasury management

Human resources TPS

The major functions would typically include:

- Personnel records
- Benefits
- Salaries
- Labour relations
- Training

The system might be split into a number of modules including:

- Payroll
- Employee records
- Employee benefits
- Career path systems (appraisal)

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Management Support System (MSS)

MSS use the internal master database to perform high-level analyses that help managers make better decisions. At the first level of an MSS is an information-reporting system, which uses summary data collected by the TPS to produce both regularly scheduled and special reports. The level of detail would depend on the user.

MSS includes other specialized tools for decision-making like centralized database such as Data Warehouse.

Companies use data warehouses to gather, secure, and analyse data for many purposes, including customer relationship management systems, fraud detection, product-line analysis, and corporate asset management. Retailers might wish to identify customer demographic characteristics and shopping patterns to improve direct-mailing responses. Banks can more easily spot credit-card fraud, as well as analyse customer usage patterns.

SPOTLIGHT

A management information system digests inputted data (distinct pieces of information such as facts, numbers and words) and processes it into useful information.

A management information system is characterized as follows:

- Supports structured decisions
- Reports on existing operations
- Little analytical capability and is relatively inflexible
- Internal focus
- Generate regular reports and typically would allow online access to a wide range of users
- Incorporate both current and historical information

Decision Support System (DSS)

A DSS is a set of related computer programs and data required to assist with the analysis and decision-making within an organization. DSS were initially developed to overcome the rigid nature of management information systems.

DSS help businesses by providing quantitative data and predictive models that aid problem-solving and decision-making. A DSS helps managers make decisions using interactive computer models that describe real-world processes.

The DSS also uses data from the internal database but looks for specific data that relate to the problems at hand. It is a tool for answering "what if" questions about what would happen if the manager made certain changes. In simple cases, a manager can create a spreadsheet and try changing some of the numbers. For instance, a manager could create a spreadsheet to show the amount of overtime required if the number of workers increases or decreases. With models, the manager enters into the computer the values that describe a particular situation, and the program computes the results. Marketing executives at a furniture company could run DSS models that use sales data and demographic assumptions to develop forecasts of the types of furniture that would appeal to the fastest-growing population groups.

The characteristics of decision support systems include:

- DSS assists managers at the tactical level when they are required to make intelligent guesses
- A DSS uses formula and equations to enable mathematical modelling
- DSS are real-time systems enabling managers to solve problems through queries and modelling
- User inputs queries and variables for the model through a user interface
- Contains a natural language interpreter for querying the system
- The user interface is integrated with data management and modelling software from the key components
- Spreadsheet packages can become the tool for the development of a decision support system.

Executive Information System (EIS)

An EIS, similar to a DSS, is customized for an individual executive. These systems provide specific information for strategic decisions. For example, a CEO's EIS may include special spreadsheets that present financial data comparing the company to its principal competitors and graphs showing current economic and industry trends.

An EIS incorporates both internal and external data and tends to be more forward-looking rather than backword-looking.

EIS typically emphasize graphical displays and simple user interfaces with a 'high-level' executive summary styled dash-board. Executives can then drill-down into various components of the dashboard to extract more detailed information if required.

Other characteristics of EIS include:

- Helps senior managers to make unstructured decisions with many contributing factors such as price fixing
- Tends to be very expensive and real-time
- Often limited in use to a small number of senior managers within the business

Expert System (ES)

An ES is a computer program that simulates the judgement and behaviour of a human or an organization that has expert knowledge and experience in a particular field. It contains a database of accumulated experience and scenarios as well as a set of rules for applying the knowledge to each particular situation described by the program. Examples include legal diagnostics, medical diagnostics, processing a loan application and on a social level, programs that play chess!

An expert system gives managers advice similar to what they would get from a human consultant. Artificial intelligence enables computers to reason and learn to solve problems in much the same way humans do, using what-if reasoning. Although they are expensive and difficult to create, expert systems are finding their way into more companies as more applications are found.

Expert systems have also been used to help explore for oil, schedule employee work shifts, and diagnose illnesses. Some expert systems take the place of human experts, whereas others assist them.

Expert systems are most effective when the following preconditions exist:

- problem is reasonably well-defined
- expert can define some rules
- problem cannot be solved through conventional transaction processing systems
- expert can be released to focus on more difficult problems
- investment is cost-justified

The advantages gained from using an expert system include:

- Allows non-experts to make expert decisions
- Fast, accurate and consistent advice
- Ability to change input details to explore alternative solutions
- Reduction in staff costs - less experts required
- Improved allocation of human resources, experts concentrate on more complex issues
- Can become a competitive advantage
- Availability potentially 24 hours 365 days per year
- Multi-access can deal with many problems at one time.

However, some disadvantages may exist, such as:

- High initial capital expenditure
- Technical support required
- System does not automatically learn; it has to be constantly updated by experts
- User as a non-expert may give inaccurate advice without recognising
- Down time - systems failures effect all users
- Reliance - probable reduction in basic skills
- Possible user resistance for higher level experts

Ina addition to the above types of IS, there are some other specialized systems in use as follows:

Financial Reporting System (FRS)

Financial accounting and reporting involves:

- Maintaining a system of accounting records for business transactions and other items of a financial nature; and
- Reporting the financial position and the financial performance of an entity in a set of 'financial statements'.

Many businesses operate a system of recording their business transactions in accounting records. This system, that is the part of all sizes of businesses, is called a book-keeping system or ledger accounting system and forms the foundation of the financial reporting system.

The information that is recorded in the book-keeping system (ledger records) of an entity are also analysed and summarised periodically, typically each year, and the summarised information is presented in financial statements.

Financial statements provide information about the financial position and performance of the entity.

Financial reporting systems must be reliable, accurate and complete. Access to data entry should be strictly controlled to authorised personnel only.

Order Processing and Inventory Control System

Order processing

The order processing system should be capable of recording all orders accurately and in a timely fashion. For some businesses such as airlines and hotels the information needs to be updated immediately, whereas for other businesses an end of day update may be sufficient.

The system will typically be linked to the inventory control system so that the sales person can establish whether the organisation is capable of fulfilling the order received.

Inventory control system

The objective of the inventory control system is to ensure that the business maintains an appropriate amount of inventory at all times. The control system should be able to indicate accurate levels of inventory for all the lines maintained by a business and trigger the ordering of replacement inventory when inventory levels fall to a certain level.

Order processing and inventory control systems typically share the following characteristics:

- The system can accurately report the current inventory level at any time
- A rule should be associated with each item that will trigger a reorder such as minimum inventory level
- The age of the inventory can be tracked. This will assist sales managers in identifying ageing stock and employing tactics to reduce it. This is particularly important with perishable inventory (e.g., food and drink) that could have hygiene as well as commercial considerations to monitor.
- The system should be able to highlight shortages
- The system should be able to show individual and total cost of items
- The system should maintain supplier details
- Delivery dates both inwards and outwards must be maintained to enable the warehouse manager to manage goods movement - inward and despatch
- The location of the inventory should be recorded to ensure it can be found easily and efficiently

Personnel System

The personnel system exists to support the human resources management function in performing its duties of maintaining an appropriate workforce. This involves:

- Recruitment
- Selection; and
- Staff development and appraisal.

Furthermore, the system contains a significant amount of sensitive and confidential information meaning there must be strict control around maintaining data security and access to the system.

The system will typically incorporate several components including:

- Recruitment
  - Highlighting internal job vacancies that are available to existing staff
  - Running external recruitment campaigns and tracking their cost effectiveness
- Redundancy
  - Planning and executing voluntary redundancy programs
  - Planning and executing compulsory redundancies making sure the company follows all the legal requirements
- Personnel management and control
  - Maintaining contract of employment details such as salary, holiday entitlement and duties
  - Family and medical contact details
  - Employment history
  - Training records

  - Training plan
  - Qualifications and skills
  - Amount of holiday accrued and taken
  - Sick leave accrued and taken plus authorised absences such as bereavements
  - Unauthorized absence
  - Time off in lieu
  - Disciplinary record
  - Bonus and pay history
  - Other rewards and commendations
  - Annual appraisal
  - Goals and objectives
  - Formal checks such as references
- Personnel management reporting – management will benefit from seeing graph trends and summary reports to help with making decisions on headcount. These might include:
  - Benefits report
  - Headcount (employee numbers) report
  - Pay details and total wage expense
  - Gender and diversity mix information
  - Age profiling
  - Tenure profiling
  - Absence analysis

Enterprise Resource Planning (ERP)

ERP is a cross-functional system driven by an integrated suite of software modules supporting the basic internal processes of a business.

The system incorporates a real-time view of core business processes such as:

- Order processing
- Inventory management

Productions Business resources

ERP systems track business resources such as:

- Cash
- Raw materials
- Production capacity
- Personnel

Commitments

ERP systems also track the status of commitments such as:

- Purchase orders
- Employee costs
- Customer orders

Tracking is permanently updated irrespective of the department that entered the information – hence the term 'enterprise'.

5 LEVELS OF INFORMATION SYSTEMS

Information systems are seen in virtually every corner of a business whether in finance, operations, human resources, or marketing. Information systems assist employees across all levels of the business.

The information requirements of a business organization can be grouped depending on different user needs and levels of decision-making. A typical business organization is divided into operational, middle, and senior level. Accordingly, the type of IS is assigned to each level of users.

The following table illustrate various levels of IS in a typical business organization.

Levels of Management	Nature of Decision-making	Types of IS
Senior Level	Strategic management	EIS
Middle Level	Tactical management	MIS, DSS
Operational Level	Operational management	TPS

Operational Level:

The operational level is concerned with performing day to day business transactions such as cashiers at a point of sale, bank tellers, nurses in a hospital, customer care staff, etc. They have defined rules that guides them while making structured decisions.

Middle Level:

The middle level users generally oversee the activities of the operational management. This includes middle-level managers, heads of departments, supervisors, etc. They take tactical, unstructured decisions partly based on set guidelines and judgmental calls.

For example, a credit manager in a bank can check the credit limit and payments history of a customer and decide to make an exception to raise the credit limit for a particular customer. The decision is partly structured in the sense that the credit manager has to use existing information to identify a payments history that benefits the organization and an allowed increase percentage.

Senior Level:

The senior level users make unstructured, strategic decisions. They are concerned with the long-term planning of the organization. They use information from tactical managers and external data to guide them when making strategic decisions.

- **Strategic information** relates to long-term decision making e.g. over a 3-5 year time horizon. Strategic information is useful to senior management and Directors for establishing the overall strategy of the business. It therefore incorporates both internal information as well as external information about competitors, the market and the general business environment.
- **Tactical information** assists managers in making short-term tactical decisions such as:
  - establishing a fee to quote on a particular order
  - whether to offer discounts on a particular product to help lower excess inventory
  - whether to switch suppliers
- **Operational information** relates to the day to day activities of an organisation. Examples might include:
  - Daily sales reports
  - Daily production reports
  - Latest inventory levels
  - Details of customer complaints

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SPOTLIGHT

Uses of information systems

Irrespective of the level of information (strategic, tactical or operational), information is generally used in one of five ways.

Use	Description
Planning	Help establish appropriate resources, time scales and forecast alternative outcomes
Controlling	Ensure processes are implemented as planned
Recording transactions	Information systems are used to record transactions throughout a business e.g. sales, purchases, errors, returns, customer complaints and quality control inspections, deposits and cash movements
Performance measurement	Compare actual versus planned (budgeted) activity to identify variances from planned activity and take corrective action as necessary
Decision making	Information systems are used to help managers make all kinds of decisions such as volume (e.g. purchases and production), price, whether to make a component internally or buy it from a supplier, whether to switch suppliers, when to replace assets and how to organize affairs to minimise a tax charge.

SELF-TEST

For the following questions select the best answer.

1. The _______________ system exists to support the human resources management function in performing its duties of maintaining an appropriate workforce. Which of the following completes the statement?
   a. Personnel
   b. Integrated
   c. Management
   d. All of the above

2. A computer system comprises four key components. Which of the following is not a key component of a computer system?
   a. Central Processing Unit
   b. Input device
   c. Output device
   d. Data Analysis Unit

3. Printers, disc drives, monitor screens are examples of _______________?
   a. Computer hardware
   b. Computer software
   c. Integrated hardware
   d. None of the above

4. Input devices facilitate the introduction of data and information into the system. Examples might include a keyboard, scanner, mouse or barcode reader. TRUE or FALSE?
   a. TRUE
   b. FALSE

5. Which of the following statements is TRUE about the Central Processing Unit?
   a. The central processing unit is the 'brain' of the computer
   b. The central processing unit takes the inputs, processes them and then outputs the results
   c. Both A and B
   d. Neither A nor B

6. Output devices facilitate the extraction of processed information from the system. Examples would include a printer, speaker or screen. TRUE or FALSE?
   a. TRUE
   b. FALSE

7. A ___________ is a hand-operated device with internal sensors that pick up the motion and convert it into electronic signals which instruct the cursor (pointer) on screen to move. Fill in the blank with the correct option that completes the sentence.
   a. Mouse
   b. Keyboard
   c. Bluetooth device
   d. Hand held pointer

8. What does MICR stand for?
   a. Magnetic instrument for character recognition
   b. Magnetic ink character recognition
   c. Master instrument for character recognition
   d. Magnetic illustrator for complex results

9. Which of the following is a disadvantage of MICR devices?
   a. MICR documents are not very costly to produce
   b. MICR documents take too much time to process
   c. MICR documents are expensive to produce
   d. MICR documents compromise on accuracy for speed

10. ____________ capture images and videos in digital form and allow easy transfer to a computer where they can be manipulated by software. Fill in the blank.
    a. Digital Cameras
    b. CTV cameras
    c. Web Cameras
    d. Light cameras

11. What is the function of an Output device?
    a. It receives processed data from the computer and presents it in some way
    b. It facilitates the introduction of data and information into the system
    c. It is a device that processes data and provides results
    d. None of the above

12. QR codes and Barcodes are examples of:
    a. Input devices
    b. Output devices
    c. Both a and b
    d. Neither a nor b

13. An __________ device is the part of a computer system that receives the processed data from the computer and presents it in some way.

    a. Processing

    b. Input

    c. CPU

    d. Output

14. OCR can be somewhat inaccurate if input image is low quality. TRUE or FALSE?

    a. TRUE

    b. FALSE

ANSWERS TO SELF-TEST

1	A
2	D
3	A
4	A
5	C
6	A
7	A
8	B
9	C
10	A
11	A
12	A
13	C
14	A

CHAPTER 6

BUSINESS ETHICS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Ethical considerations in business decisions
2. Understanding ethical issues
3. Situations involving business ethics
4. Testing techniqes for ethical decision-making
5. Corporate Social Responsibility
6. Consequences of unethical behaviour
7. Managing ethical behavior in business

SELF-TEST

AT A GLANCE

- In addition to the primary goal i.e., value maximization for shareholders, businesses are responsible not only to the bottom-line, but to providing goods and services in an ethically responsible manner.
- A proper governance process must put in place to achieve key goals and objectives of an organization through ethical decision-making, and socially responsible management.
- This chapter will focus on:
  - Personal and professional ethics
  - Tools and techniques for creating ethical awareness and setting ethical standards
  - Concept of individual and corporate responsibility

1. ETHICAL CONSIDERATIONS IN BUSINESS DECISIONS

What is ethics

Ethics is defined as the "discipline dealing with what is good and bad and with moral duty and obligation". It is a set of moral standards for judging whether something is right or wrong.

The ethics of doing business are different from the ethics of normal social behavior. Businesses compete with each other, and many decisions are taken for commercial reasons, regardless of their effect. For example, organisations will close down loss-making operations, regardless of the impact on the employees who are made redundant. Misconduct can take on many forms within the business environment, including deceptive business practices and the withholding of important information from investors or consumers.

Business ethics

Business ethics are set of moral principles which guide organizations what is right, wrong, and appropriate in the workplace.

Every organization, including nonprofits, has to manage the ethical behavior of its employees and other stakeholders in the overall operations of the organization.

2. UNDERSTANDING ETHICAL ISSUES

Recognizing ethical issues is the most important step in understanding business ethics. An **ethical issue** is an identifiable problem, situation, or opportunity that requires a person to choose from among several actions that may be evaluated as right or wrong, ethical or unethical. In business, such a choice often involves weighing monetary profit against what a person considers appropriate conduct.

Ethical issues in business are generally associated with the following aspects of behavior:

- Acting within the law. In international business, ethical behavior often means compliance with accepted international codes of behavior, such as a code against bribery, by organisations seeking to win a major contract from a customer.
- Fair and honest dealing with suppliers and customers.
- Acting fairly towards employees and showing due concern for the welfare of employees.
- Showing respect and concern for the communities in which the business entity operates.
- Showing respect for human rights, and refusing to deal with any entities that do not show concern for human rights. A significant issue for some organisations in recent years has been public pressure to avoid dealing with.
- Suppliers in developing countries who use child slave labor.
- Showing concern for the environment and the need for sustainable businesses.

Suppose a organisation awards a construction contract to a firm owned by the father of the home minister while the organisation is under investigation. If this construction award has the potential to shape the outcome of the investigation, a conflict of interest has occurred.

A conflict of interest, one of the most common ethical issues identified by employees, exists when a person must choose whether to advance his or her own personal interests or those of others. Insider trading is an example of a conflict of interest. Insider trading is the buying or selling of stocks by insiders who possess material that is still not public.

3. SITUATIONS INVOLVING BUSINESS ETHICS

Every day, managers and business owners make business decisions based on what they believe to be right and wrong. Through their actions, they demonstrate to their employees what is and is not acceptable behavior and shape the moral standard of the organization. Some common examples that may be considered ethical issues are illustrated below.

1. ***Taking things that don't belong to you****.* The unauthorized use of someone else's property or taking property under false pretenses is taking something that does not belong to you. Even the smallest offense, such as using the postage meter at your office for mailing personal letters or exaggerating your travel expenses, belongs in this category of ethical violations.
2. ***Saying things you know are not true****.* Often, when trying for a promotion and advancement, fellow employees discredit their coworkers. Falsely assigning blame or inaccurately reporting conversations is lying. Saying things that are untrue is an ethical violation.
3. ***Giving or allowing false impressions***. The salesperson who permits a potential customer to believe that cardboard boxes will hold the customer's tomatoes for long-distance shipping when the salesperson knows the boxes are not strong enough has given a false impression. A car dealer who fails to disclose that a car has been in an accident is misleading potential customers.
4. ***Buying influence or engaging in a conflict of interest.*** A conflict of interest occurs when the official responsibilities of an employee or government official are influenced by the potential for personal gain.

   Suppose a organisation awards a construction contract to a firm owned by the father of the home minister while the organisation is under investigation. If this construction award has the potential to shape the outcome of the investigation, a conflict of interest has occurred.

   A conflict of interest, one of the most common ethical issues identified by employees, exists when a person must choose whether to advance his or her own personal interests or those of others. Insider trading is an example of a conflict of interest. Insider trading is the buying or selling of stocks by insiders who possess material that is still not public.
5. ***Hiding or divulging information.*** Failing to disclose the results of medical studies that indicate your firm's new drug has significant side effects is the ethical violation of hiding information that the product could be harmful to purchasers. Taking your firm's product development or trade secrets to a new place of employment constitutes the ethical violation of divulging proprietary information.
6. ***Taking unfair advantage***. Many current consumer protection laws were passed because so many businesses took unfair advantage of people who were not educated or were unable to discern the nuances of complex contracts. Credit disclosure requirements and new regulations on auto leasing all resulted because businesses misled consumers who could not easily follow the jargons of long, complex agreements.
7. ***Committing improper personal behavior***. Although the ethical aspects of an employee's right to privacy are still debated, it has become increasingly clear that personal conduct outside the job can influence performance and organisation reputation. Thus, a organisation driver must abstain from substance abuse because of safety issues.
8. ***Abusing power and mistreating individuals***. A manager sexually harasses an employee or subjects employees to humiliating corrections or reprimands in the presence of customers. In some cases, laws protect employees. Many situations, however, are simply interpersonal abuse that constitutes an ethical violation.

   Abusive or intimidating behavior is the most common ethical problem for employees. These concepts can mean anything from physical threats, false accusations, profanity, insults, yelling, harshness, and irrationality to ignore someone or simply being annoying.
9. ***Permitting organizational abuse.*** Many multi-national organisations with operations overseas, such as Apple, Nike, and Levi Strauss, have faced issues of organizational abuse. The unfair treatment of workers in international operations appears in the form of child labor, demeaning wages, and excessive work hours. Although a business cannot change the culture of another country, it can perpetuate or stop abuse through its operations there.

10. ***Violating rules.*** Many organizations use rules and processes to maintain internal controls or respect the authority of managers. Although these rules may seem troublesome to employees trying to serve customers, a violation may be considered an unethical act.

11. ***Condoning unethical actions.*** What if you witnessed a fellow employee embezzling organisation funds by forging her signature on a check? Would you report the violation? Tolerance of others' unethical behavior is itself unethical.

12. ***Misuse of Organisation Time***. Theft of time is a common area of misconduct observed in the workplace. One example of misusing time in the workplace is by engaging in activities that are not necessary for the job.

4. TESTING TECHNIQUES IN ETHICAL DECISION-MAKING

Although we've presented a variety of ethical issues that may arise in business, it can be difficult to recognize specific ethical issues in practice. Whether a decision maker recognizes an issue as an ethical one often depends on the issue itself. Managers, for example, tend to be more concerned about issues that affect those close to them, as well as issues that have immediate rather than long-term consequences. Thus, the perceived importance of an ethical issue substantially affects choices. However, only a few issues receive scrutiny, and most receive no attention at all.

The Mirror Test

When an ethical issue is involved, an accountant should carry out a mirror test. To carry out a mirror test, you have to answer a basic question about the ethics of a course of action. If you choose a course of action, are you able to look yourself in the mirror and see a person who has acted in a moral and ethical way.

Can you justify the decision you have taken from an ethical perspective?

Three questions that you can ask when carrying out the mirror test are as follows:

1. Is it legal? If it is not legal, you should not be doing it.
2. Even if the action is legal, is it ethically, correct? Does it violate organisation's code of ethics?
3. What will other people think? Think about the opinion of people whose views matter to you, such as close family members (a parent, spouse, or close friend) or the media. Are you satisfied with the effect of your action on these people?

A problem for accountants is often that an action appears to be legal (or not illegal) but is nevertheless unethical and should be avoided.

Consequences Test

The consequences of unethical decisions can be severe, so it is wise to consider them in advance. Think not only of the potential monetary costs associated with certain causes of action but also the reputational costs (brand equity), relationship costs, and psychological costs (the burden of regret).

5. CORPORATE SOCIAL RESPONSIBILITY

A business enterprise is an important part of the society and it should do its operations and earn money in ways that satisfy the expectations of the society. Social responsibility of a business refers to the obligations to take those decisions and perform those actions which are desirable in terms of the objectives and values of society. It is the idea that businesses should balance profit-making activities with activities that benefit society; it involves developing businesses with a positive relationship with the society in which they operate.

Social responsibility in business, also known as corporate social responsibility (CSR), pertains to people and organizations behaving and conducting business ethically and with sensitivity towards social, cultural, economic, and environmental issues.

A business may receive the following advantages from being socially responsible.

- Being a socially responsible organisation can bolster an organisation's image and build its brand.
- Social responsibility empowers employees to leverage the corporate resources at their disposal to do good.
- Formal corporate social responsibility programs can contribute positively to employee morale and lead to greater productivity in the workforce.
- Embracing socially responsible policies can help in attracting and retaining customers, which is essential to an organisation’s long-term success.

Customers may be encouraged to pay a premium for some products knowing that part of the profits will be channeled towards social causes near and dear to them.

Principles of Corporate Social Responsibility

Corporate social responsibility has five main aspects. For any organisation, some of these aspects might be more significant than others.

1. An organisation should operate in an ethical way and with integrity. A organisation should have a recognized code of ethical behaviour and should expect everyone in the organisation to act in accordance with the ethical guidelines in that code.
2. An organisation should treat its employees fairly and with respect. The fair treatment of employees can be assessed by the organisation’s employment policies, such as providing good working conditions and providing education and training to employees.
3. An organisation should demonstrate respect for basic human rights. For example, it should not tolerate child labour.
4. An organisation should play a responsible role in its community. Responsibility to the community might be shown in the form of investing in local communities, such as local schools or hospitals. This can be an important aspect of CSR for organisations that operate in under-developed countries or other regions of the world.
5. An organisation should do what it can to sustain the environment for future generations. This could take the form of:
   - reducing pollution of the air, land or rivers and seas
   - developing a sustainable business, whereby all the resources used by the organisation are replaced
   - cutting down the use of non-renewable (and polluting) energy resources such as oil and coal and increasing the use of renewable energy sources (water, wind)
   - re-cycling of waste materials.

Examples of Socially Responsible activities

- **Environmental efforts**: One primary focus of corporate social responsibility is the environment. Businesses, regardless of size, have large carbon footprints. Any steps they can take to reduce those footprints are considered good for both the organisation and society.
- **Philanthropy**: Businesses can practice social responsibility by donating money, products or services to social causes and nonprofits. Larger organisations tend to have a lot of resources that can benefit charities and local community programs. It is best to consult with these organizations about their specific needs before donating.
- **Ethical labor practices**: By treating employees fairly and ethically, organisations can demonstrate their social responsibility. This is especially true of businesses that operate in international locations with labor laws that differ from those in the developed world.
- **Volunteering**: Attending volunteer events says a lot about organisation's sincerity. By doing good deeds without expecting anything in return, organisations can express their concern for specific issues and commitment to certain organizations.

6. CONSEQUENCES OF UNETHICAL BEHAVIOUR

Poor business ethics can create a very negative image for an organisation, can be expensive for the firm and/or the executives involved, and can result in bankruptcy and jail time for the offenders.

Acting ethically reduces risk. There are several possible consequences of unethical behaviour.

- When business conduct is illegal or in breach of regulations, there is a risk of being 'found out'. The consequences could be the payment of fines to the authorities or compensation to individuals who have suffered as a consequence of the illegal behaviour. In some cases, individual directors might be liable to imprisonment for illegal behaviour.
- When businesses act legally but in a way that the general public considers 'immoral', there is a risk of action by the government to make such action illegal.
- Businesses that act in an unethical way are also exposed to reputation risk.

Reputation risk

Many large organisations take the view that in a competitive business environment, customer loyalty depends on the general public's perception of the organisation's behaviour, which establishes a reputation. Reputation comes from business practice, such as providing high quality products at a fair price. It also comes from ethical behaviour.

Organisations with a good reputation find it easier to win and keep loyal customers, and also loyal employees. When a business reputation is damaged, there is a risk of losing customers to rival organisations.

Although the evidence for the importance of reputation risk is inconclusive, there is no doubt that many large organisations are very aware of their reputation and reputation risk. They therefore invest heavily in trying to maintain their business reputation, through public relations and pursuing 'ethical' business strategies.

Organisations that have been exposed to reputation risk include:

- organisations accused of buying from suppliers in developing countries that use child labor or slave labor
- organisations accused of polluting the environment
- organisations in the food and drugs industries accused of selling dangerous food products or dangerous drugs.

Other consequences

Ethical misconduct in any organisation can lead to very serious consequences which can cause the organisation time and money in trying to repair their business reputation and any legal issues that may arise depending on the severity of the situation. It can cost a business millions of rupees and even legal action in some extremely serious cases. In order to really protect an organisation from an ethical misconduct scandal, one needs to incorporate a management plan in order to stay on top of any unethical practices within the corporate environment. To do this we must first understand the effects that poor corporate ethics can cause to an organisation in order to setup barriers to help prevent something like this occurring.

Productivity Levels Decrease

The main goal of any corporation is to drive through sales from customers to maintain a strong presence in the business world. Unfortunately, when a level of unethical behaviour starts to form, it can cause productivity levels to decrease which surround the person or corporation in question. When this happens, errors start to form in a once productive production line. This in turn can cause other employees to feel unmotivated resulting in a complete slowdown of the sale process that can lose you valuable time and money.

Loss of Respect

In episodes where managers or leaders start to make unethical decisions, it can lead to employees losing a lot of respect for their bosses. When this occurs, it can be difficult for the leader to gain back the respect and trust that's been lost. It also causes problems for them to run a successful business when their team feels as if they're making poor corporate choices. Employees may also feel resentful towards their leaders. This is because, as a part of the organisation, they feel their reputation is also starting to fall apart along with the business's reputation.

Loss of Public Credibility

If a lack of ethics in a business becomes public knowledge, that business loses credibility. While some businesses survive public knowledge of a lack of ethics through reimaging and advertising campaigns, many lose a key customer base. Even if a business recovers from news about its lack of ethics, it takes a lot of time and money to restore its image and consumer confidence. Customers that abandon an organisation because they are dismayed by poor ethical practices will find other products and services to meet their needs. Those customers are difficult to win back, even after ethical lapses are rectified.

Legal Issues

In severe cases of unethical misconduct, it can lead to severe legal issues that result in loss of time, large fines, and other penalties including imprisonment. The cost of legal battles can go on for months to years and can lead into the millions of dollars depending on the corporation's particular situation and level of unethical behaviour. In addition to this, executives who break the law can lead employees the same mistakes and face criminal charges.

Impact on Employee Performance

Lack of ethics has a negative effect on employee performance. In some cases, employees are so concerned with getting ahead and making money that they ignore procedures and protocol. This can lead to additional paperwork and careless errors that result in the task having to be completed again. Additionally, employees who feel acting ethically and following the rules will not get them ahead in the business sometimes feel a lack of motivation, which often leads to a decline in performance.

Employee Relations Are Affected

When a manager or head of a business exhibits a lack of ethical behavior, he faces losing the respect of his employees. It is difficult to have a successful business without well-respected leaders. Lack of ethical behavior can also cause tension among employees, with some employees resenting those who do not play by the rules and still manage to get ahead. Unethical behavior in the workplace also has the potential to lead to a lack of trust among employees, which is detrimental to a business that relies on collaboration and a sense of community.

7. MANAGING ETHICAL BEHAVIOUR IN BUSINESS

People choose between right and wrong based on their personal code of ethics. They are also influenced by the ethical environment created by their employers. Many individuals have great control over personal ethics outside the workplace, but are influenced by the behaviour of their co-workers and superiors who exert significant control over choices at work through authority and example.

If the organisation fails to provide good examples and direction for appropriate conduct, confusion and conflict will develop and create potential for misconduct. For example, if your boss or coworkers leave work early, you may be tempted to do so as well. If you see co-workers engaged in personal activities such as shopping online or watching YouTube on organisation time, then you may be more likely to do so as well. In addition, having sound personal values contributes to an ethical workplace.

It is difficult for employees to determine what conduct is acceptable within an organisation if the firm does not have established ethics policies and standards.

Organizations can reduce the potential for ethical consequences by educating their employees about ethical standards, by providing current news on ethical issues, by leading through example, and through various informal and formal programs.

Corporate Code of Ethics

A corporate code of ethics, is a code of ethical behaviour, is a formal written statement, and should be distributed or easily available to all employees. The decisions and actions of all employees in the organisation must be guided by the code.

Many public organisations have a published code of business ethics. For example:

- The New York Stock Exchange rules require organisations whose shares it trades to have a publicly displayed code of business conduct and ethics.
- In the UK, most of the top UK organisations have a code of ethics.

The effectiveness of a code of ethics depends on the leadership of the organisation, its directors and senior managers. These individuals must be seen to comply themselves with the ethical code; otherwise other employees will see no purpose in complying with the code themselves. The culture of an organisation drives its ethical behaviour and a code of ethics provides useful guidance.

If ethical codes are to be effective, then:

- They must be strongly endorsed from the top of the organisation. (Enron, the collapsed US corporation, had an ethical code but the board of directors chose to over-rule it.)
- Training must be given. If not, many employees might not even be aware that it exists, let alone know how to apply it.
- The code must be kept up-to-date.
- The code must be available to all, for example, through the corporate intranet.

Code of Ethics for Chartered Accountants

The Institute of Chartered Accountants of Pakistan(ICAP) is a member of the International Federation of Accountants (IFAC). IFAC is a global organization of the accountancy profession comprising more than 175 member and associate organizations in 130 countries and jurisdictions, representing nearly 3 million professional accountants.

IFAC develops and issues in the public interest high-quality ethics standards and other pronouncements for professional accountants for use around the world. The member bodies of IFAC are also encouraged to adopt high standards of ethics for their members and promote good ethical practices globally.

Accordingly, ICAP has adopted IFAC's code of ethics. ICAP members are required to adhere to the requirements of the Code of Ethics and exhibit the highest standards of ethics and professional conduct that are expected of the accountancy profession.

Ethical behavior by chartered accountants plays a vital role in ensuring public trust in financial reporting and business practices and upholding the reputation of the accountancy profession.

The Code requires that chartered accountants should comply with five fundamental principles of professional ethics which are as follows:

- integrity
- objectivity
- professional competence and due care
- confidentiality
- professional behavior

Integrity

The fundamental principle of integrity to be straightforward and honest in all professional and business relationships.

Daniyal is a chartered accountant in Rosemund & Co. They are in the process of inviting quotations for the supply of machinery for their new factory. It is expected that the machinery installation will be subject to inspection. It is estimated that it will take a time period of 2-3 months for the commencement of operations. The Human resource department has also initiated the process of hiring staff for the new factory. Daniyal also sits on the interview panel. A candidate has been shortlisted for one of the positions. He matches the job description and is asking a salary which is within organisation's budgeted amount. During the interview, he informed that he has got another job offer, due to his financial needs, he can only wait till two months, else he will take up the other job offer. The HR manager asked him to refuse the other job as the organisation will commence its operations within two months. Daniyal reprimanded the HR manager and told the candidate that it can take more than 2 months for the organisation to commence its operations and he should take up the other job offer if he wants to.

In this case, Daniyal has abided by the principle of integrity.

Objectivity

Objectivity involves not compromising professional or business judgments because of bias, conflict of interest or undue influence of others.

Ali, a chartered accountant, is a manager in Delta Co, an organisation which deals in the manufacturing of soaps and detergents. He authorizes payments to suppliers, for raw material purchase, after ensuring that the required documents are in order such as purchase order, goods received note (GRN) and payment requisition by the relevant department.

He has received a requisition for payment to a supplier who is the brother of the Chief Financial Officer (CFO). The goods have not been delivered yet, however, the CFO has advised Ali to authorize the payment, which is against organisation policy. Ali has refused to the CFO that the payment shall not be made unless GRN is received, despite being advised by the CFO.

In this case Ali has abided by the principle of objectivity.

Professional Competence and Due Care

i. to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and
ii. to act diligently and in accordance with applicable technical and professional standards.

AT A GLANCE

SPOTLIGHT

Sara is a senior manager-Finance in Razi & Co. She passed her CA exams in 2016 and still refers from International Financial Reporting Standards (IFRS) Edition 2016 from which she prepared for her exams.

Sara is in violation of the fundamental principle of "Professional Competence and Due Care" because she does not provide her professional services based on current edition of the IFRS.

Confidentiality

to respect the confidentiality of information acquired as a result of professional and business relationships.

Arham is an organisation secretary in alpha beta Co and gets to know all policy matters which require the approval of the Board of directors.

Each year, the board of directors approves the salary adjustments and HR promotions during June/July. In the recent board meeting, Arham has found out that his friend's promotion has also ben approved by the Board. He shares this information with him as soon as the board meeting is over, although the HR department has not issued any official notification yet.

Arham is in violation of the fundamental principle of "Confidentiality".

Professional Behavior

to comply with relevant laws and regulations and avoid any conduct that the chartered accountant knows or should know might discredit the profession.

Shoaib Ahmed and Ameet Kumar are CFOs in rival beverages organisations. They are invited on a talk show on national tv. During one of the questions, they get into a debate which gets heated. Both Shoaib and Ameet lose their cool and get into a verbal fight. This behavior demonstrates violation of the fundamental principle of "Professional Behavior".

SELF-TEST

For the following questions select the best answer.

1) _______________ is defined as "discipline dealing with what is good and bad and with moral duty and obligation"
   a. Ethics
   b. Business Ethics
   c. Legal Ethics
   d. Corporate Social Responsibility

2) _______________ is defined as "set of moral principles which guide organizations what is right, wrong, and appropriate in the workplace."
   a. Ethics
   b. Business Ethics
   c. Legal Ethics
   d. Corporate Social Responsibility

3) _______________ is defined as "conducting business ethically and with sensitivity towards social, cultural, economic, and environmental issues"
   a. Ethics
   b. Business Ethics
   c. Legal Ethics
   d. Corporate Social Responsibility

4) Ethically speaking, a car dealer can sell a car without disclosing that there was an accident as far as the car was repaired and tested by a reputed mechanic. TRUE or FALSE?
   a. TRUE
   b. FALSE

5) Ethically speaking, a builder can bribe the Building Control Authority to build few extra unauthorized floors as far as there is a genuine commitment to buy 100 ambulances for Edhi Trust. TRUE or FALSE?
   a. TRUE
   b. FALSE

6) XYZ Organisation has decided to install a hand-made carpet factory in an underdeveloped locality. They plan to hire underage students as workers paying them below minimum wage. They believe it is their social responsibility to help poor students and their families. TRUE or FALSE?
   a. TRUE
   b. FALSE

7) I saw that there is a vacancy for HR, and my cousin has educcation and experience in this area. I think she could fit in the organisation. I don't see any conflict here. What is the best course of action?
   a. I should talk to HR and ask them to give priority to my cousin, as she is the best candidate.
   b. I will ensure by speaking to other colleagues that she will get the position
   c. I can ask my cousin to apply online and use my name as referral.
   d. As I am sure that my cousin will get the position, I can tell her to join me and my colleagues for breakfast in the office next morning

8) Which of the following statement is true in testing ethical decision-making for a project?
   a. Select only if mirror test is cleared
   b. Select without considering mirror test
   c. Select if legality is not obvious but can find a consultant to fix it.
   d. Select if primary objective of shareholders' value maximization is certain ignoring mirror test

9) Which of the following statement is not an advantage of being socially responsible?
   a. Being a socially responsible organisation can bolster a organisation's image and build its brand.
   b. Social responsibility empowers employees to leverage the corporate resources at their disposal to do good.
   c. Formal corporate social responsibility programs can contribute positively to employee morale and lead to greater productivity in the workforce.
   d. Embracing socially responsible policies cannot help in attracting and retaining customers, which is essential to a organisation's long-term success.

10) Which of the is an example of socially responsible activities?
   a. Environmental efforts
   b. Volunteering
   c. Both (a) and (b)
   d. None of the above

11) Which of the following statement is not True?
   a. Evidence for reputation risk is conclusive
   b. Environmental efforts is one of the primary focus of CSR
   c. Mirror testing is a technique for ethical decision-making
   d. Avoiding conflict of interest is a consideration for business ethics

12) Organisations that have been exposed to reputation risk include:
   a. Organisations accused of buying from suppliers in developing countries that use child labor or slave labor
   b. Organisations accused of polluting the environment
   c. All of the above
   d. None of the above

13) Following are the not the key consequences of unethical behaviour:
   a. Labour practices
   b. Conflict of interest
   c. All of the above
   d. None of the above

14) Which of the following statement is True for corporate code of ethics?
   a. It may be formal or informal
   b. In UK very few top organisations have it.
   c. You can't train people. It's a natural instinct.
   d. Strongly endorsed from the top

15) ICAP code of ethics requires following?

a. Professional competence
b. Integrity
c. Confidentiality
d. All of the above

16) Following are the ways organizations can reduce the potential for ethical consequences by:

a. Educating their employees
b. Leading through example
c. All of the above
d. None of the above

ANSWERS TO SELF-TEST

1	A
2	B
3	D
4	B
5	B
6	B
7	C
8	A
9	D
10	C
11	A
12	C
13	D
14	D
15	D
16	C

CHAPTER 7

MARKETING CONCEPTS

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Marketing
2. Branding
3. Selling

SELF-TEST

AT A GLANCE

- Marketing plays a key role in the success of a business by generating sales revenue, supported by branding and selling activities.
- Marketing is a broad term which include the process of discovering the needs and wants of potential buyers and customers, and then providing goods and services that meet or exceed their expectations.
- This chapter will focus on:
  - Marketing concept and strategy
  - Product types, characteristics, and life cycle
  - Branding importance and key elements

Difference between marketing and selling activities

1. MARKETING

Marketing is an important part of a firm's overall strategy. Other functional areas of the business—such as operations, finance, and all areas of management—must be coordinated with marketing decisions. Marketing has the important function of providing revenue to sustain a firm. Only by creating trust and effective relationships with customers can a firm succeed in the long run. Businesses try to respond to consumer wants and needs and to anticipate changes in the environment. Unfortunately, it is difficult to understand and predict what consumers want: Motives are often unclear; few principles can be applied consistently; and markets tend to fragment, each desiring customized products, new value, or better service.

It is important to note what marketing is not: It is not manipulating consumers to get them to buy products they do not want. It is not just selling and advertising; it is a systematic approach to satisfying consumers. Marketing focuses on many activities—planning, pricing, promoting, and distributing products—that foster exchanges.

1.1 The Marketing concept

A vital part of any business undertaking, marketing is a group of activities designed to expedite transactions by creating, distributing, pricing, and promoting goods, services, and ideas. These activities create value by allowing individuals and organizations to obtain what they need and want. A business cannot achieve its objectives unless it provides something that customers value. But just creating an innovative product that meets many users' needs isn't sufficient in today's volatile global marketplace. Products must be conveniently available, competitively priced, and uniquely promoted.

At the heart of all marketing activities is the exchange, the act of giving up one thing (money, credit, labor, goods) in return for something else (goods, services, or ideas). Businesses exchange their goods, services, or ideas for money or credit supplied by customers in a voluntary exchange relationship. An exchange takes place when two parties give something of value to each other to satisfy their respective needs or wants. In some exchanges, nonmonetary things are exchanged, such as when a person who volunteers for the company's CSR activity receives a souvenir or certificate in exchange for time spent. Companies build up their entire strategies around what would make this exchange possible and worthwhile for both the business and its customers.

One common misconception is that some people see no difference between marketing and sales. They are two different things that are both part of a company's strategy. Sales incorporates actually selling (exchanging) the company's products or service to its customers, against a consideration (e.g., cash or credit), while marketing is the process of communicating the value of a product or service to customers so that the product or service sells.

The marketing concept involves the use of marketing data to focus on the needs and wants of customers in order to develop marketing strategies that not only satisfy the needs of the customers but also the accomplish the goals of the organization and generate value for the business. An organization uses the marketing concept when it identifies the buyer's needs and then produces the goods, services, or ideas that will satisfy them. The marketing concept is oriented toward pleasing customers (be those customers' organizations or consumers) by offering value. Specifically, the marketing concept involves the following:

- Focusing on the needs and wants of the customers so the organization can distinguish its product(s) from competitors' offerings. Products can be goods, services, or ideas.
- Integrating all of the organization's activities, including production and promotion, to satisfy these wants and needs.
- Achieving long-term goals for the organization by satisfying customer wants and needs legally and responsibly.

Today's competitive business environment has diverted all businesses, big or small, towards applying the marketing concept. Ride hailing services like Careem and Uber found that its customers are unable to get products or items delivered. Therefore, they started a delivery and logistics service using the existing fleet of cars and motor bikes. Many established food chains, e.g. Pizza Hut offer loyalty points or membership cards to regular customers to retain them and lure them away from new entrants. One important key to understanding the marketing concept is to know that using the marketing concept means the product is created *after* market research is used to identify the needs and wants of the customers. Products are not just created by production departments and then marketing departments are expected to identify ways to sell them based on the research.

An organization that truly utilizes the marketing concept uses the data about potential customers from the very inception of the product to create the best good, service, or idea possible, as well as other marketing strategies to support it.

When you think of marketing products, you may think of tangible things—cars, MP3 players, or books, for example. What most consumers want, however, is a way to get a job done, solve a problem, or gain some enjoyment. You may purchase a Hoover vacuum cleaner not because you want a vacuum cleaner but because you want clean carpets. Starbucks serves coffee drinks at a premium price, providing convenience, quality, and an inviting environment. Therefore, the tangible product itself may not be as important as the image or the benefits associated with the product. This intangible "something of value" may be capability gained from using a product or the image evoked by it, or even the brand name. Good examples of brand names that are easy to remember include Avon's Skin So Soft, Tide detergent, and the Ford Mustang. The label or brand name may also offer the added bonus of being a conversation piece in a social environment, such as "The Choice of a New Generation" by PEPSI or"Taste the Feeling" by Coca-Cola.

Marketing focuses on a complex set of activities that must be performed to accomplish objectives and generate exchanges. These activities include buying, selling, transporting, storing, grading, financing, marketing research, and risk taking.

Buying. Everyone who shops for products (consumers, stores, businesses, governments) decides whether and what to buy. A marketer must understand buyers' needs and desires to determine what products to make available.

Selling. The exchange process is expedited through selling. Marketers usually view selling as a persuasive activity that is accomplished through promotion (advertising, personal selling, sales promotion, publicity, and packaging).

Branding. Branding is an activity that the marketing department would undertake in order to increase sales or promote the products. Branding also helps in differentiating the product from competing alternatives (e.g., a logo, or a registered trademark, or a unique product name may be ways of branding).

Transporting. Transporting is the process of moving products from the seller to the buyer. Marketers focus on transportation costs and services.

Storing. Like transporting, storing is part of the physical distribution of products and includes warehousing goods. Warehouses hold some products for lengthy periods in order to create time utility and optimize availability of some products. This especially pertains to a seasonal good such as orange juice. Fresh oranges are only available for a few months annually, but consumers demand juice throughout the entire year. Sellers must arrange for cold storage of orange juice concentrate so that they can maintain a steady supply all of the time.

Grading. Grading refers to standardizing products by dividing them into subgroups and displaying and labeling them so that consumers clearly understand their nature and quality. Many products, such as meat, steel, and fruit, are graded according to a set of standards that often are established by the government.

Financing. For many products, especially large items such as automobiles, refrigerators, and new homes, the marketer arranges credit to expedite the purchase.

Marketing Research. Through research, marketers ascertain the need for new goods and services. By gathering information regularly, marketers can detect new trends and changes in consumer tastes.

Risk Taking. Risk is the chance of loss associated with marketing decisions. Developing a new product creates a chance of loss if consumers do not accept the product or its associated promotion in the intended way. This would present the risk of losing all costs associated with developing the product and related investments.

1.2 What is a Product?

Before going into detail of each of the above activities it is important to understand the concept of a product (or service), for which the entire process is developed by any business.

"Anything that can be offered to a market for attention, acquisition, use or consumption that might satisfy a want or need. It includes physical objects, services, persons, places, organizations and ideas".

-Kotler and Armstrong

A **product**—whether a good, a service, an idea, or some combination— is a complex mix of tangible and intangible attributes that provide satisfaction and benefits. A good is a physical entity you can touch. A Porsche Cayenne, a Hewlett- Packard printer, and a kitten available for adoption at an animal shelter are examples of goods.

A **service** is the application of human and mechanical efforts to people or objects to provide intangible benefits to customers. Air travel, dry cleaning, haircuts, banking, insurance, medical care, and day care are examples of services.

Ideas include concepts, philosophies, images, and issues. For instance, a lawyer, for a fee, may advise you about what rights you have in the event that the FBR decides to audit your tax return. Other marketers of ideas include political parties, lobby groups, and schools.

A product has emotional and psychological, as well as physical characteristics, that include everything that the buyer receives from an exchange. This definition includes supporting services such as installation, guarantees, product information, and promises of repair.

Products usually have both favorable and unfavorable attributes; therefore, almost every purchase or exchange involves trade-offs as consumers try to maximize their benefits and satisfaction and minimize unfavorable attributes. Products are among a firm's most visible contacts with consumers. If they do not meet consumer needs and expectations, sales will be difficult, and product life spans will be brief. The product is an important variable—often the central focus—of the marketing mix; the other variables (price, promotion, and distribution) must be coordinated with product decisions.

Characteristics of a Product

- A product needs to be *relevant*: the users must have an immediate use for it. A product needs to be functionally able to do what it is supposed to, and do it with a good quality.
- A product needs to be *communicated:* Users and potential users must know why they need to use it, what benefits they can derive from it, and what it does difference it does to their lives. Advertising and 'brand building' best do this.
- A product needs a *name:* a name that people remember and relate to. A product with a name becomes a brand. It helps it stand out from the clutter of products and names.
- A product should be *adaptable:* with trends, time and change in segments, the product should lend itself to adaptation to make it more relevant and maintain its revenue stream.

Types of Products

Marketers must know how consumers view the types of products their companies sell so that they can design the marketing mix to appeal to the selected target market. To help them define target markets, marketers have devised product in to two main categories: consumer products, and industrial products.

Consumer Products

Products that are bought by the end user are called **consumer products**. They include electric razors, sandwiches, cars, stereos, magazines, and houses.

Most products produced to serve consumers can be classified as convenience products, shopping products, or specialty products.

- **Convenience products** are widely available to consumers, are purchased frequently, and are easily accessible. Milk, newspapers, soda, and chewing gum are examples of convenience products.
- **Shopping products** differ from convenience products in that they are not purchased frequently. Before purchasing shopping goods, consumers typically shop around and compare the quality and prices of competing products. Furniture and appliances are examples of shopping products.
- **Specialty products** are products that specific consumers consider to be special and therefore make a special effort to purchase. A Rolex watch and a Jaguar automobile are examples of specialty products. When evaluating specialty products, consumers base their purchasing decision primarily on personal preference, not on comparative pricing.

Industrial Products

These are products which are used as input for manufacturing other products. Unlike consumer goods, these are not for direct consumption. These are meant for business and non-personal use. Some examples of industrial products are raw materials, machines, tools, etc.

Industrial products have limited buyers, since they are not consumer goods. Examples are paper, diamonds, gold, silver, etc. Where, gold is used for making jewellery, and paper is used in printing. Industrial goods are not bought for ultimate consumption by buyers.

But no product may be exclusively classified as consumer goods or industrial goods. For example- Flour is a consumer product when bought by a housewife for cooking purpose, but if it is bought by an hotelier or bakery unit, who buys it as input and sells it to the ultimate consumer as a different product.

The rationale of classifying goods into consumer goods and industrial goods is the divergence in buying motives, approaches, and attitude in respect of these two sets of products. An industrial product buyer is more cost, quality, standard conscious and more deliberative than a consumer product buyer.

For example- a manufacturer may not be willing to sacrifice qualities and cost because it will affect the ultimate product. But a consumer goods customer is said to be more impulsive and under psychological pressures while taking purchase decisions. Thus, marketing policies and strategies should be designed separately for consumer goods and industrial goods.

The four broad categories of Industrial goods are as follows:

- **Raw Materials:** Raw means unprocessed and untreated material. For instance, potatoes, salt, and cooking oil are raw material for a company that produces chips such as Lays and Bingo. Similarly, meat is raw material for a kabab-maker and sand is raw material for a brick-maker. Raw material is worked upon and processed for creating end product.
- **Manufactured Parts**: Some of the raw materials take the form of manufactured parts or components. For example- car companies use manufactured parts such as tyres, batteries, lamps, pistons, radiators, and air conditioning assemblies to produce cars. These parts are not fashioned or processed further, rather they are assembled into the final product as they were.

However, some of the manufactured materials are 'worked upon' or further processed to make an end product. For example- cotton yarn is processed to make apparel or iron rods and wires are used by fabricators. Component or part can be distinguished from material by whether these undergo change or not. Components are used without any change in the end product, while materials undergo a change.

- **Capital Items:** This category of industrial products includes capital items that are used in the production process. What sets apart capital items from others is that these are long-term assets such as plant, machinery, and equipment.

For instance, assembly line or welding robots in an automobile factory are capital items that last for years and help produce revenue. Capital items can belong to a factory or an office. For example- a lift truck or welding machine belongs to a factory, while a computer or fax machine belongs to an office.

- **Supplies:** Products in this category are usually indirect items that contribute to the production of end product. These products are also called consumables. Supplies are hygiene requirements whose presence does not directly matter but their shortage can have a significant effect.

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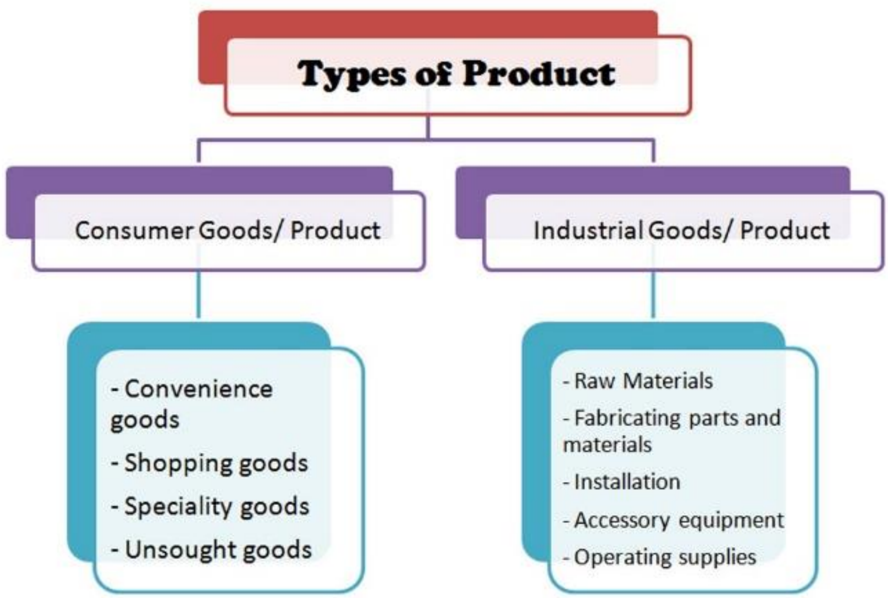
For instance, oil and grease used for machine lubrication is hardly paid attention to but an un-lubricated machine can significantly affect productivity. A small price item like cotton cloth is used to wipe out dust during quality inspection process of a car, but the price of cotton does not indicate its significance in the quality process. Supplies that are used in office include paper, mops, cleaners, pencils, and files. Supplies are also used in services. For example- repair and maintenance service are part of this category.

Services

A service is an intangible part of a product. It is an action or effort to fulfil a demand or satisfy customer needs. It is unable to store or own it and consumed at a point of sale. For instance, if you visit a doctor, he offers his services to cure a disease. Other examples of services are banking, postal or educational service and many more.

Digital Products

A digital product is created in a digital format as a file which might be for sale or not. A person can download and stream it by using a computer or other electronic devices. Any digital product might include audio video file, ebook, desktop or mobile applications, downloadable templates graphics, fonts and PSD files. Consumers who purchase these digital products are known as digital buyers



Difference between industrial and consumer products		
Basis	**Industrial products**	**Consumer products**
Meaning	These products are used for further production of other goods.	These products are used for final consumption by the direct consumers.
Number of buyer	The buyers of industrial goods are limited.	The buyers of consumer goods are many in number
Buying decision	Decisions of buyers are influenced by technical specification and goodwill.	Decisions of buyers are influenced by advertising and various sales promotional schemes.
Nature of demand	These products have derived demand.	These products have direct demand.

1.3 Developing a Marketing Strategy

To implement the marketing concept and customer relationship management, a business needs to develop and maintain a marketing strategy, a plan of action for developing, pricing, distributing, and promoting products that meet the needs of specific customers. This definition has two major components: selecting a target market and developing an appropriate marketing mix to satisfy that target market.

1.3.1 Selecting a Target Market

A market is a group of people who have a need, purchasing power, and the desire and authority to spend money on goods, services, and ideas. A **target market** is a more specific group of consumers on whose needs and wants a company focuses its marketing efforts. For instance, Khaadi initially focused on women of age 25 and above as the target market for its products. Later on the brand expanded to cater to not only women of all age groups but men and children as well. This strategic focus allowed the company to tailor products to attract specific demographics with much success. In the past few years, the company has even diversified into home linen and accessories and created spin-off brands like Chapter 2 by Khaadi for a funkier and experimental set of consumers within their target market.

Identifying a target market helps a company focus its marketing efforts on those who are most likely to buy its products or services. Concentrating on potential customers lets the firm use its resources efficiently.

Target markets can be broadly classified as ***consumer markets*** or ***industrial markets***. Consumer markets exist for various consumer products and services (such as cameras, clothes, and household items), while industrial markets exist for industrial products that are purchased by firms (such as plastic and steel). Some products (such as tires) can serve consumer markets or industrial markets (such as car manufacturers). Classifying markets as consumer or industrial provides only a broad description of the types of customers who purchase products, however. Consequently, firms attempt to describe their target markets more narrowly.

Market Segmentation

Some firms use a **total-market** approach, in which they try to appeal to everyone and assume that all buyers have similar needs and wants. Sellers of salt, sugar, and many agricultural products use a total-market approach because everyone is a potential consumer of these products. Most firms, though, use market segmentation and divide the total market into groups of people. A **market segment** is a collection of individuals, groups, or organizations who share one or more characteristics and thus have relatively similar product needs and desires.

Market segmentation is the process of separating, identifying, and evaluating the layers of a market to identify a target market. For instance, a target market might be segmented into two groups: families with children, and families without children. Families with young children are likely to buy hot cereals and presweetened cereals. Families with no children are more likely to buy health-oriented cereals. A business market may be segmented by large customers and small customers or by geographic area.

Common traits used to describe a target market segment include the consumer's gender, age, and income bracket but there may be other factors such as:

- *Demographic*—age, sex, race, ethnicity, income, education, occupation, family size, religion, social class. These characteristics are often closely related to customers' product needs and purchasing behavior, and they can be readily measured. For example, clothing and fragrances are often segmented by sex or gender. Toys can often be segmented by age.
- *Geographic*—climate, terrain, natural resources, population density, subcultural values. These influence consumers' needs and product usage. Climate, for example, influences consumers' purchases of clothing, automobiles, heating and air conditioning equipment, and leisure activity equipment.
- *Social factors*—personality characteristics, motives, lifestyles, faith and belief systems. Soft-drink marketers provide their products in several types of packaging, including two liter bottles and cases of cans, to satisfy different lifestyles and motives.

1.3.2 Creating a Marketing Mix

Marketers use a number of different "tools" to develop the products or services that meet the needs and wants of their customers, provide excellent value for the customers, and satisfy those customers. The next step in developing a Marketing strategy is determining the five different components of marketing. These components are called "the Five Ps" of marketing. They are the methods, tools, and processes used by marketers to develop and market products.

These five tools are also called "the marketing mix." These traditionally are called the 4Ps. Some new texts have included 'People' or 'Packaging' as the 5th P of the marketing mix as well:

Product

A product is something offered in exchange and for which marketing actions are taken and marketing decisions made. Products can be goods (physical things such as smartphones) or services (such as the telecommunications that must be used for a smartphone to work) or ideas (such as the thought that being constantly connected through telecommunications is absolutely crucial in today's society). All products have both tangible and intangible aspects. Every product is made at a cost and each is sold at a price. The price that can be charged depends on the market, the quality, the marketing and the segment that is targeted. Each product has a useful life after which it needs replacement, and a life cycle after which it has to be re-invented. Firms must continually improve existing products and develop new products to satisfy customers over time. In this way, firms generate high sales growth, which normally increases their value.

Price

Price is a value that a consumer is willing to give up in exchange for a product. Price may be monetary or nonmonetary (such as waiting in long lines for a restaurant or giving blood at the local blood bank). Price may be in different forms such as rent, fees, charges, and others.

Marketers view price as much more than a way of assessing value, however. It is a key element of the marketing mix because it relates directly to the generation of revenue and profits. Prices can also be changed quickly to stimulate demand or respond to competitors' actions. The sudden increase in the cost of commodities such as oil can create price increases or a drop in consumer demand for a product.

Place

Place refers to the process of distribution or making products available to customers in the quantities desired. For example, consumers can rent DVDs and videogames from a physical store, a vending machine, or an online service. Intermediaries, usually wholesalers and retailers, perform many of the activities required to move products efficiently from producers to consumers or industrial buyers. These activities involve transporting, warehousing, materials handling, and inventory control, as well as packaging and communication.

Promotion

Promotion includes methods for informing and influencing customers to buy the product. Promotion includes several different components – traditional advertising, sales promotion, public relations, personal selling, social media, and e-commerce. Promotion is often mistaken for marketing because it is the most visible part of marketing; however, marketing encompasses much more than just promotion. The aim of promotion is to communicate directly or indirectly with individuals, groups, and organizations to facilitate sales of a product.

People

This includes the process of utilizing organization's employees to support the marketing strategies of the company. All products have both tangible and intangible aspects. People (as a marketing strategy) are crucial to the development of the product's intangible aspects.

1.4 The Product Life Cycle

Most products experience a product life cycle, or a typical set of phases over their lifetime. The marketing decisions made about a particular product may be influenced by the prevailing phase of the cycle. Product managers create marketing mixes for their products as they move through the life cycle. The product life cycle is a pattern of sales and profits over time for a product (e.g., Dalda Cooking oil) or a product category (e.g., Edible oils and ghee). As the product moves through the stages of the life cycle, the firm must keep revising the marketing mix to stay competitive and meet the needs of target customers.

The typical product life cycle has four specific phases:

- Introduction
- Growth
- Maturity
- Decline

Introduction

The introduction phase is the initial period in which consumers are informed about a new product. The promotion of the product is intended to introduce the product and make consumers aware of it. In some cases, the product is first tested in particular areas to determine consumer reaction. For example, the concept of direct satellite television was tested in various locations. The initial cost of producing and advertising the product may exceed the revenue received during this phase. The price of the product may initially be set high if no other competing products are in the market yet. This strategy is referred to as price skimming.

Growth

The growth phase is the period in which sales of the product increase rapidly. The marketing of the product is typically intended to reinforce its features. Cellular telephones and direct satellite TVs are in the growth phase. Other firms that are aware of the product's success may attempt to create a similar or superior product. The price of the product may be lowered once competing products enter the market.

Maturity

The maturity phase is the period in which additional competing products have entered the market, and sales of the product level off because of the increased competition. At this point, most marketing strategies are used to ensure that customers are still aware that the product exists. Some marketing strategies may offer special discounts to maintain market share. The firm may also revise the design of the existing product (product differentiation) to maintain market share. Standard cable television service is an example of a product at the maturity phase.

Decline

The decline phase is the period in which sales of the product decline, either because of reduced consumer demand for that type of product or because competitors are gaining market share. If firms do not prepare for a decline phase on some products, they may experience an abrupt decline in business. Some firms begin to prepare two or more years before the anticipated decline phase by planning revisions in their existing products or services.

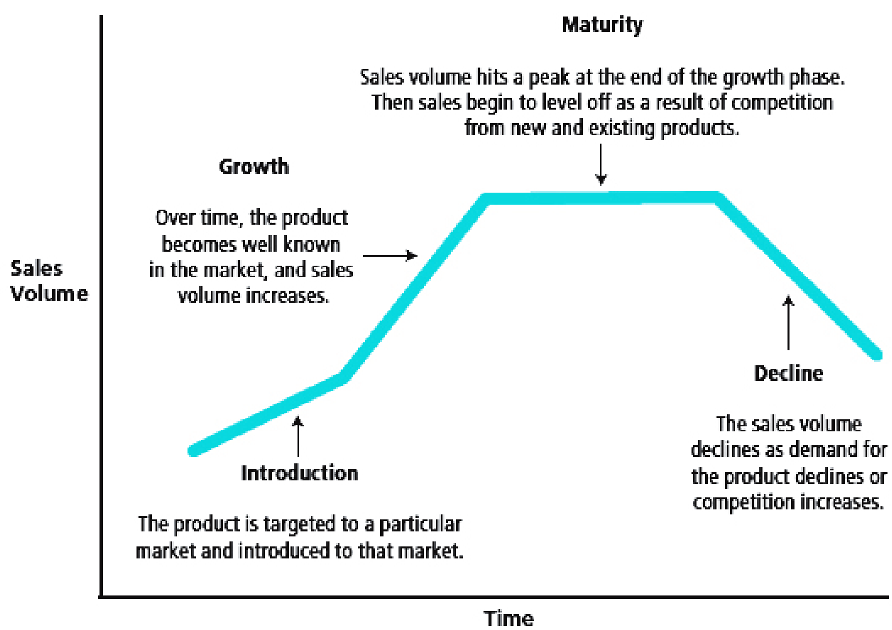


Figure - Phases of The Product Life Cycle

2. BRANDING

The word "brand" is derived from the Old Norse "brand" meaning "to burn," which refers to the practice of producers burning their mark (or brand) onto their products. Italians are considered among the first to use brands in the form of watermarks on paper in the 1200s. However, in mass-marketing, this concept originated in the nineteenth century with the introduction of packaged goods.

During the Industrial Revolution, the production of many household items, such as soap, was moved from local communities to centralized factories to be mass-produced and sold to the wider markets. When shipping their items, factories branded their logo or insignia on the barrels used. Eventually these "brands" became trademarks, or recognized symbols of a company or product that are established by use. These new brand marks enabled packaged-goods manufacturers to communicate that their products are distinctive and should be trusted as much as (or more than) local competitors. Campbell Soup, Coca-Cola, Juicy Fruit gum, and Quaker Oats were among the first products to be "branded."

Branding is a method of identifying products and differentiating them from competing products. Brands are typically represented by a name and a symbol. A **trademark** is a brand's form of identification that is legally protected from use by other businesses. Some trademarks have become so common that they represent the product itself. For example, "Coke" is often used to refer to any cola drink, and "Pampers is frequently used to refer to any baby diaper. Some symbols are more recognizable than the brand name. McDonald's, Nike, Pepsi, and Mercedes all have easily recognized symbols.

2.1 Importance of Branding

Branding is absolutely critical to a business because of the overall impact it makes on a company. Branding can change how people perceive a brand, it can drive new business and increase brand awareness.

Effective branding encompasses everything that shapes the perception of a company or product in the minds of customers. Names, logos, brand marks, trade characters and trademarks are commonly associated with brand, but these are just part of the picture. Branding also addresses virtually every aspect of a customer's experience with a company or product: visual design, quality, distinctiveness, purchasing experience, customer service, and so forth. Branding requires a deep knowledge of customers and how they experience the company or product. Brand-building requires long-term attention and investment in communicating about and delivering the unique value embodied in a company's "brand," but this effort reaps long-term profitability.

In consumer and business-to-business markets, branding can influence whether consumers will buy the product and how much they are willing to pay. Branding can also help in new product introduction as a new brand extension or product line builds on consumers' positive perceptions of the established brand.

Branding Gets Recognition

The most important reason branding is important to a business is because it is how a company gets recognition and becomes known to the consumers. The logo is the most important element of branding, especially where this factor is concerned, as it is essentially the face of the company.

This is why a professional logo design should be powerful and easily memorable, making an impression on a person at first glance. Printed promotional products are a way of getting this across.

Branding Increases Business Value

Branding is important when trying to generate future business, and a strongly established brand can increase a business' value by giving the company more leverage in the industry. This makes it a more appealing investment opportunity because of its firmly established place in the marketplace.

Branding Generates New Customers

A good brand will have no trouble drumming up referral business. Strong branding generally means there is a positive impression of the company amongst consumers, and they are likely to do business with a company because of the familiarity and assumed dependability of using a name they can trust. Once a brand has been well-established, word of mouth will be the company's best and most effective advertising technique.

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Improves Employee Pride and Satisfaction

When an employee works for a strongly branded company and truly stands behind the brand, they will be more satisfied with their job and have a higher degree of pride in the work that they do. Working for a brand that is reputable and help in high regard amongst the public makes working for that company more enjoyable and fulfilling. Having a branded office, which can often help employees feel more satisfied and have a sense of belonging to the company, can be achieved through using promotional merchandise for staff desktop.

Creates Trust Within the Marketplace

A professional appearance and well-strategised branding will help the company build trust with consumers, potential clients and customers. People are more likely to do business with a company that has a polished and professional portrayal.

Being properly branded gives the impression of being industry experts and makes the public feel as though they can trust the company, the products and services it offers and the way it handles its business.

Branding Supports Advertising

Advertising is another component to branding, and advertising strategies will directly reflect the brand and its desired portrayal. Advertising techniques such as the use of promotional products from trusted companies such as Outstanding Branding make it easy to create a cohesive and appealing advertising strategy that plays well into the branding goals.

2.2 Key Elements of Branding

The key concepts of branding are the pillars, which help the companies to promote their brands towards their target customers.

- **Brand Positioning**: Branding positioning is all about placing an image of the product in the minds of customers.
- **Brand Attributes**: The brand attributes are bundle of features and characteristics which highlights personality aspects of brand. The brand attributes are developed through actions, images and advertising.
- **Brand Elements**: The brand elements are components, which creates the identity of brands such as name, slogan, colour, characters, symbol, sound, jingle, shape, graphic, tastes and movements etc. For example, the symbol of Honda (H), slogan of Dawlance "Dawlance Reliable Hai", character of KFC "KFC + old man", the yellow colour of McDonald's (M) and jingle of Nokia (Tune) etc. are the examples of brand elements, which creates the brand.
- **Brand Ownership:** A brand owner may seek to protect proprietary rights in relation to a brand by registering the trademark such that it becomes a "Registered Trademark." Also, a firm or licensor can also grant the right to use their brand name, patents or sales knowledge in exchange for some form of payment.
- **Brand Personality**: The personality of brand includes all the characteristics of the brand that represent the business culture, its purpose, overall mission and vision and goals.
- **Unique Selling Propositions (USP):** The USP's are the key characteristics and factors, which emphasizes that the company's product is better than other similar products available in the market.
- **Brand Image:** The brand image is basically customer's perception about a specific brand.

3. SELLING

During WWII world industry geared up for accelerated wartime production. When the war was over this stimulated industrial machine turned to producing consumer products. By the mid 50's supply was starting to out-pace demand in many industries. Businesses had to concentrate on ways of selling their products. Numerous sales techniques such as closing, probing, and qualifying were all developed during this period and the sales department had an exalted position in a company's organizational structure.

The Selling Concept proposes that customers, be individual or organizations will not buy enough of the organization's products unless they are persuaded to do so through selling effort. So organizations should undertake selling and promotion of their products for marketing success. The consumers typically are inert and they need to be motivated for buying by converting their inactive need in to a buying motive through persuasion and selling action.

This approach is particularly useful in cases of unsought goods like life insurance, vacuum cleaner and firefighting equipment. These industries are seen having a strong network of sales force. This concept is also applied where businesses need to sell due to over-production of goods where their goal is to sell what they produce than what the customer really wants, e.g. perishable products.

Selling refers to the short term need to close a sale, get an agreement signed, or ultimately do what needs to be done to sell a product. Sales techniques and strategies are really based on what it takes to 'close the deal', which is crucial to any business. For example, setting sales volume targets for a period (weeks, months, and quarters) and have strategies in place where the individuals responsible for actually selling can make those targets

Difference between Marketing & Selling

Marketing and sales are both aimed at increasing revenue. They are so closely intertwined that people often don't realize the difference between the two. Indeed, in small organizations, the same people typically perform both sales and marketing tasks. Nevertheless, marketing is different from sales and as the organization grows, the roles and responsibilities become more specialized.

	Marketing	Sales
Definition	Marketing is the systematic planning, implementation and control of business activities to bring together buyers and sellers.	A sale is a transaction between two parties where the buyer receives goods (tangible or intangible), services and/or assets in exchange for money.
Approach	Broader range of activities to sell product/service, client relationship etc.; determine future needs and has a strategy in place to meet those needs for the long term relationship.	Make customer demand match the products the company currently offers.
Focus	Overall picture to promote, distribute, price products/services; fulfill customer's wants and needs through products and/or services the company can offer.	Fulfill sales volume objectives
Process	Analysis of market, distribution channels, competitive products and services; Pricing strategies; Sales tracking and market share analysis; Budget	Usually one to one
Scope	Market research; Advertising; Sales; Public relations; Customer service and satisfaction .	Once a product has been created for a customer need, persuade the customer to purchase the product to fulfill her needs

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	Marketing	Sales
Horizon	Longer term	Short term
Strategy	Pull	Push
Priority	Marketing shows how to reach to the Customers and build long lasting relationship	Selling is the ultimate result of marketing.
Identity	Marketing targets the construction of a brand identity so that it becomes easily associated with need fulfillment.	Sales is the strategy of meeting needs in an opportunistic, individual method, driven by human interaction. There's no premise of brand identity, longevity or continuity. It's simply the ability to meet a need at the right time.

The typical goal of marketing is to generate interest in the product and create leads or prospects. Marketing activities include:

- consumer research to identify the needs of the customers
- product development – designing innovative products to meet existing or latent needs
- advertising the products to raise awareness and build the brand.
- pricing products and services to maximize long-term revenue.

On the other hand, sales activities are focused on converting prospects to actual paying customers. Sales involves directly interacting with the prospects to persuade them to purchase the product.

Marketing thus tends to focus on the general population (or, in any case, a large set of people) whereas sales tends to focus on individuals or a small group of prospects.

To summarize the aims and functions of the marketing department is to promote products and services based on thorough marketing research into customer demands. The sales function is to support the marketing department and it ensures that customers are provided with a quality product in a timely manner.

Neither function operates in a vacuum and both functions rely heavily on each other to achieve sales and marketing effectiveness in an organization.

SELF-TEST

For the following questions select the best answer.

1. _____________ is a systematic approach to satisfying consumers.
   (a) Selling
   (b) Branding
   (c) Accounting
   (d) Marketing

2. Marketing focuses on many activities including ________ and ___________ that foster exchanges.
   (a) Planning & Pricing
   (b) Branding & Budgeting
   (c) Marketing & Transporting
   (d) Selling & Paying

3. Which one of the following is not included in complex set of activities for marketing?
   (a) Transporting
   (b) Storing
   (c) Grading
   (d) Accounting

4. Which one of the following is not a classification of a product?
   (a) Goods
   (b) Service
   (c) Idea
   (d) Relevance

5. Which of the following are considered characteristics of a product?
   (a) Name
   (b) Adaptable
   (c) All of the above
   (d) None of the above

6. Which of the following are considered types of products?
   (a) Banking
   (b) Manufacturing
   (c) All of the above
   (d) None of the above

7. Which of the following product type can be sub-divided into convenience, shopping, or shopping products?
   (a) Industrial
   (b) Banking
   (c) Manufacturing
   (d) Consumer

8. Capital items and supplies are sub-categories of which product type?

(a) Industrial
(b) Banking
(c) Manufacturing
(d) Consumer

9. Which of the following is an _________ intangible part of a product?
(a) Goods
(b) Service
(c) Idea
(d) Relevance

10. A consumer who purchase an ebook on Kindle are known as a _______ buyer. Please select the correct answer.
(a) Technical
(b) Advanced
(c) Contemprorary
(d) Digital

11. One of the characteristics of industrial products is that it has:
(a) Derived demand
(b) Direct demand
(c) Local demand
(d) Foreign demand

12. One of the characteristics of consumer products is that it has:
(a) Many buyers
(b) Limited buyers
(c) Local buyers
(d) Foreign buyers

13. Which of the following is not a factor to describe a target market segment?
(a) Demography
(b) Geography
(c) Equality
(d) Specialty

14. Traditionally, the market mix has 4Ps. Which of the following is considered the 5th component?
(a) Product
(b) Price
(c) All of the above
(d) None of the above

15. Which of the following is the typical product life cycle phases?
(a) Introduction, Growth, Peak, Decline
(b) Introduction, Growth, Maturity, Decline
(c) Introduction, Expansion, Maturity, Decline
(d) Product, Price, Promotion, Place

16. ________is method of identifying products and differentiating them from competing products.
    (a) Selling
    (b) Competing
    (c) Branding
    (d) Inspecting

17. ______ refers to the short term need to get an agreement signed,
    (a) Selling
    (b) Competing
    (c) Branding
    (d) Marketing

18. ________ tends to focus on the general population, whereas __________ tends to focus on individuals or a small group of prospects. Please fill the blanks in right order.
    (a) Marketing, Selling
    (b) Selling, Marketing
    (c) Buying, Selling
    (d) Selling, Buying

ANSWERS TO SELF-TEST

1	D
2	A
3	D
4	D
5	C
6	D
7	D
8	A
9	B
10	D
11	A
12	A
13	C
14	D
15	B
16	C
17	A
18	A

CHAPTER 8

HUMAN RESOURCE STRATEGIES

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Human resource management overview
2. Recruitment
3. Selection
4. Training & development
5. Employees retention
6. Objective Based Q&A

SELF-TEST

AT A GLANCE

- Successful human resource management is based on a company's ability to attract and hire the best employees, equip them with the knowledge and skills they need to excel, compensate them fairly, and motivate them to reach their full potential and perform at high levels.
- Human resource management is a key function in an organization to achieve its strategic goals and objectives, through creating a strategy for meeting current and future human resource needs.
- This chapter will focus on key elements of human resource management function such as:
  - Strategy and planning
  - Job analysis and description
  - Recruitment and selection process
  - Training and development activities
  - Compensation and benefits
  - Retention strategies

1. HUMAN RESOURCE MANAGEMENT OVERVIEW

Human resources (labour) is one of the four traditional factors of production. It refers to the economic contributions of people working with their minds and body. The success of a business entity depends on the skills and experience of its human resources. A critical success factor for an entity might be to have at its disposal sufficient human resources with the necessary skills. Without the key skills, it might be impossible to develop the business successfully.

Today's competitive business environment is based upon knowledge and learning. The companies that succeed will be those that learn fast, use knowledge efficiently, and develop new insights. Accordingly, the role of human resources has evolved over the years. Human resources are mainly employees (full time, part time, home workers). However, human resources might also be individuals who provide consultancy services or expert services, but are not employed by the entity. Human resources might also be provided by sub-contractors and other organisations to which work is outsourced.

1.1 The objective of human resource strategy

A responsibility of the human resource management function is to:

- assess the quantity and quality of human resources currently available, including strength and skills.
- estimate the quantity and quality of human resources that will be needed in the future, including numbers and skills.
- consider ways of 'filling the gap' and ensuring that the entity has the human resources that it needs.

The key objective of a human resources strategy is to ensure that the human resources are available, as required. (In some cases, it might also be necessary to consider reducing the numbers of employees whose skills are declining in importance, through programs of **redundancy** or **re-training** and **relocation**).

1.2 Human Resource Planning

A human resource plan consists of a forecast of the human resources that will be required at a given time in the future, and plans for ensuring that the required numbers and skills will be available. A plan will typically look forward about three to five years. Beyond five years, it might be difficult to forecast requirements with any accuracy or reliability.

A human resource plan of a business enterprise would cover the following areas:

- job analysis and design
- human resource requirements – skills and strength
- recruitment of new staff
- training and development to improve skills
- performance appraisal, to monitor and control the development of skills
- promotion and rewards
- motivation strategy
- redundancies, where some employees will be surplus to requirements, and
- re-training.

The plans should be realistic, and should therefore take into consideration environmental factors such as:

- population trends, and the total size of the work force in each country where the entity has its operations
- government policy, such as changes in the retirement age of workers
- educational system, and the numbers of students going from elementary school to college and university education
- the availability of individuals who are trained in a particular skill or vocation

- changing patterns of employment, possibly with increasing numbers of part-time workers or home workers
- competition for high skill human resources from competitors and other businesses such as programmers
- trends in sub-contracting and outsourcing
- trends in IT and other technological changes that might affect labour requirements

1.3 Job Analysis

Job analysis involves the observation and study of pertinent information about a job—the specific tasks that comprise it; the knowledge, skills, and abilities necessary to perform it; and the environment in which it will be performed. Managers use the information obtained through a job analysis to develop job descriptions and job specifications.

Job analysis is performed as part of human resource management which includes defining the scope of jobs, writing job descriptions, holding performance appraisals, selecting and promoting staff, performing a training needs assessment and as the basis for compensation and organisational planning.

The purpose of a job analysis is to:

- produce a detailed specification of the job (a 'job description'); and
- produce a specification of the qualities needed from the individual who will do the job (a 'person specification').

Job Description

A job description is a formal, written explanation of a specific job that usually includes job title, tasks to be performed (for instance, receiving customers at front desk), relationship with other jobs, reporting lines, physical and mental skills required (such as communication with sales staff or daily MIS reporting), duties, responsibilities, and working conditions. Every job description should also have the position (e.g., AVP, VP) within the company's organizational hierarchy and range of annual remuneration.

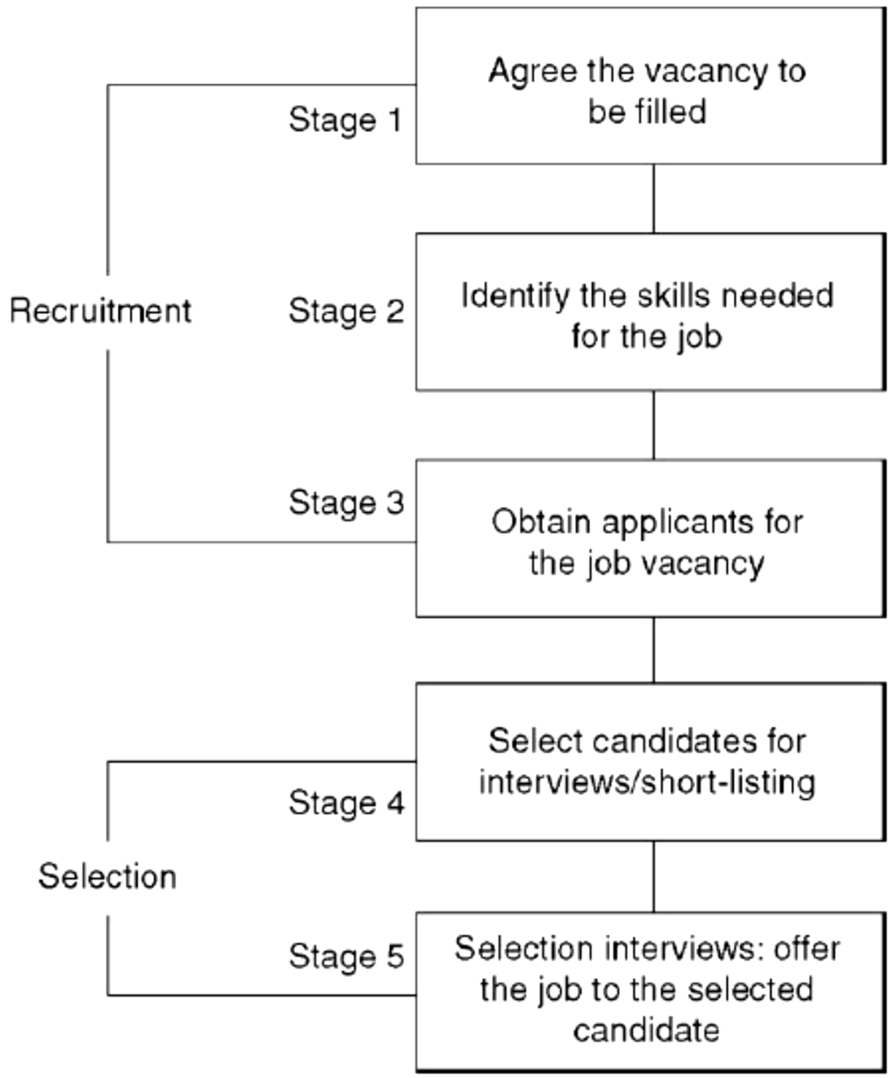
*A **job description** is a formal description of a job, its purpose and scope, and the formal duties and responsibilities of the jobholder.*

Job Specification

A job specification describes the qualifications and skills necessary for a specific job, in terms of education (some jobs require a college degree), experience, personal characteristics (job ads frequently request outgoing, hardworking persons), and physical characteristics.

Both the job description and job specification are used to develop recruiting materials such as newspapers, trade publications, and online advertisements. Both may be used in the selection process, to identify the most suitable applicant for a job vacancy.

Once the human resource managers have developed an HR plan including an estimated demand for new staffing needs, their job duties and responsibilities and the qualifications that would help them carry out their jobs in an effective manner, they can begin the recruitment and selection process. Both are discussed individually in the following sections whereas the chart below summarizes the various stages involved in both activities.


Agree the vacancy to be filled
Stage 1
Recruitment
Stage 2
Identify the skills needed for the job
Stage 3
Obtain applicants for the job vacancy
Select candidates for interviews/short-listing
Stage 4
Selection
Stage 5
Selection interviews: offer the job to the selected candidate

2. RECRUITMENT

The people who work for an organisation are extremely valuable assets. Without its employees, an organisation would not exist and could not operate. The efficiency and effectiveness of an organisation depend on the skills and abilities of its employees.

Over time, changes occur in the work force.

- Some existing employees leave the organisation, for example, to take a job somewhere else or due to retirement.
- Employees who have acquired enough skills and experience might be moved on to other jobs within the organisation that make better use of their developing talent.
- The labour requirements of the organisation will change, as new skills requirements are created and old skills are no longer required. People are recruited to fill the new jobs, with new skills. Some existing employees might be made redundant.

Changes in a work force must be properly managed, in order to make sure that the work force remains efficient and effective. It is therefore important to make sure that job vacancies are filled when they occur. It is also important to make sure that suitable individuals are appointed to do the jobs. This is where the function of recruitment and selection come in.

***Recruitment** starts when a job vacancy is identified. It is the process of obtaining a supply of suitable possible candidates to fill the vacancy.*

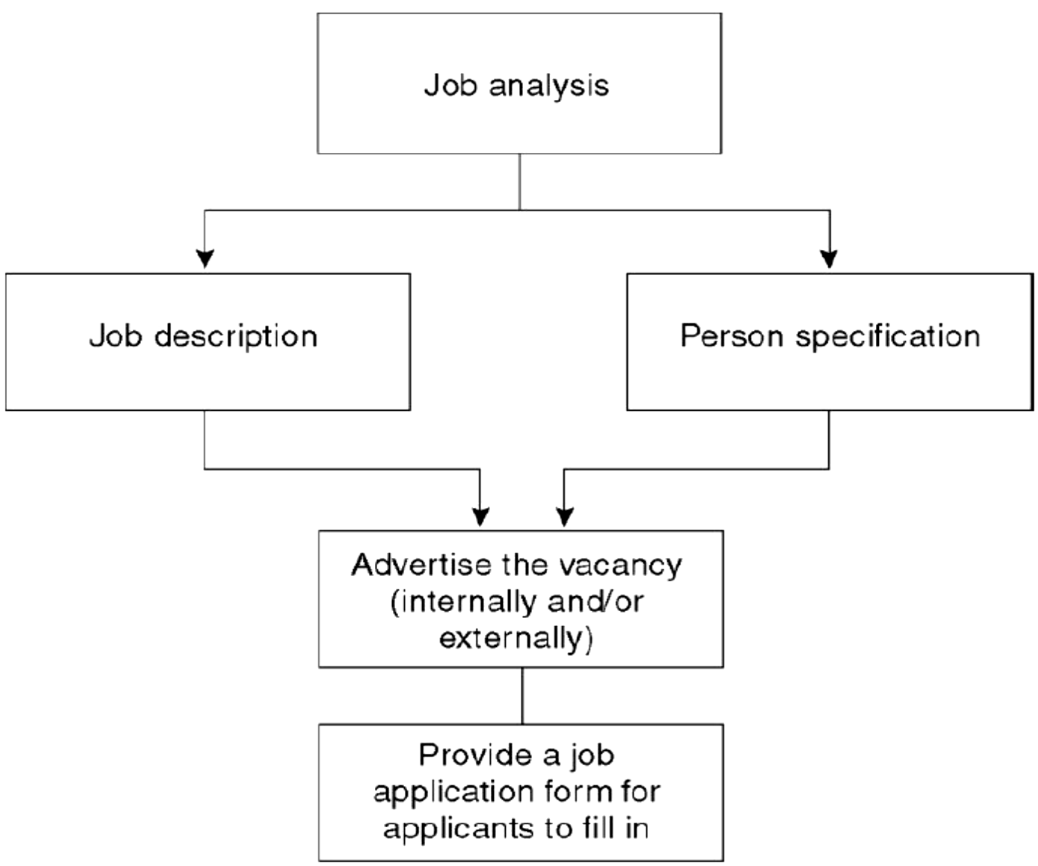


Figure – A plan for the recruitment process

Jobs must be brought to the attention of individuals who might want to apply for them. A job vacancy might be 'advertised':

- within the organisation (internally) to existing employees;
- externally, to people outside the organisation; and
- both internally and externally.

Internal Recruitment

Internal recruiting seeks to fill open positions with persons already working in the company. The cost of hiring current employees to fill job openings is inexpensive when compared with the cost of hiring and training new employees from external sources. It is also good for employee morale. Internal recruiting can also be beneficial because existing employees have already been proven. Their personalities are known, and their potential capabilities and limitations have been thoroughly assessed. However, hiring from within creates another job vacancy to be filled.

Internal recruitment can be greatly facilitated by using a human resource information system that contains an employee database with information about each employee's previous work experience, skills, education and certifications, job and career preferences, performance, and attendance. **Promotions** and **job transfers** are the most common avenues to fill positions by the method of internal recruitment.

When vacancies are filled by internal recruitment, the following methods may be used, individually or together:

- Performance reports and appraisals of individuals
- List of potential employees who are ready for promotion may be invited to apply for a more senior job when a vacancy arises.
- The 'in-house' or company magazine
- The organisation's website or HR portal

External Recruitment

External recruiting is an effort to fill positions with applicants from outside the firm. Some firms may seek to recruit more qualified candidates than current employees when using external recruiting, especially for some specialized job positions. In certain situations, to avoid internal competition, an external candidate is preferred.

There are a number of avenues to source external applicants for open positions. A company may choose the desired medium based on its goals and overall strategy.

- Recruitment agencies
- Media advertising (Television, Radio, National or international Newspapers)
- Open-house (also called open-days) are commonly used in universities to attract fresh graduates.
- Job Fairs
- Internet resources (e.g. Rozee.pk, Monster.com, etc.) and Social Media (e.g. LinkedIn)
- Internship programs
- Company website (Careers section)

3. SELECTION

Selection is the process of collecting information about applicants and using that information to decide which ones to hire. It includes the application itself, as well as interviewing, testing, and reference checking and other tools organisations may use to filter out the most suitable applicants from the recruitment pool.

***Selection** is the process of appointing the most suitable candidate to a job vacancy, by choosing the best individual from the candidates available.*

Whereas recruitment is concerned with quantity – getting candidates to apply for job vacancies – selection is concerned with quality – choosing the individual who seems the best for the job.

Selection steps or hurdles are described below:

1. **Initial Screening**

   During initial screening, an applicant completes an application form and/or submits a resume, and has a brief interview of 30 minutes or less. The job application includes information about educational background, previous work experience, and job duties performed. Another key discussion point is remuneration expectation to avoid wasting time and effort.

2. **Employment tests**

   Another step in the selection process is testing. Ability and performance tests are used to determine whether an applicant has the skills necessary for the job. Aptitude, IQ, technical, or personality tests may be used to assess an applicant's potential for a certain kind of work and his or her ability to fit into the organization's culture.

   Used individually or together, the tests can assess cognitive ability (ability to learn, adapt, and solve problems), motivation potential (attitude, behavior performance, and productivity), and knowledge and skills (math, verbal, data entry, software proficiency).

3. **Selection interview**

   The tool most widely used in making hiring decisions is the selection interview, an in depth discussion of an applicant's work experience, skills and abilities, education, and career interests. For managerial and professional positions, an applicant may be interviewed by several persons, including the line manager for the position to be filled. This interview is designed to determine a person's communication skills and motivation. During the interview, the applicant may be presented with realistic job situations, such as dealing with a disgruntled customer, and asked to describe how he or she would handle the problem.

4. **Background and reference check**

   If applicants pass the selection interview, most firms examine their background and check their references. In recent years, an increasing number of employers, such as Unilever and Shell Pakistan Limited, want to research applicants' backgrounds, including their legal history, reasons for leaving previous jobs, their creditworthiness (credit check) or general conduct to assess job match.

5. **Physical exams and medical exams**

   A firm may require an applicant to have a medical checkup to ensure he or she is physically able to perform job tasks. Some jobs such as Airline industry or law enforcement may put more emphasis on physical fitness and mental agility. Other companies may ask candidates to submit medical tests (including drug test for certain jobs) to minimize medical insurance risks and related productivity issues.

6. **Decision to hire.**

   Once the screening is completed, the top candidate can be selected from this list and offered the job; the remaining qualified applicants can be considered if the top candidate does not accept the job offer.

   If an applicant progresses satisfactorily through all the selection steps (or jumps all of the selection hurdles), a decision to hire the person is made; however, the job offer may be contingent on passing a physical exam and/or general medical tests. The manager of the new employee plays a major role in the final decision to hire.

   By the time the steps for screening applicants are completed, the application list should have been reduced to a small number of qualified candidates. Some firms take their hiring process (and related effort and cost) very seriously because they recognize that their future performance is highly dependent on the employees that they select.

7. **Offer of employment**

   The selection process ends with an offer of employment and acceptance of the offer by the chosen applicant.

   The employer may not be sure whether or not the individual who is offered the job will accept it. It is therefore prudent to identify a short-list of acceptable applicants, listed in order of reference. If the candidate at the top of the list refuses the job, the next person on the list can be made an offer, and so on until someone in the list accepts the offer of the job.

   When the job has been accepted, the arrangement should be confirmed and accepted in writing. Employment legislation might require that the new employee should be given a formal written contract of employment.

Importance of good selection

Good selection decisions improve the quality of employees within the organisation. When an organisation has high-quality employees, it should perform better. It will become a competitive advantage for it. A good selection is therefore an important factor in improving the human capital of the organisation (employee quality) and helping the business to be more successful in achieving its objectives.

4. TRAINING & DEVELOPMENT

Once the most qualified applicants have been selected, have been offered positions, and have accepted their offers, they must be formally introduced to the organization and trained so they can begin to be productive members of the workforce.

To ensure that both new and experienced employees have the knowledge and skills to perform their jobs successfully, organizations invest in training and development activities. Training and development involves learning situations in which the employee acquires additional knowledge or skills to increase job performance.

Training objectives specify performance improvements, reductions in errors, job knowledge to be gained, and/or other positive organizational results.

Well-motivated individuals learn from undertaking their work, and get better at what they do over time. Organizations benefit from individuals learning as people become more efficient and more effective as they learn.

Training *is a process in which individuals are taught something specific. A training programme should have a particular objective, to teach the individual some theoretical or practical knowledge, or to give the individual a new information or skills related to their work.*

Development *is a process of learning through experience and doing work that augments an employee's skillset and prepares him/her for growth. Individuals learn as they develop by doing different things at work and gaining new experiences*.

Development is achieved through gaining experience and therefore developing a career. Individuals learn and develop through experience in different work situations and by having extra responsibilities or opportunities to use their own initiative.

Organizations benefit from the training and development process, because it produces a better work force, and there should be programs of training and development for employees at different levels.

4.1 Benefits of training and development

Training and development have benefits for both the employer and the employee.

Benefits for the employer

The benefits of training and development for the organisation are as follows:

- Training and development creates a more talented and skilled work force leading to:
  - higher productivity, therefore lower costs of output;
  - less waste;
  - better performance by employees in their jobs; therefore, higher standards of achievement;
  - less need for close supervision of subordinates by their managers; and
  - an ability to compete more effectively with business rivals.
- Providing employees with training and planned development will improve their morale, and increase their commitment to the organisation. It should be easier to retain talented staff. If employees are not given the training and development they want and expect, they may resign and go to work for a different employer.

Benefits for the employee

There are also benefits of training and development for the individual:

- Learning through training and development improves the motivation of the individual and gives them a sense of being more valuable (and marketable).
- Career development increases job satisfaction.
- Training and development, by raising the level of skills and abilities, improve the individual's prospects for promotion and higher pay.

Since an individual gains personal benefits, and at the same time there are benefits for the organisation, training and development can help to create compatibility between the personal objectives of individual employees and the corporate objectives of the organisation.

4.2 Tools of training

Tools of training can be grouped into the following categories:

- **Formal training** in a training room environment:
  - 'in house', where all the trainees are from the same organisation. (In Pakistan it is common for 'in-house' training courses to be delivered by colleagues.)
  - 'external', where the training is provided by an external trainer or training firm, and the trainees come from different organisations e.g. the IBA Centre for Executive Education.
- **Computer-based training (CBT)** where trainees work at their own pace from a computer training package. CBT is highly interactive and typically integrates information and learning-based components with short, frequent tests.
- **Training in the work place.** Training in the work place is a method of development of individuals, as well as a method of training. Work place training is for technical or practical skills, whereas work place development helps the individual to gain experience and develop personal skills, such as management and leadership.
- **Induction.** In-house training may be provided by the organisation's own trainers and experts. Alternatively, in-house training may be provided by an external trainer or training firm, hired to deliver the training programme. Formal training may end in an examination, leading to a qualification or certificate – such as a professional accountancy qualification or an MBA degree (Master in Business Administration) with a business school.

4.3 On the Job Training

When an employee learns the job in actual working site in real life situation, and not simulated environment, it is called on-the-job training and also known as job instruction training. This type of training is the most commonly used method. Under this method, the individual is placed on a regular job and taught the skills necessary to perform that job. The trainee learns under the supervision and guidance of a qualified worker or instructor.

On-the-job training has the advantage of giving first-hand knowledge and experience under actual working conditions. On-the-job training methods include job rotation, coaching, mentoring or training through participation in cross-functional team assignments. Some types of on-the-job training are listed below:

- Orientation
- Coaching
- Mentoring
- Job instruction manuals
- Apprenticeships
- Work shadowing

4.4 Off the job Training

Off-the-job training is conducted in a location specifically designated for training. It may be near the workplace or away from work, at a special training center or a resort. Conducting the training away from the workplace minimize distractions and allows trainees to devote their full attention to the material being taught. Also some trainings require special tools or facilities that may not be available at the workplace. Some organizations also invest in their own training centres outside of the work premises to send their employees for certain courses. For example State Bank of Pakistan sends their freshly hired trainees to the National Institute of Banking & Finance (NIBAF) for a specialized and intensive course before they can start the actual work.

Some avenues of off-the-job training may include:

- Class room lectures and courses
- Audio visual films and presentations
- Seminars
- Simulation Centres
- Game theory sessions
- Case Study sessions
- Team-Building meets and activities
- Programmed Instruction
- Online courses

4.5 Tools of development

Development improves the skills, knowledge and abilities of an individual through real work experience. Unlike on-the-job training, however, development is not so much concerned with teaching the individual how to do a particular task or job. It is more concerned with giving the individual more experience and responsibilities, so that he or she is able to improve and become a more valuable resource (employee).

Development programmes are commonly associated with managers. They benefit from development to become better managers, capable of moving on to more senior positions.

Tools of development can be grouped into the following categories:

- **Job rotation.** Job rotation means moving an individual from one job to another at fairly regular intervals, so that the individual gains familiarity with the work done in each job. For example, a trainee accountant in the accounts department might be given a job for three months or six months in the payables ledger section, before being moved to the receivables ledger, then to the payroll department, then to the costing department, and so on. Job rotation gives the individual a broad range of experience in the activities of the organisation. This should be useful when he or she is eventually ready for promotion to a more senior position.
- **Secondment.** An individual might be 'seconded' to work somewhere else for a period of time. Secondments are periods of time spent away from the normal working environment, in another department or as part of a project team. For example, an accountant might be seconded from the accounts department to work with the sales team for a while. Similarly, an accountant might be seconded to join a project team that has been set up to design and implement a new computer system. Individuals benefit from secondments because they gain experience from working with people from different parts of the organisation, or with external consultants.
- **Deputising** for a manager or supervisor. An individual may be given the opportunity to deputise for his or her boss when the boss is absent from work for an extended period, on holiday or due to illness. The individual gains experience by doing the job of the boss for a period of time.
- **Delegation**. A boss who wants to develop individuals will give the individuals additional responsibilities, and delegate authority to the individuals to make their own decisions. Individuals will gain experience from the additional authority and responsibility, and will be accountable to their boss for how they have carried out the additional responsibilities.
- **Appraisals.** Formal appraisals are a part of development process.
  - **Job Design.** Employees can be given opportunities for development through careful job design. Job design involves looking at the current jobs in an organisation or department, and considering whether they can be altered (designed) in a way that gives more fulfilment and greater experience to the job holder. Two types of job re-design are:
  - **Job enrichment** Job enrichment means making the job 'richer' by building more responsibility into it. When a job is enriched, the job holder is given more authority (authority for a higher level of decision-making).
  - **Job enlargement.** Job enlargement means giving the job holder more tasks to do, but without any additional authority. All the additional tasks are at the same 'level' as the existing tasks in the job.

5. EMPLOYEES RETENTION

Once an organization has spent such a considerable time and investment in recruitment, selection and development of its employees, failing to retain a them would prove very costly to business and create organizational issues such as insecure coworkers, excess job duties that coworkers must absorb, time invested in recruiting, hiring, and training a new employee.

Employee Retention is a process in which the employees are encouraged to remain with the organization for the maximum period of time or until the completion of the project. Employee retention is beneficial for the organization as well as the employee.

5.1 Employee Turnover

Turnover, which occurs when employees quit or are fired and must be replaced by new employees, results in lost productivity from the vacancy, costs to recruit replacement employees, management time devoted to training and development, and socialization expenses for new employees.

Part of employee turnover is inevitable due to retirement, separation, promotions and in the worst case death. Nevertheless, for operations to run smoothly, most organisations aim to optimize the rate of turnover for their organization.

A well-organized human resources department strives to minimize losses due to separations and transfers because recruiting and training new employees is very expensive. Note that a high turnover rate in a company may signal problems with the selection and training process, the compensation program, or even the working environmrnt of company. To help reduce turnover, companies have tried a number of strategies, including giving employees more interesting job responsibilities (job enrichment), allowing for increased job flexibility, and providing more employee benefits.

To reduce voluntary turnover organisations can come up with various strategies to keep the employees satisfied and stay in the organization. To do these employers must recognize key reasons why employees would want to leave.

Why employees leave?

Employees quit their job for many reasons. They move due to family reasons to another location, stay home to take care of their loved ones, change careers, find career growth or promotions, go back for higher education or seek higher salaries. Those reasons are not easy to address by an employer because they involve life events in the employee's world outside of work.

But, the majority of reasons why employees quit their job are under the control of the employer. In fact, any element of your current workplace, your culture, and environment, the employee's perception of his job and opportunities are all factors that the employer can influence.

Following are some examples of reasons that can affect an employee's decision to leave, among others:

- Relationship with the supervisor and co-workers
- Unchallenging work tasks
- Financial reasons
- Family and personal reasons
- Termination of a fixed contract
- Financial instability of a company
- Lack of flexible work hours

5.2 Employee Retention Strategies

While offering a good paycheck is important, companies need to go a little deeper to make sure their turnover rate is low. Progressive HR functions are now ensuring that employees establish a long-term association with the company beyond the paycheck.

Here are a few strategies that an HR function can employ to retain its valuable employees:

1. A well-defined career path:

Employees, whether freshers or ones with experience, want to understand how the leadership of an organisation can facilitate their growth. They want to see tangible examples of how their counterparts have grown in the firm. For many, growth is not just a vertical ladder. A lateral lattice is equally important. The young workforce is keen on having early experiences of doing different things rather than being sandboxed into one job role. Hence, it is important for companies to chart out well-defined career paths that factor in a `variety of work' that encourages their employees to stick to the organisation.

2. Compensation

Compensation constitutes the largest part of the employee retention process. The employees always have high expectations regarding their compensation packages. Compensation packages vary from industry to industry. So an attractive compensation package plays a critical role in retaining the employees.

Compensation includes salary and wages, bonuses, benefits, prerequisites, stock options, bonuses, vacations, etc. While setting up the packages, the following components should be kept in mind:

- Salary and monthly wage: It is the biggest component of the compensation package. It is also the most common factor of comparison among employees.
- Salary and wages represent the level of skill and experience an individual has. Time to time increase in the salaries and wages of employees should be done. And this increase should be based on the employee's performance and his contribution to the organization.
- Bonus: It is usually given to the employees at the end of the year or on a festival.
- Economic benefits: It includes paid holidays, leave travel concession, etc.
- Long-term incentives: It include stock options or stock grants. These incentives help retain employees in the organization's startup stage.
- Health insurance: It is a great benefit to the employees. It saves employees money as well as gives them a peace of mind that they have somebody to take care of them in bad times. It also shows the employee that the organization cares about the employee and its family.
- After retirement: It includes payments that an employee gets after he retires like gratuity, EPF (Employee Provident Fund), etc.
- Miscellaneous compensation: It may include employee assistance programs (like psychological counseling, legal assistance, etc.), discounts on company products, use of a company car, etc.

3. Work Relationships

Work relationships that affect employee retention include supervisory management support and coworker relations. A supervisor or manager builds positive relationships and aids retention by being fair and nondiscriminatory, allowing work flexibility and work-family balancing, giving feedback that recognizes employee efforts and performance, and supporting career planning and development.

Additionally, many individuals build close relationships with coworkers. Such work-related friendships do not appear on employee records, but these relationships can be an important signal that a workplace is positive. Overall, what this means is that it is not just where people work, but also with whom they work, that affects employee retention. If individuals are not linked with or do not relate to their coworkers, there is greater likelihood for turnover to occur.

4. Job and Work-Life

Many individuals have seen a decline in job security during the past decade. All the downsizings, layoffs, mergers and acquisitions, and organizational restructurings have affected employee loyalty and retention. As coworkers experience layoffs and job reductions, the anxiety levels of the remaining employees rise. Consequently, employees start thinking about leaving before they too get cut. Organizations in which job continuity and security are high tend to have higher retention rates.

Some jobs are considered "good" and others are thought to be "bad," but not all people agree on which jobs are which. As mentioned previously, the design of jobs and peoples' preferences can vary significantly. Job design factors that can impact retention include the following:

- A knowledge, skills, and abilities mismatch, either through overqualification or underqualification, can lead to turnover.
- Job accomplishments and workload demands that are dissatisfying or stressful may impact performance and lead to turnover.
- Both timing of work schedules and geographic locations may contribute to burnout of some individuals.
- The ability of employees to balance work and life requirements affects their job performance and retention.

5. Work-life balance:

Irrespective of their industry, it is important for working professionals to maintain a work-life balance. While high-paying jobs do demand longer hours of work, organisations should implement flexible working hours and work from home policies while respecting their core office culture. Practices like occasional work from home, flexible work arrangements, `ME' time (keeping a chunk of their time to pursue a hobby of their choice) are ways to help employees maintain a healthy work-life balance.

6. Organizational Environment

It is not about managing retention. It is about managing people. If an organization manages people well, employee retention will take care of itself. Organizations should focus on managing the work environment to make better use of the available human capital. People want to work for an organization which provides:

- Appreciation for the work done
- Ample opportunities to grow
- Friendly and cooperative environment
- A feeling that the organization is second home to the employee

Organizational environment includes:

- Culture
- Values
- Company reputation
- Quality of people in the organization
- Employee development and career growth
- Risk taking
- Use of leading technologies
- Trust

7. Recognition and feedback:

Typically, bosses are quick on giving feedback when issues crop up. However, appreciation is rare when things go smooth. Letting your employees know that you appreciate their efforts, recognising and highlighting impactful outcomes and giving timely feedback is crucial. Similarly, gaining feedback from employees and engaging oneself in meaningful dialogues to improve areas that are creating obstacles is important.

8. Transparent and fair reviews:

Enabling transparent and clear reviews and appraisals for employees helps them achieve more with a clear picture of being rewarded on the basis of merit. The review process should celebrate key milestones in an employee's career in an organisation where the focus is on highlighting key achievements, strengths and development areas, followed by a mutually agreed upon goal setting discussion.

SELF-TEST

For the following questions select the best answer.

1. Human resources cover following types of employees?
   - (a) Full-time
   - (b) Part-time
   - (c) All of the above
   - (d) None of the above

2. Which of the following is not a responsibility of the human resource management function?
   - (a) assess the quantity and quality of human resources currently available
   - (b) estimate the quantity and quality of human resources that will be needed in the future
   - (c) encourage employees of low performance to leave
   - (d) consider ways of 'filling the gap' and ensuring that the entity has the human resources that it needs

3. The ideal duration of a human resource plan is:
   - (a) three to five years
   - (b) three to seven years
   - (c) below three years
   - (d) over three years

4. Which of the following is not an area to be covered in a human resource plan?
   - (a) Staff recruitment
   - (b) Performance appraisal
   - (c) Marketing campaign
   - (d) Redundancy

5. Human resource plans should, and should therefore take into consideration environmental factors.
   - (a) simplistic
   - (b) critical
   - (c) realistic
   - (d) idealistic

6. Which of the following is not the purpose of a job analysis?
   - (a) Job description
   - (b) Job specification
   - (c) All of the above
   - (d) None of the above

7. Which of the following is not a stage of recruitment?
   - (a) Agree the vacancy
   - (b) Select the candidate
   - (c) Identify the skills
   - (d) Obtain applications

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8. Which of the following is not a stage of selection?
   (a) Agree the vacancy
   (b) Select the candidate
   (c) All of the above
   (d) None of the above

9. Requesting a candidate's credit check is part of which of the following human resource management activity?
   (a) Recruitment
   (b) Selection
   (c) Development
   (d) Retention

10. Which of the following is not a tool of training?
   (a) CBT
   (b) SAT
   (c) All of the above
   (d) None of the above

11. Which of the following is not a type of on-job-training?
   (a) Orientation
   (b) Job instruction manuals
   (c) Simulation
   (d) Apprenticeships

12. Which of the following is a tool of development?
   (a) Secondment
   (b) Delegation
   (c) All of the above
   (d) None of the above

13. Which of the following is generally not a reason of an employee's decision to leave?
   (a) Financial instability of a company
   (b) Bad relationship with manager
   (c) Bad relationship with secretary
   (d) Boring work

14. Which one of the following is not included in an annual package?
   (a) Bonus
   (b) EPF
   (c) Air Tickets
   (d) Appraisals

15. Employee turnover is defined as:
   (a) Staff joining the job
   (b) Staff leaving the job
   (c) Staff increasing the revenue turnover
   (d) Staff increasing the sales turnover

ANSWERS TO SELF-TEST

1	C
2	C
3	A
4	C
5	C
6	C
7	B
8	A
9	B
10	B
11	C
12	C
13	C
14	D
15	B

CHAPTER 9

BUSINESS OPERATIONS OF A MANUFACTURING ORGANISATION

AT A GLANCE

SPOTLIGHT

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Operations of a manufacturing company
2. A typical structure of a manufacturing company
3. Key departments of a manufacturing company
4. Manufacturing and operations management

SELF-TEST

AT A GLANCE

Manufacturing is a specialized form of business, where raw materials are processed into finished goods using tools, machinery, and human capital. It may be a labour or capital intensive, or a combination of both.

The key objective of a manufacturing business is to efficiently produce and deliver quality products at a competitive price. To achieve this objective, a manufacturer needs to manage and control its operations and optimally integrate them with other key functions such as marketing, finance, and human resources.

This chapter will focus on key elements of operational management and structure of a manufacturing business such as:

- Transformation process
- Production planning and control including location, design, and resource management
- Organizational structure
- Key departments
- Benefits of operations management

1. OPERATIONS OF A MANUFACTURING COMPANY

In this section you will learn about the actual operations of a manufacturing company. The section includes a discussion of key processes of a manufacturing company. The explanation is supported by examples from companies in different industries.

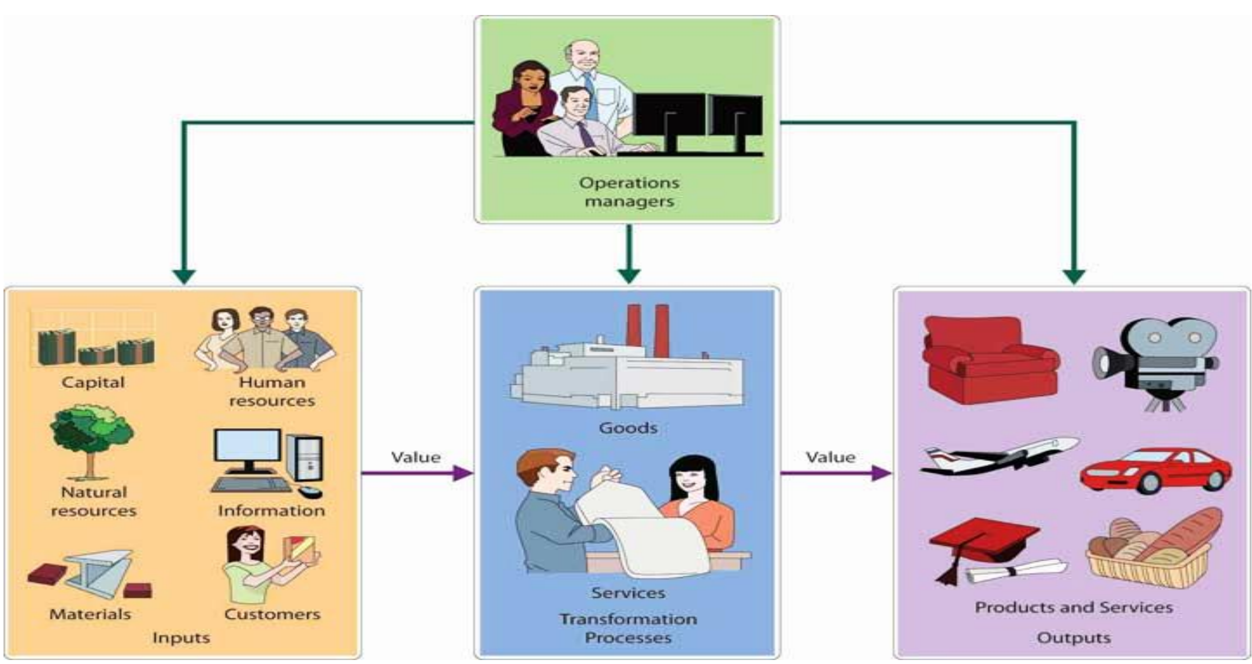
1.1 The Transformation Process

Every organization—whether it produces goods or provides services—focuses on furnishing customers with quality products. Technological advancements, ongoing competition, and consumer expectations force companies to take the overall manufacturing process seriously, integrate with other key functions such as sales and marketing, finance and accounting, procurement, human resources, legal, etc. However, the **key objective** remains the same: **to produce and deliver quality products at a competitive price in a timely manner**. The competition also forces manufacturers to innovate and improve the process by superior automation, enhanced quality-control techniques, and efficient supply-chain management.

Thus, to compete with other organizations, a company must convert resources (materials, labor, money, information) into goods or services as efficiently as possible. Managing this conversion process is the role of operations management. They are the people charged with managing and supervising the conversion process. They control significant part of a firm's assets, including inventories, wages, and benefits. They also work closely with other major divisions of the firm, such as marketing, finance, accounting, and human resources, to ensure that the firm produces its goods profitably and satisfies its customers. Marketing personnel help them decide which products to make. Accounting and human resources help them face the challenge of combining people and resources to produce high-quality goods on time and at reasonable cost. Operations management is also involved in the development and design of goods and determine what production processes will be most effective.

The upper-level manager who directs this transformation process is called an *operations manager*. The operations of a manufacturing company, then, consists of all the activities involved in transforming a product idea into a finished product, as well as those involved in planning and controlling the systems that produce finished goods. In other words, operations managers manage the process that transforms the inputs into the outputs. Figure below "The Transformation Process" illustrates this traditional function of operations management.

Figure 1.1 The Transformation Process



1.2 Objectives of operation management in Manufacturing

All manufacturers set out to perform the same basic function: *to transform resources into finished goods*. To perform this function in today's business environment, manufacturers must continually strive to improve operational efficiency. They must adjust their production processes with the following objectives in mind:

- to focus on quality,
- to minimize the costs of materials and labor, and
- to eliminate all costs that add no value to the finished product.

Making the decisions involved in the effort to attain these goals is the job of the operations manager. That person's responsibilities can be grouped as follows:

- ***Procurement & purchasing***. Before production begins, a company must plan the sourcing of materials and inputs that are required for making a finished product.
- ***Production planning***. During production planning, managers determine how and when the goods will be produced, where the production will take place, and how the manufacturing facilities will be laid out. This includes to determine site locations and obtain the necessary resources. Overall, four important decisions are made in production planning (i) type of production process, (ii) site selection, (iii) facility layout, and (iv) resource planning.
- ***Production control***. Once the production process is under way, managers must continually schedule and monitor the individual activities that make up that process. They must be open to feedback and respond to make adjustments where needed. At this stage, they also oversee the purchasing of raw materials and the handling of inventories, and ensure controlling the costs. Three key scheduling tools are: Gantt charts, the critical path method (CPM), and the program evaluation and review technique (PERT).
- ***Quality control***. Finally, the operations manager is directly involved in placing various controls to ensure that goods are being produced according to specific criteria and that quality standards are adhered to. It takes more than just inspecting goods at the end of the assembly line to ensure quality control, however. Quality control requires a company-wide dedication to managing and working in a way that builds excellence into every facet of operations. Key techniques include total quality management (TQM), and six sigma. ISO 9000 and ISO 14000 are the industry standards to ensure the existence of sound quality procedures.
- **Continuous Development**. At the end, finding more efficient methods of producing the products is imperative to remain competitive in the marketplace.
- **Production planning** is one of the most important part of operations management. It allows the business to consider competitive environment and its own strategic goals to find the best production methods. Good production planning has to balance goals that may conflict, such as providing high-quality service while keeping operating costs low, or keeping profits high while maintaining adequate inventories of finished products. Sometimes accomplishing all these goals is difficult. Following are some of the key decision points in the production planning.

1) **Planning Phases**: Production planning involves three phases. Long-term planning has a time frame of three to five years. It focuses on which goods to produce, how many to produce, and where they should be produced. Medium-term planning decisions cover about two years. They concern the layout of factory or service facilities, where and how to obtain the resources needed for production, and labor issues. Short-term planning, within a one-year time frame, converts these broader goals into specific production plans and materials management strategies.
2) **Types of Production Process**: Another discussion point in production planning is what type of production process to be adopted. In general, there are three types of production process: mass-production, mass-customization, and customization.

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In **mass-production**, manufacturing many identical goods at once, is the common theme. Many products are made sequentially. Breads, and soft drinks are the common examples.

Henry Ford's Model-T automobile is a good example of early mass-production. Each car turned out by Ford's factory was identical, right down to its color. If you wanted a car in any color except black, you were out of luck. Canned goods, over-the-counter drugs, and household appliances are other examples of goods that are mass-produced. The emphasis in mass production is on keeping manufacturing costs low by producing uniform products using repetitive and standardized processes. As products became more complicated to produce, mass production also became more complex. Automobile manufacturers, for example, must now incorporate more sophisticated electronics into their car designs. As a result, the number of assembly stations in most automobile manufacturing plants has increased.

In **mass-customization**, goods are produced using mass-production techniques, but only up to a point. At that point, the product is custom-tailored to the needs or desires of individual customers. Dell computers is a common example. Another example is American Leather, a Dallas-based furniture manufacturer, which uses mass-customization to produce couches and chairs to customer specifications within 30 days. The basic frames in the furniture are the same, but automated cutting machinery precuts the color and type of leather ordered by each customer. Using mass-production techniques, they are then added to each frame.

In **customization**, the firm produces goods one at a time according to the specific needs or wants of individual customers. Unlike mass customization, each product or service produced is unique. Building individual houses is a common example. Another example is a print shop which may handle a variety of projects, including newsletters, brochures, stationery, and reports. Each print job varies in quantity, type of printing process, binding, color of ink, and type of paper. A manufacturing firm that produces goods in response to customer orders is called a job shop.

In addition, the manufacturing process can be divided into two types: (i) process manufacturing, where the basic inputs are converted into one or more outputs, like wheat is converted into flour, and (ii) assembly manufacturing, where the basic inputs, are either combined to create the output or transformed into the output. An airplane, for example, is created by assembling thousands of parts.

3) **Timing**: The production timing can be grouped into: (i) continuous process, or (ii) intermittent process. A continuous process uses long production runs that may last days, weeks, or months without equipment shutdowns. This is best for high-volume, low-variety products with standardized parts, such as nails, glass, and paper. In an intermittent process, short production runs are used to make batches of different products. Machines are shut down to change them to make different products at different times. This process is best for low-volume, high-variety products such as those produced by mass customization or customization. Job shops are examples of firms using an intermittent process.

4) **Location**: Another major decision is about where to locate the manufacturing facility. The facility's location affects operating and shipping costs and, ultimately, the price of the product or service and the company's ability to compete. Mistakes made at this stage can be expensive, because moving a production facility once production begins is difficult and costly. Firms must weigh several factors to make the right decision such as:

   - Access to production resources / inputs: This includes materials, parts and equipment, and human resources.
   - Marketing: This includes proximity to customers and competitirs.
   - Manufacturing base / zone: This include industrial zones where many other manufacturing units are already based. *t* provides an easy access to human resources and other required inputs. Some special zones also provide tax breaks.

5) **Layout**: The goal is to determine the most efficient and effective design for the production process. A manufacturer might opt for a U-shaped production line, for example, rather than a long, straight one, to allow products and workers to move more quickly from one area to another. Main types of facility layouts are process, product (or assembly-line), fixed position, and cellular manufacturing. Workers are positioned according to the selected layout.

6) The process layout is a facility arrangement in which work flows according to the production process. All workers performing similar tasks are grouped together, and products pass from one workstation to another. The process layout is best for firms that produce small numbers of a wide variety of products, typically using general-purpose machines that can be changed rapidly to new operations for different product designs. For example, a manufacturer of custom machinery would use a process layout.

   The product (or assembly-line) layout is a facility arrangement for products that require a continuous or repetitive production process. When large quantities of a product must be processed on an ongoing basis, the workstations or departments are arranged in a line with products moving along the line. Automobile and appliance manufacturers, as well as food-processing plants, usually use a product layout.

   The fixed-position layout is a facility arrangement in which the product stays in one place and workers and machinery move to it as needed. Some products cannot be put on an assembly line or moved about in a plant. A fixed-position layout lets the product stay in one place while workers and machinery move to it as needed. Products that are impossible to move—ships, airplanes, and construction projects—are typically produced using a fixed-position layout.

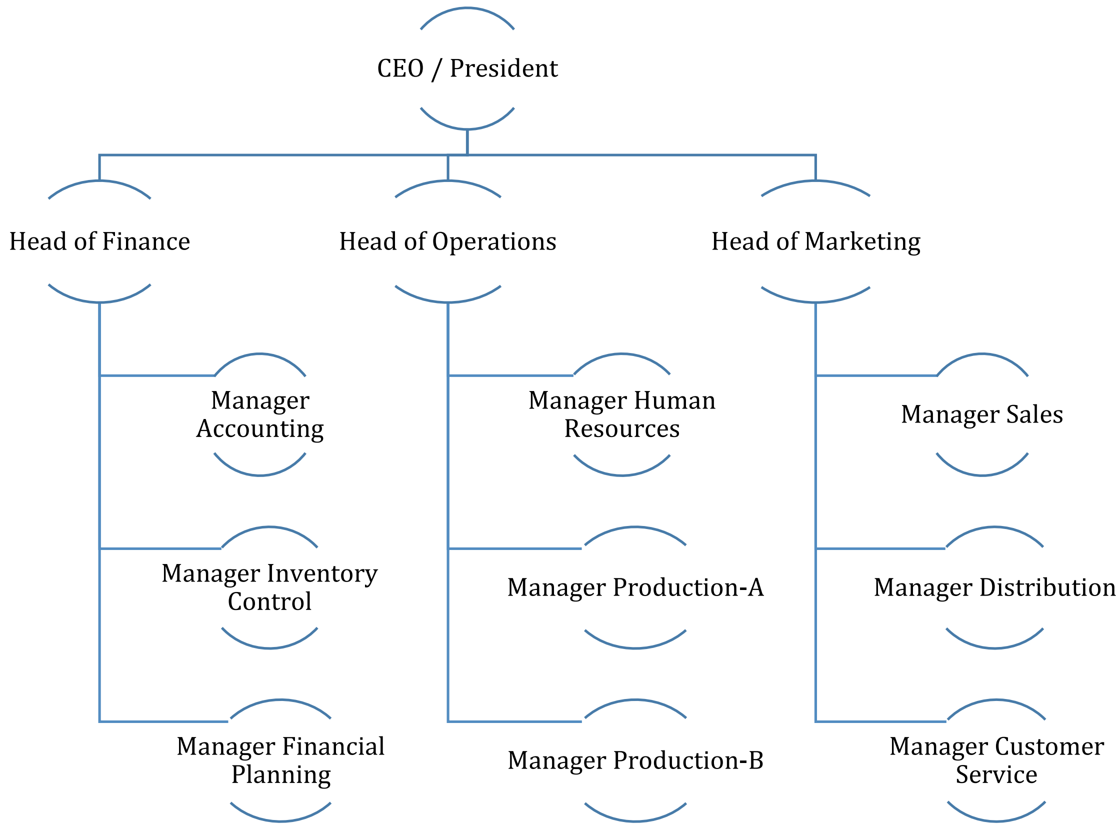
7) **Resource Planning and Supply Chain Management**: Resource planning begins by specifying which raw materials, parts, and components will be required, and when, to produce finished goods. To determine the amount of each item needed, the expected quantity of finished goods must be forecast. Resource planning include key decisions like make-or-buy, outsourcing, and inventory management. In addition, supply-chain management focuses on smoothing transitions along the supply chain, with the ultimate goal of satisfying customers with quality products and services. A critical element of effective supply-chain management is to develop tight bonds with suppliers. This may mean reducing the number of suppliers used and asking them to offer more services or better prices in return for an ongoing relationship.

8) **Information Systems**: Resource planning leads to another important decision which is selecting the type of information systems to control the flow of resources and inventory. Some of the key systems in use are: Material requirement planning (MRP), Manufacturing resource planning II (MRPII), Enterprise resource planning (ERP).

1.3 Management of a manufacturing facility

Organization is the key to operating a successful and efficient manufacturing business. Each person in the company must be aware of his role within the organization and must be mindful of the chain of command. Just like in any organization, the structure is visually represented through organization charts. An organization chart shows the chain of command of the company and the proper flow of responsibility within the manufacturing set up which is essential for the company to run in an efficient manner.

Following is a standard organizational chart for a typical manufacturing business:



Types of human resource in a manufacturing set-up

Executive Management

Executive management is the top of the organization. An executive manager may be a person with the title of Chief Executive Officer, Chief Operating Officer, President or other similar title. An executive manager has the ultimate responsibility of choosing a manufacturing strategy, just like choosing the primary direction of all other departments, and is also ultimately responsible for the outcomes of that strategy. A wise executive manager will seek input and feedback from relevant and technical managers when devising a manufacturing strategy.

Manufacturing or Production Manager

The manufacturing or production manager of an organization is the leader of the production workers and supervisors in the production facility. Most production managers report directly to the executive manager, where he is given his directives for managing the production process. A wise production manager will seek input and feedback from his production line supervisors and production employees regarding the effectiveness of the production strategy. The production manager usually reports the successes or failures of the predetermined manufacturing strategy to the executive manager.

Production Line Supervisors

Production line supervisors are the liaison between the production workers and the production manager. Although the production manager is responsible for the entire manufacturing facility, the production line supervisor is responsible for only the production, or assembly, line where he is stationed. A production line supervisor may be responsible for multiple assembly lines within a certain production line. It is essential for the production manager to relay the manufacturing strategy given to him to the production line supervisors that report to him.

Production Workers

The production worker is at the bottom of the manufacturing organizational chart. However, the production worker is one of the most important pieces to the manufacturing strategy set forth by executive management. The production worker, when trained properly and given the proper tools needed to complete his job efficiently, can be the reason for the success or failure of the manufacturing strategy. Production workers report to the production line supervisor.

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2. A TYPICAL STRUCTURE OF A MANUFACTURING COMPANY

2.1 The Organization Structure

The structuring or organizing process is generally accomplished by three primary decisions:

1. Division of labor: determining job duties and responsibilities
2. Departmentalization: grouping jobs together
3. Delegation: assigning authority and responsibilities

An organizational structure describes the relationships of resources within a company. It begins with people but also includes materials, money, and information.

Division of Labour

Division of Labour means that the main process of production is split up into many simple parts and each part is taken by different workers who are specialized in the production of that specific part.

Different workers perform different parts of production on the basis of their specialization. The result is that goods come to the final shape with the co-operation of many workers. For example – in a large-scale readymade garment factory, one person cut the fabric, the second person stiches it with machines, the third buttons, the fourth perform folding and packing, etc.

Adam Smith (1723–1790), an economist, was the first person to introduce the concept of division of labour in his famous book The Wealth of Nations in 1776. He illustrated the way goods or services are produced when divided into a number of tasks that are performed by different workers, instead of all the tasks being done by the same person.

The concept of division of labour has contributed immensely to operations of a manufacturing company which continues to this day. Key advantages of division of labour in a manufacturing concern are:

- Increased efficiency
- Improvement in quality
- Utilisation of specialised skills and talents of workers
- Economies of scale
- Faster training of workers

Although used widely in manufacturing organisations, diviosn of labour may have some disadvantages as well:

- Boredom
- Lack of creativity
- Redundancy due to new technology
- Lack of responsibility and interdependence

Departmentalization

Manufacturing companies typically use **traditional structures** for organizing their resources. These almost always involve departmentalization so that similar tasks can be grouped together. Traditional structures are quite rigid, grouping employees by one or more of the following criteria:

- Function
- Products
- Processes
- Customers
- Regions

Two other types of business structures are **contemporary** and **team structures**. These are more flexible than traditional structures, allowing management to move employees as needed to respond to dynamic working environments. Project-based companies, like software companies and service companies, for example, would often benefit from these more-flexible types of structures.

A typical manufacturing company department structure would, for the sake of example, consist of a few core departments and some support functions. A vice president would oversee each of these divisions and report to the company president, who is responsible for all three divisions and is normally at the top of a manufacturing company organizational chart.

Functional Departmentalization

Functional departmentalization bases the departments on the **primary functions** conducted by the company. Functions could include manufacturing, engineering, legal, finance, human resources, sales and marketing.

For example, Ethan Allen Interiors, a furniture manufacturer, uses the functional model. It has five different departments for retail operations, manufacturing and sourcing, logistics, operations and product design.

Product Departmentalization

Product departmentalization divides company resources based on **the products being manufactured.** This is typically only done within the operations division. For example, an appliance manufacturer could have a production manager for small appliances and another for large appliances.

Process Departmentalization

Process departmentalization divides departments based on **the work being done**. For example, in a furniture manufacturing company, lumber cutting and treatment, furniture assembly and finishing could each be divided into separate departments with managers for each department or a supervisor for each department reporting to the operations manager.

Customer Departmentalization

Customer departmentalization usually involves different units based on the type of customers being served. For example, one manufacturing unit would be catering to products being sold to industrial consumers and another manufacturing unit would be churning out products for household consumers.

Another example is for a lubricants manufacturing company where a specific manufacturing facility would be making lubricants for large scale machinery and another would be making specialized products for cars and other automotive.

Marketing could be further divided into different marketing efforts, such as online marketing and retailer relations. Sales departments are often divided into units based on internal and external sales forces or different types of clients or customers.

Geographic Departmentalization

When a manufacturer has more than one location, it's often advantageous to divide the company by **region.** How this is done depends on the size of the company and the work being done in each location. At one end of the spectrum, a large manufacturer with independent operations in different countries, like an auto manufacturer, could have separate companies in each country. A smaller company may have a plant manager at each location, each reporting to the VP of operations.

Ford Motor Company, for example, has three global divisions: Americas, Asia-Pacific, Europe, Middle East and Africa. An executive VP is in charge of each of these divisions. These are in addition to the company's functional groups, which operate at a global level.

Delegation

If all organisational activities, strategic and routine, could be managed by the top executives, the need for a formal organisational structure with functional departments, staffed with people of different calibre, carrying out different activities would not have arisen. Since it is not possible, because of physical and mental limitations, for one person to perform all activities with respect to all functional areas, it becomes necessary that he gives part of his workload to subordinates along with commensurate authority to carry out the assigned task. This concept is called **delegation.**

Delegation is a process the manager uses in distributing work to the subordinates.

2.2 Combining Business Structures

For exceptionally large manufacturers, it doesn't make much sense to limit the company's organization structure to just one model. For example, Procter & Gamble's "four pillars" refer to four departmentalization models, which it uses at the same time.

1. First Pillar: Global business units organize the company by its product lines, such as baby products, beauty products, fabric and home care, etc.
2. Second Pillar: Selling and marketing operations groups are arranged with the geographical model for North America, Latin America, North America, Latin America, Asia-Pacific, Europe, China, India, the Middle East and Africa.
3. Third Pillar: Global business services division also uses a geographic model to support its other business units in areas like accounting, information technology, payroll and facilities management.
4. Fourth Pillar: Corporate functions, using the functional model, provides the company with resources such as human resources, legal, marketing, research and development and business development.
5. Fifth Pillar: Global business services division also uses a geographic model to support its other business units in areas like accounting, information technology, payroll and facilities management.

2.3 Choosing an Organizational Structure

A small manufacturing unit with a limited workforce may be able to work efficiently as a functional structure. However, when the company grows, when more products are added to production facilities and when a second or third plant is needed, the questions surrounding organizational structure become much more complex.

It is important to align the choices in organizational structure with the company's strategies. This involves asking critical questions such as:

- Should manufacturing responsibility be centralized, or should decisions be made locally to account for regional differences?
- How can you best ensure technology standards are implemented across all business units?
- Should units like engineering, asset management and maintenance be integrated into manufacturing or separated from it?
- How much responsibility will plant managers have?
- How will responsibility be organized below the plant manager?

Overall, a manufacturing business functions best when its facilities, technologies, and policies are integrated with recognized priorities of corporate strategy. That's how a manufacturing business gain efficiency by improving its operations and productivity.

The manufacturing organizational structure also needs to be consistent with the corporate priorities. However, simplicity of design is the main element, which in turn requires to have a balance between two extreme structures such as either a product- or a process-focused form of organization. The proper selection of an optimal organization structure can smooth a company's growth by lending stability and efficiency to its operations.

Comparison between product-based and process-based manufacturing organizational structures:

Key Responsibilities	Product-based Organization	Process-based Organization
Responsibility of cost or profit assigned	Product groups level	Centralized at corporate level
Centralized corporate staff - relatively	Small	Large
Corporate function responsibilities	• Review request for funds • Communicate corporate policies • Assist in functional needs of: ○ HR management and development ○ Procurement • Performance evaluation of plant controllers as a profit center	• Assistance to marketing • HR policies • Recruitment of plant controllers • Procurement and logistic • Inventory management • Assistance in production scheduling • Plant performance evaluation as a cost center
Manufacturing & operational responsibilities	• Assistance to marketing • Procurement and logistics • Production scheduling and control • Management level recruitment for plant	• Operational efficiency • Operational level recruitment for plant • Training and development for operational staff

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3. KEY DEPARTMENTS OF A MANUFACTURING COMPANY

A typical manufacturing company like any other business organisation may consist of the following main departments or functions:

- Production
- Research and Development (R&D)
- Purchasing
- Marketing and Sales
- Human Resource Management
- Accounting and Finance.

Production

The Production function undertakes the activities necessary to provide the organisation's products or services. Its main responsibilities are:

- production planning and scheduling
- control and supervision of the production workforce
- managing product quality (including process control and monitoring)
- maintenance of plant and equipment
- control of inventory
- deciding the best production methods and factory layout.

Close collaboration will usually be necessary between Production and various other functions within the organisation, for example:

- Research and Development, concerning the implications of product design for production methods and cost
- Marketing, concerning desired product functionality, appearance, quality, durability and so on
- Finance, concerning the availability of funds for purchase of new equipment and maintaining the optimal inventory levels.
- Human Resource Management, concerning staff motivation implications of job design and production methods.

The Research and Development function

The Research and Development (R&D) function is concerned with developing new products or processes and improving existing products/processes. R&D activities must be closely coordinated with the organisation's marketing activities to ensure that the organisation is providing exactly what its customers want in the most efficient, effective and economical way.

Purchasing

The Purchasing department is responsible for purchase and sourcing of all raw material and other resources used in the production. The primary responsibility of the Purchase department is to find and acquire the most suitable material at the most optimum price in alignment with the overall objectives of the company and the production department.

Marketing & Sales

Once any product or service is ready to consumed by the end users, it is important to communicate to the target audience about them and the company. In its formal usage, marketing serves as the umbrella function that manages advertising, promotions, public relations and sales. Marketing functions include research and development, pricing, distribution, customer service, sales and communications.

In its narrowest form, a sales department advises the marketing department based on its feedback with customers and focuses on customer contact to drive sales. The marketing department tells the sales staff what to emphasize and what sales tools to be used.

Human Resource Management

HR is a key pillar to the success of manufacturing industries, because to ensure your business can overcome the challenges threatening the industry, you need to make sure you have a skilled workforce.

Human resource management in the manufacturing industries is often concerned with payroll, administrative work and mediating between the management and the workers. Mostly, the manufacturing companies lean on the HRD function in times of labor unrest and strikes.

Accounting and Finance

The Accounting and Finance function of a manufacturing company is concerned with the following:

- Financial record keeping of transactions involving monetary inflows or outflows.
- Preparing financial statements (the income statement, balance sheet and cash flow statement) for reporting to stakeholders such as shareholders. The financial statements are also the starting point for calculating any tax due on business profits.
- Payroll administration for paying wages and salaries and maintaining appropriate income tax and insurance records.
- Preparing management accounting information and analysis to help managers to plan, control and make production decisions.

AT A GLANCE

SPOTLIGHT

4. MANUFACTURING AND OPERATIONS MANAGEMENT

A manufacturing company is involved in design, development and production of goods from raw materials for sale to distributors or retailers.

Manufacturing operations management refers to the ongoing process of monitoring and improving production processes.

Typically, manufacturing management centers on optimizing efficiency to produce the best quality products at the lowest possible prices.

Manufacturing operations management involves the tools and methods to optimise production. This includes managing business resources such as people, technology, equipment, and other resources that improve the efficiency and productivity of the manufacturer.

Manufacturing operations management ensures that the physical equipment and the user interface of a business work harmoniously for the benefit of the company. A manufacturing system provides a platform where human and automated activities are blended in real-time.

Benefits of a Manufacturing Operations Management include:

Giving your company a competitive advantage

Managing your business operations gives you the ability to deal with important internal and external factors. Some of the key internal factors include intellectual capital, operating policies, and average attrition rates. The external factors to improve competitiveness are political (e.g., new legislation), economic (e.g., inflation), social (e.g., change in fashion or taste). A business can does not control external factors, but rather try to exploit them in its own favour.

Increasing your profitability

When the operations are running smoothly, managers will have more time to generate new ideas and apply them to increase company sales. When you have an experienced manager, the monitoring of your revenue and expenses becomes easier. In the long run, your overall income increases. When your business profitability is well managed, it becomes easier to compete and grow.

Increased efficiency and product quality

Operations management gives you the opportunity to increase the efficiency of the way you manufacture goods. You are also able to improve the way your raw materials are stored. The advantage of this is that you can minimise damage and, hence, minimise losses.

Manufacturing operations management includes making use of useful tools such as warehouse management software, production software, defect-trackers, and process re-engineering programs. All these tools assist in increasing the efficiency of your facility.

Ensures you comply with government regulations

By managing your business operations, each head of the department in your company takes the responsibility to ensure that all tasks performed under him are done in a lawful manner. This protects your company from potential government fines and severe regulatory decisions.

Increased customer satisfaction

Meet customer expectations by deploying a quality management program to help maintain high standards while ensuring efficiency. When customer expectations are met, satisfaction level can increase, which can also lead to better retention and increased referrals.

Helps in waste reduction

Another benefit of employing manufacturing operations management is the application of manufacturing systems that aid in reducing waste production. Often these systems will have an inventory management function to help control inventory and consequently reduces the potential of production issues due to the lack of stock. Investing in these types of management system helps reduce inventory space and improve accuracy.

Increased teamwork

Manufacturing operations management requires different departments to work together to produce quality products. This helps improve business productivity and meet the expectations of your customers.

Ensure that you employ innovative technology to help your company achieve its set goals and objectives. You also need to ensure that your system is working by carrying out regular statistical control methods.

SELF-TEST

1. The process to convert resources into finished goods is the responsibility of which of the following groups?
   - (a) Finance
   - (b) Sales
   - (c) Operations
   - (d) Marketing

2. Which of the following statements are correct?
   - (a) Marketing help decide which product to make.
   - (b) Accounting and human resources help to face the challenge of combining people and resources to produce high-quality goods on time and at reasonable cost.
   - (c) All of the above
   - (d) None of the above

3. Which of the following is not an objective of operations management?
   - (a) focus on quality
   - (b) minimize the costs of materials and labor
   - (c) maximize the sale
   - (d) eliminate all costs that add no value to the finished product

4. Which of the following is not a responsibility of operations manager?
   - (a) Production planning
   - (b) Production control
   - (c) Production audit
   - (d) Quality control

5. Which of the following is a correct statement?
   - (a) Mass-customization means manufacturing many identical goods at once.
   - (b) Mass-production means goods are produced using mass-production techniques, but only up to a point.
   - (c) All of the above
   - (d) None of the above

6. Which of the following describes the type of production process that “the firm produces goods one at a time according to the specific needs or wants of individual customers”?
   - (a) Mass-production
   - (b) Mass-customization
   - (c) Mass-communication
   - (d) Customization

7. Which of the following is a correct statement?

   (a) In process manufacturing, the basic inputs are converted into one or more outputs.

   (b) Airplane manufacturing is an example of process manufacturing.

   (c) All of the above

   (d) None of the above

8. Which of the following is a correct statement?

   (a) Continuous process is best for high-volume, low-variety products with standardized parts, such as nails, glass, and paper.

   (b) Intermittent process is best for low-volume, high-variety products such as those produced by mass customization or customization.

   (c) All of the above

   (d) None of the above

9. Which of the following is not a factor for selecting a right location for a manufacturing facility?

   (a) Proximity to resources

   (b) Proximity to government

   (c) Proximity to market

   (d) Manufacturing zone

10. Which of the following is not a type of production facility design arrangement?

   (a) W-shaped

   (b) Cellular

   (c) Fixed

   (d) U-shaped

11. Which of the following is not a key system for resource planning?

   (a) MRP

   (b) MRPII

   (c) SQL

   (d) ERP

12. Which of the following is a correct statement for types of human resource in a manufacturing set-up?

   (a) Executive management and production manager

   (b) Line supervisor and cost accountant

   (c) All of the above

   (d) None of the above

13. Which of the following is not part of the three primary decisions factors for structuring or organizing process?
    (a) Division of labour
    (b) Departmentalization
    (c) Diversification
    (d) Delegation

14. Which of the following is not a criterion to group employees by a manufacturing company under the traditional structuring?
    (a) Product
    (b) Process
    (c) Geography
    (d) Education

15. Which of the following is not a benefit of a manufacturing operations management?
    (a) Profitability improvement
    (b) Efficiency enhancement
    (c) Teamwork manipulation
    (d) Waste reduction

ANSWERS TO SELF-TEST

1	C
2	D
3	C
4	C
5	D
6	D
7	A
8	C
9	B
10	A
11	C
12	C
13	C
14	D
15	C

CHAPTER 10

INDUSTRIES OF PAKISTAN

IN THIS CHAPTER:

AT A GLANCE

SPOTLIGHT

1. Power industry
2. Textile industry
3. Pharmaceutical industry
4. Oil & Gas Exploration

AT A GLANCE

The industrial sector of the country contributes to approximately 13 percent of Pakistan's (2020-21) annual GDP. In 2020-21 it recorded a growth of 8% as compared to the growth of 5% last year. Manufacturing is the most vibrant subsector having over 60-70% contribution to the industrial sector. Major sectors in industries include cement, fertilizer, edible oil, sugar, steel, tobacco, chemicals, machinery, food processing, and medical instruments, primarily surgical. Pakistan is the largest producer and exporter of surgical instruments in the world. In Pakistan, SMEs have a significant contribution to the total GDP, which accounts for 90 percent of all the enterprises in Pakistan and employ almost 80 percent of the total non-agriculture labor.

This chapter provides an introduction to some of the major industries of Pakistan and their operations.

1. POWER INDUSTRY

Electric power supply has a direct positive correlation with economic development and growth of a country. Consequently, power shortage has an adverse impact on the country's GDP through lost productivity.

Historically, Pakistan's power sector consisted of two government owned utilities, WAPDA and K-Electric (previously, KESC). While K-Electric was responsible for power distribution in Karachi and adjacent areas; WAPDA, a semi-autonomous statutory body, was mandated to regulate and distribute power in the remaining country. In addition, water and hydropower resources came under the umbrella of WAPDA.

Due to the economic burden, inefficiencies in sector and customer dissatisfaction, this arrangement was reconsidered and following major steps were taken over the time:

- KESC was privatized in 2005 as K-Electric (KE)
- WAPDA was unbundled into various Generation Companies (GENCOs), National Transmission & Dispatch Company (NTDC) and Distribution Companies (DISCOs), while the functions of its power wing were redefined as Hydel Power Generation and Operation & Maintenance (O&M) of power houses. Following unbundling of its power wing, WAPDA's mandate is now development of water and hydropower resources and to operate as hydro electric utility.

Key Glossary:

A **value chain** is a set of activities that an organization operating in a specific industry performs in order to deliver a valuable product for the market.

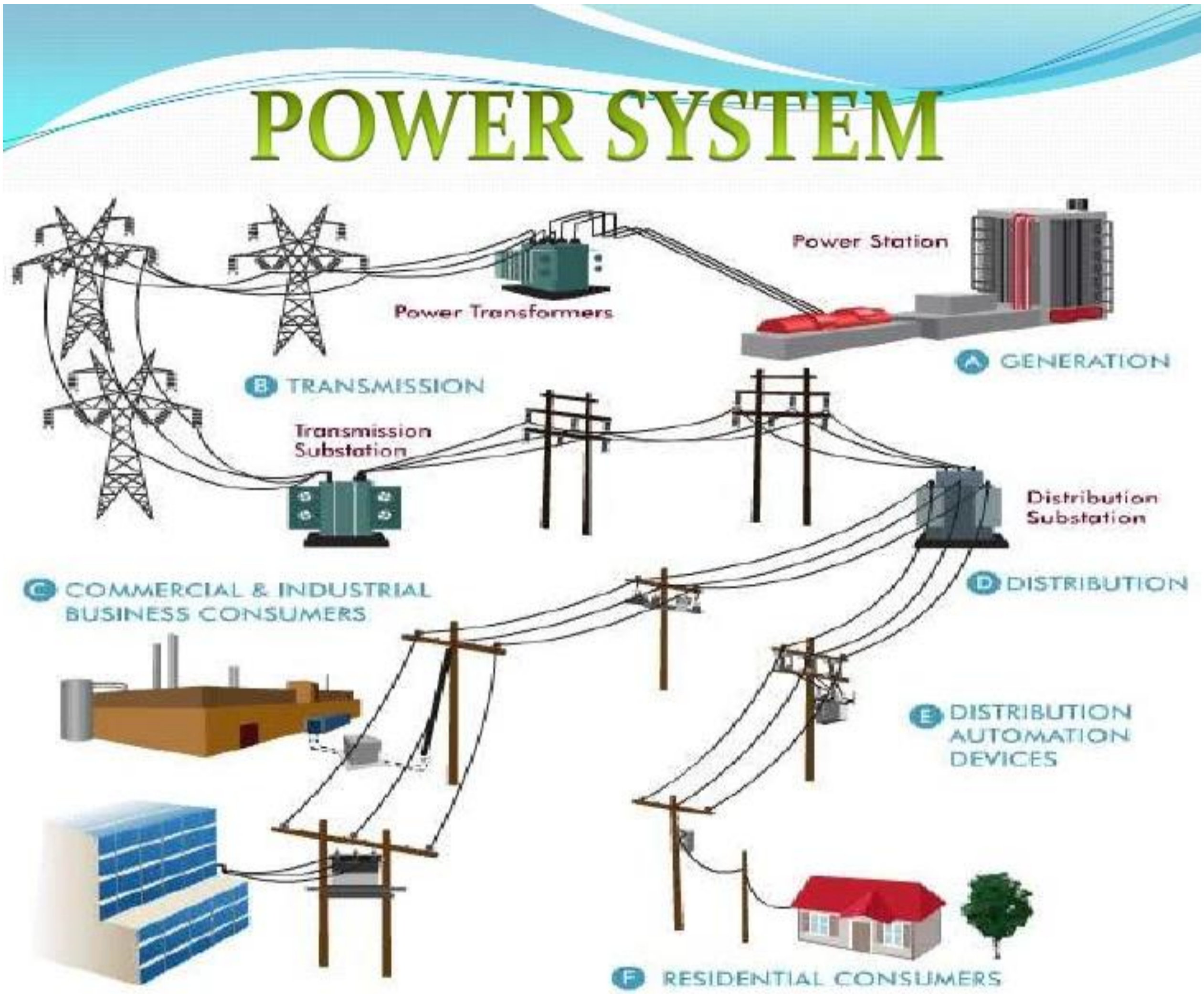
Upstream refers to the material inputs needed for production, while **downstream** is the opposite end, where products get produced and distributed.

Vertical integration refers to an arrangement in which the supply chain of a company is integrated and owned by that company.

Supply chain refers to the entire process of making and selling commercial goods, including every stage from the **supply** of materials and the manufacture of the goods through to their distribution and sale.

Capital intensive refers to the degree that a company must invest money in physical or financial assets in order to produce a profit.

The value chain of the power sector is depicted in the following diagram:



Generation – at a power plant

The upstream part of the value chain is called Generation or Generators. Different technologies and fuel sources are used for this purpose. Thermal technologies use different sources of fuel, such as natural gas, coal, furnace oil etc. On the other hand, renewable technologies include hydro, solar, wind etc.

Transmission – from turbine to grid station

When the turbines generate electricity, its voltage is significantly increased by passing it through step-up transformers. Once the high-voltage electricity reaches the grid, electricity is reduced in voltage, again through the use of transformers, to make it safe for use by households and end users.

Distribution – from grid station to end users

When electricity leaves the Grid Station's transformer, it enters distribution power lines on its way to the final destination. Once it reaches the neighbourhood, electricity passes through another transformer (usually pole-mounted, called PMT) for further voltage reduction. This ensures that it is safe to use in homes and offices

Transmission & Distribution Losses

In an ideal scenario, electricity that has left the power plant and the energy billed should be equal. However, that is not the case. The shortfall of electricity between energy generated and energy billed is called transmission and distribution losses.

Karachi and its adjacent areas are served by K-Electric; a privately owned utility company. Currently, this is the only vertically integrated company in the power sector involved in generation, transmission and distribution segments. Rest of Pakistan's power sector is the sum of generation, transmission and distribution companies, working in each segment. Transmission and distribution sector is almost wholly operated by government owned companies; with private sector Independent Power Producers (IPP's) also having a share in power generation and a small portion of transmission.

1.1 Salient Features of a Power Generation Company

Capital intensive

The industry is highly capital intensive particularly in the area of electricity generation

Tariff (pricing)

Pricing in the power industry is determined by the regulator and government authorities.

Subsidy in tariff

Subsidies are provided by government in different segments to encourage or promote a certain segment of the economy or particular industry and consumers.

Fixed return ensured to investors

A tariff on the basis of fixed rate of return on investment over plant life/contract period is determined by the regulator; and is contracted. All cost variations are also admissible.

Government guarantee

GOP issues guarantee to IPPs, backing up the payment obligation of the power purchaser

Predominated by government

With contribution of private sector mainly in generation segment, the sector has high dominance by government.

Highly regulated

Power Sector is a highly regulated sector. Regulatory authority for this purpose is NEPRA, which is an autonomous body mandated by the law to regulate the power sector to ensure that the interests of investors and customers are protected, and a competitive environment is maintained.

1.2 Composition of a Typical Power Company

Core Business Functions

The core business functions remain the technical side of the business and includes plant and network operations and maintenance side. An integrated company would have these functions distributed into generation, transmission and distribution, while others will be confined to their relevant area.

The following are some of the support departments in a power company:

- Finance
- Procurement and logistics
- Regulatory
- Health, safety and environment (HSE)
- Information Technology
- Billing function
- Marketing and communication

Finance

As with all other industries, finance department oversees the entire financial management of the organization.

Typical finance functions include:

- General Accounting & Financial Reporting
- Taxation & Insurances
- Business Partnering
- Accounts Payable
- Accounts Receivables
- Budget Monitoring & Control
- Treasury Management
- Management Reporting

Procurement and logistics

Procurement and logistics strive to ensure that required items are timely available to business unit at competitive price. Its inventory management segment ensures that stores and spares are kept in pristine condition and are ready for use when the need arises.

A large portion of the procurement (especially generation related) involves imports of fuel, and plant and equipment, which require a robust import and clearance function.

An important role of this function is to schedule maintenance of plant and machinery during low demand season i.e. winters; hence plan the overall logistics cycle accordingly.

Procurement and logistics also ensures that inventories are kept within range so the working capital is not tied up while spares are available when needed.

Regulatory

Regulatory / legal function ensures that the organization is in compliance with laws and regulations and their application.

It is very important for the regulatory function to keep close coordination with the regulatory authority and get timely clearance of subsidies and dues from the government. It also ensures that the processes are updated and aligned with all government rules and regulations.

Health, safety and environment (HSE)

Operating in a sector where the primary product poses a hazard to life, HSE is of utmost importance. Companies are required to abide by safety requirements of various documents including Power Safety Code, Distribution Code, Power Safety Manual and other applicable documents.

Some of the key responsibilities of HSE are:

- Compliance with legal and regulatory requirements related to HSE
- To ensure HSE requirements are embedded in routine and non-routine activities
- Prevention of injuries and ill-health through proactive system of risk management
- Conservation of natural resources and reduction of carbon footprint by assessment to environmental impact and mitigation of adverse effects
- Employee trainings and supervision
- Continuous improvement through a system of performance planning, measurement and regular reviews

Human Resources

Driven by the need to succeed in today's volatile business environment, organizations require right and ready talent to successfully execute business strategy.

Some of the key responsibilities of this function are:

- Source and retain manpower with required skillset to work on plant and network
- Maintaining industrial relations for labour
- Learning and development of talent
- Mapping the needs of employees in various segments and expectations of the company

Information Technology

The value of real time information is ever more with fast paced business realities of today. Information technology function facilitates via use of software and hardware to provide its users with the tools to extract, utilize, analyze & present data in meaningful way.

Some of the key responsibilities of this function are:

- Infrastructure development and maintenance over large geographical area
- Integrity and security of customers / suppliers information
- Provide need based hardware & software solutions along with integration of information such as plant management, finance and customer account management

Billing Function

Billing function ensures timely issuance of accurate bills to customers and their subsequent recovery. Some of the key responsibilities of this function are:

- Management of a large volume of various consumer segments of a distribution company
- Customer account maintenance
- Loss minimization and timely recoveries
- Addressing customer complaints

Marketing and Communication

Due to monopolistic nature of business with long term secured contracts and exclusive area licenses available, marketing function in power sector is limited to:

- Media and PR management; as power related issues directly affect the lives of people
- Uplift and secure the corporate image
- Communication for corporate affairs

Key Challenges

Some of the key challenges faced by a power company are as follows:

- Availability of machines and network and their efficient operation
- Reliable and safe operations
- Uninterrupted power supply to consumers
- Prompt response to customer complaints
- Timely collection of bills
- Reducing power theft and line losses
- Circular debt issue

2. TEXTILE INDUSTRY

Textile Industry is one of the largest industries in Pakistan. It plays a vital role in contributing to the country's economy through its industrial production, high employment opportunities and bringing in Foreign exchange. The industry is going through tremendous changes with respect to globalization and many economic challenges. The proportion of textile industry in the country's economy along with its contribution to exports, in terms of GDP employment, foreign exchange earnings, investment and value addition and revenue generation altogether placed the industry as the single largest manufacturing sector of the country. The main factor to contribute to such huge developments in the textile industry is the production of cotton in the country,

Textile sector is a major contributor to Pakistan's total exports, representing approximately 57% of country's total exports in FY 2020-21. The textile sector contributes nearly one-fourth of industrial value added products and provides employment to 40% industrial labor force. This value added sub sector of textile industry is a made up sector which in addition to meeting local needs, exports products under different categories including garments, hosiery, bed wear, towels and tents/canvas.

In addition, various other subsectors within textile industry in Pakistan includes Spinning, Weaving, Processing and Stitching (explained later).

All Pakistan Textile Mills Association (APTMA) being the major representative association of textile sector in Pakistan, has 396-member textile mills out of which 315 are spinning units, 44are weaving units and 37 are composite units.

The major cities representing textile industries include Karachi, Faisalabad and Lahore. Top ten textile companies with the highest market capitalization (Market capitalization refers to the total rupee market value of a company's outstanding shares of stock. Commonly referred to as "market cap," it is calculated by multiplying the total number of a company's outstanding shares by the current market price of one share) as on April 30, 2019 are as under:

COMPANY	TYPE
Nishat Mills Limited	Textile Composite
Feroze1888 Mills Limited	Textile Composite
Interloop Limited	Textile Composite
Sapphire Textile Mills Limited	Textile Composite
Gul Ahmed Textile Mills Limited	Textile Composite
Ibrahim Fibres Limited	Synthetic and Rayon
Sapphire Fibres Limited	Textile Composite
Dawood Lawrencepur Limited	Textile Composite
Gatron (Industries) Limited	Synthetic and Rayon
Kohinoor Textile Mills Limited	Textile Composite

Source: Pakistan Stock Exchange Limited

To facilitate export oriented sectors, State Bank of Pakistan (SBP) introduced certain financing schemes at low markup rates. Such schemes include Export Refinancing Scheme (ERF) and Long Term Finance Facility (LTFF) for meeting exporter's short term and long term financing needs respectively. Textile sector, being the leading export sector of Pakistan, is the beneficiary of such schemes as well as tax exemptions in certain instances.

In recent years, growth in textile industry has been dull and stagnant due to multiple factors:

- Textile products are available at lower prices in other countries because of subsidies and other benefits and therefore Pakistan's products have become less competitive.
- In Pakistan, tariffs on imported textile materials are applied to provide protection to domestic industry which has resulted in inefficiencies in the local manufacturing process.

- Stagnant domestic cotton production, due to climate changes, farmers' interest in more profitable crops, or lack of using new technology and modern methods of harvesting.
- Limited number of value added products.
- Low usage of manmade fibers.
- Failure to benefit from cost efficiencies through cluster development & growth.
- Absence of modern management practices.
- Lack of skilled labor

2.1 The Value Chain of Textile Business

Raw Material Sourcing (Cotton, Polyester & Viscose)

Primary raw materials used in the textile industry are cotton, polyester and viscose. Cotton is a natural fiber grown as industrial product in Pakistan within which Punjab and Sindh are the major cotton growing provinces. The other two raw materials are manmade fibers which are both locally produced and imported.

Local cotton from the fields reaches textile spinners through cotton ginners. Cotton ginning is a process in which cotton fibers are separated from the seeds and wastes such as leaves. The raw material for cotton ginners is seed cotton (phutti) and its finished product is cotton bale. Cotton ginners, represented by Pakistan Cotton Ginners Association (PCGA), are located in cotton growing areas of Punjab and Sindh. Most of the cotton ginners are not registered as corporate entities and operate sale channels with the help of cotton brokers.

Demand and supply dynamics of cotton ginners is affected by various factors including weather conditions, import duties on imported cotton, exchange rates and general economic conditions of the country.

Textile spinners and textile composites seek services of brokers to source cotton from cotton ginners. The agro economics largely derives the local crop pricing, however, for high quality cotton, textile industry is dependent on import channels.

Cotton is being imported from around the world majorly from USA and India while other import regions include Middle East, Europe and Asia as well. Locally, Punjab and Sindh are considered as major cotton growing districts. Ibrahim Fibers and ICI Polyester are major polyester manufacturers in Pakistan.

The polyester is also being imported, majorly from China and Korea and some other Asian countries. Viscose is also being sourced through import channels. Major import countries for viscose include China, Indonesia and Korea.

Spinning

Spinning is a process in which raw materials including cotton and polyester are converted into yarn in a climate controlled facility. For planning purposes on subunit levels, a 'spin plan' is prepared for planning the yarn types to be produced as well as for backward planning of input requirement for each subsection of spinning process. Input is determined backward from auto cone to mixing process keeping in view the waste percentage in each process. The capacity of spinning unit is denominated in 'number of spindles' in ring section, a front end sub unit in spinning process.

Weaving

In weaving, yarn thread from the spinning department is weaved to form greige (unfinished woven or knitted) fabric. Weaving is a process in which longitudinal threads i.e. threads along the length of fabric (warp) and lateral threads i.e. threads along the width of fabric (weft) are interlaced to manufacture fabric. The quality and type of fabric is determined by several factors i.e. yarn quality, number of warp per inch (ends), number of wefts per inch (picks), fabric width and weaving pattern. There are different patterns of weaving such as plain weave, satin weave and twill. Loom plan or weave plan is prepared for production planning which generally, includes allocation of looms to production of desired type of weaved fabric, loom speed, target production and tentative completion date. The capacity of weaving unit is determined by number and type of looms and is denominated in square meter equivalent to 50 picks.

Warping: It is a process of making a sheet of yarn threads in the form of warping beam. The yarn cones are installed on creels in warping section which are warp in the form of sheet of longitudinal yarn threads. There are different types of warping such as direct / beam warping, sectional / pattern warping and ball warping.

- Sizing: In this process, the number of ends required for a given fabric quality are taken from multiple warping beams to the weaving beam. Moreover, sizing chemicals are applied on yarn thread to cover the yarn surface to withstand friction in weaving process.
- Drawing: It is a process of preparing weaver's beam for the purpose of weaving fabric on the loom according to design of the fabric.
- Weaving: It is a process of making fabric by interlacement of warp and weft on looms. The warps are installed in looms in the form of weaving beams and yarn cones are installed to take form of weft. The weft from yarn cones are weaved in threads from weaving beam to manufacture fabric of desired quality. There are different types of looms available varying in weaving speed and production efficiencies such as shuttle looms, air jet, shuttle less looms and power looms. Moreover, the maximum width of fabric also varies with looms. Additionally, a jacquard head is used to make special weave fabrics.
- Folding: Weaved cloth from loom shed is brought into folding section for inspection, mending, grading and packing of fabric. Inspection of fabric is generally done on basis of 4 Point system (American system). Maximum 4 penalty points can be given to one fault. If points per 100 sq. yards are less than 20, fabric will be graded as 'A-Grade Fabric', however, the criteria is generally agreed with customers for quality of fabric. After inspection, packing is done in form of bales, rolls or thaans as per the requirement.

Processing

In processing, greige fabric is converted into processed fabric i.e. fabric is bleached, dyed and/or printed. As per the desired quality of processed fabric, fabric route is determined for applying different processing operations which are summarized below:

- Singeing: Singeing is designed to burn off the surface fibers the fabric to invoke smoothness in it. The fabric passes over brushes to raise the fibers, then passes over a plate heated by gas flames.
- De-sizing: De-sizing is the process of removal of sizing material on fabric (greige fabric is sized as part of weaving).
- Scouring: Scouring, is a chemical washing process carried out on fabric to remove natural wax and non-fibrous impurities from the fabric including soiling and dirt. At this stage even the most naturally white fabric is in yellowish tone.
- Bleaching: Bleaching improves whiteness of fabric by removing natural coloration and impurities from the fabric through a washing process. The degree of necessary bleaching is determined by the required whiteness and absorbency of fabric.
- Dyeing: Dyeing is the process of adding color to the bleached fabric as per requirement.
- Printing: Printing is the process of applying color designs and patterns to the fabric. There are different kinds of printing such as digital printing and printing through engraving screens.
- Finishing: In finishing, different processes are applied to improve the look, performance, shrinkage, or 'hand' (feel) of the fabric. Such finishing processes include raising, calendaring and sanforizing.
- Folding: It is consistent with the one in weaving, however, processing faults are also inspected during this process.

AT A GLANCE
SPOTLIGHT

Garment Manufacturing

Garment manufacturing is labor intensive section of textile industry. This section is further divided into three major categories: woven, knitted and home textiles. In manufacturing, fabric is cut and stitched as per requirement and design of desired product. Design and cutting phase of stitching operation varies with complexity of the product involved. Hence, for garment designing and cutting, automated CAD, automated fabric spreading and automated cutting methods are applied; whereas for home textile, manual operations are applied from designing to cutting of fabric. Stitching production lines and stitching operations are designed keeping in view the product being stitched. Therefore, different models are applied in stitching operations such as stitching of complete unit by one person to specific stitching task by specialized workers. Garment manufacturing process is summarized below:

Quality Controls and Quality Audits

Parallel with all production operations from spinning to final product, quality controls are being exercised to ensure prevention of production faults and to rectify defects on spot, rather than waiting for the manufactured product. Hence, in sub operations of main textile operation, different quality control tests are designed and performed to rectify production errors through machine adjustment and reworks. Quality control also incorporates all fabric and garment testing such as tearing, tensile and appearance after wash tests to make sure the product meets the performance requirements.

Moreover, in-house quality audits are performed before sending shipment to final customer. These quality audits are generally performed by independent team. However, department structure may vary from organization to organization. For sample selection and passing criteria, different Acceptable Quality Limits (AQLs) are being applied. For example, AQL 4 means that there should not be more than 4% defective pieces of sample selected. These quality audits are generally applied to ensure that shipped goods are not rejected at customer's quality audit.

- Cutting: First, fabric is spread for bulk cutting and is cut using the manual or automated machines. Cutting methods vary from hand held cutting machines to laser cutting as per the design fed in the automated machines.
- Stitching: After cutting, the cut pieces along with stitching accessories such as threads, buttons, hooks and zips are forwarded to stitching section where workers sew the cutting pieces into required product. Generally, inline inspections are performed in the stitching section to detect and remove stitching faults instantly.
- Laundry: Laundry is a major value addition part of garment manufacturing both in woven and knitted products but especially in denim woven. Here the production is washed for cleaning and de-sizing to give it the required final look and feel. Dyeing garments made out of RFD (Ready for Dyeing) fabrics is also done in this stage.
- Finishing: After laundry, units are forwarded to Trimming and Pressing section where trained staff removes unnecessary threads from products and press the stitched articles. The pressed articles along with packing accessories such as insert cards, stickers, branding hashtags and labels are packed into cartons or polythene bags as per requirement.

Shipment and Logistics

The last part of value chain is arranging shipments for customer. For local customers, both ex-mill and ex-party terms are agreed with customer. In ex-mill terms, arranging transportation is the responsibility of the customer, whereas in ex-party terms, the company is responsible for transportation. For export suggested terms for customer, including Free On Board (FOB) and Carriage Insurance and Freight (CIF) are generally agreed with. These terms are generally called incoterms. Sometimes, due to delays in supply chain process, air shipments have to be made by textile companies to avoid penalties. However, this is the least preferable mode due to involvement of hefty air freight cost.

2.2 Core Operations of a Textile Business

Accounts and Finance

Financial reporting and taxation frameworks, as applicable for other companies in Pakistan, are also applicable to textile companies. Hence, finance executives in textile companies have similar roles and responsibilities in standard operations of accounts, finance and tax. These roles (including but not limited to) are as follows:

- Budgeting and forecasting
- Financing and treasury operations
- Working capital management
- Costing
- Financial statement closing process
- General accounting
- Legal compliances including those relating to taxation, corporate and labor laws

Sales and Marketing

There are different sales and marketing channels in textile industry such as export markets, local markets and retail network. Highly specialized marketing staff, having knowledge and experience of dealing with specified export market and export products, are being employed. Marketing activities include international exhibitions, trade fairs, product samples and personal inquiries.

The top five export markets along with percentage share for each kind of Pakistani value added textile products are as under:

- Ready Made Garments (US$ 2.451 billions):
- USA (23%) Spain (14%) United Kingdom (13%) Germany (13%) Belgium (6.97%)
- Bed ware (US$ 1.768 billions):
- USA (27%) Germany (14%) Netherlands (10%) Belgium (8%) Italy (7%)
- Textile Made-up other than Bed ware & Towels (US$ 0.57 billions):
- USA (77%) Germany (7%) Netherlands (3%) France (3%) Canada (2%)
- Cotton Fabrics (US$ 1.438 billions):
- Bangladesh (33%) Italy (11%) Turkey (11%)%) China (9%) Portugal (6%)

Local markets exist in all textile representative cities such as Karachi, Faisalabad, Lahore and Multan.

Health Safety and Environment (HSE)

Health Safety and Environment (HSE) has great importance in textile industry. To ensure health and safety, employees are trained about operational precautions and self-protection. Awareness sessions are also conducted about HSE internal policies and best practices as per local and international standards. Workers are trained in PPE (Personal Protective Equipment), firefighting and responding in emergency conditions. Moreover, textile companies take different measures for the sake of environment sustainability, such as waste water/effluent treatment, compliance with RSL (Restrictive Substance List) and sourcing prescribed chemicals only. Textile companies are to ensure that hazardous wastes and chemical effluents are treated to remove hazardous materials before discharging these wastes in environment. Moreover, sourcing of chemicals in processing is controlled so that minimum wastes and effluents are discharged.

Especially in export oriented companies, customers specify mandatory certifications such as ISO 14001 & Nordic Swan Ecolabel. In this regard, textile industry designs procedures for continuous compliance with frameworks given in such certification.

3. PHARMACEUTICAL INDUSTRY

Pakistan has a very vibrant and forward looking Pharma Industry. At the time of independence in 1947, there was hardly any pharma industry in the country. Growth in sales of national companies has been higher than the multinationals. It is essentially a low-cost generic market with large number of new generic medicine launched at higher unit price.

There are approximately 650 companies operating in the Pakistani Pharmaceutical market, out of which less than 30 are multinational companies. The Pharmaceutical industry contributes approximately 1% to the GDP of Pakistan annually. Today Pakistan has about 759 pharmaceutical manufacturing units including those operated by 25 multinationals present in the country. The Pakistan Pharmaceutical Industry meets around 70% of the country's demand of Finished Medicine.

The National pharma industry has shown a progressive growth over the years, particularly over the last one decade. The industry has invested substantially to upgrade itself in the last few years and today the majority industry is following Good Manufacturing Practices (GMP), in accordance with the domestic as well as international Guidance. Currently the industry has the capacity to manufacture a variety of product ranging from simple pills to sophisticated Biotech, Oncology and Value Added Generic compounds.

Although Pakistan 's pharmaceutical and healthcare sectors are expanding and evolving rapidly, about half the population has no access to modern medicines. Clearly this presents an opportunity, but much more work needs to be done by the government and industry's stakeholders.

The Pharmaceutical market in Pakistan is estimated by IMS (MAT June 2017) at Rs.300 billion, growing at a rate of 12% (5 year CAGR). The industry is dominated by local / national companies which account for 2/3rd of market share whereas multinationals enjoy the remaining 1/3rd. Top ten companies constitute approximately 46% of the market whereas top 50 share approximately 90% of the market.

Top 10 Pharmaceutical Companies in Pakistan

Name	Ranking	National / Multinational
GlaxoSmithKline Pakistan Limited	1	Multinational
Getz Pharma (Private) Limited	2	National
Sami Pharmaceutical (Private) Limited	3	National
Abbott Laboratories Pakistan Limited	4	Multinational
Martin Dow Pharmaceuticals (Pakistan) Limited	5	National
The Searle Company Limited	6	National
Sanofi Aventis Pakistan Limited	7	Multinational
OBS Pakistan (Private) Limited	8	National
GSK Consumer Healthcare Pakistan Ltd	9	Multinational
Hilton Pharma (Private) Limited	10	National

Source: IMS MAT 2017

There are around 9,000 actively marketed drugs in Pakistan sold at licensed pharmacies on prescription. In addition, there is a large segment of Over the Counter (OTC) products e.g., multivitamins; pain, cold and flu relief.

Pharmaceutical sector in Pakistan is strictly regulated by the government. The Drug Regulatory Authority of Pakistan (DRAP) controls the registration of new medicines and new manufacturing sites. It also determines the Maximum Retail Price (MRP) of all medicines marketed in Pakistan.

The Pakistani Pharmaceutical market is largely an out-of-pocket market (healthcare spending mainly coming from individuals' personal savings), however government provides free or low cost treatment at government hospitals and clinics. Although Pakistan does not have a national health insurance cover, the Health Insurance industry is gradually evolving to provide hospitalization coverage for the citizens. Public Private Partnership in health sector has also increased with several Pharmaceutical companies working with government and NGOs to provide necessary access to medicines.

Pharmaceutical companies are geographically spread all over Pakistan. Pharmaceutical production units in provinces tend to concentrate in major cities like Karachi, Lahore and Peshawar. Although the numbers reflect that majority of firms are in the province of Punjab, but in terms of production, capacity utilization, volume and size of business, Karachi leads the way as far as pharmaceutical firms are concerned.

1.1 Salient Features of a Pharmaceutical Company

Sales Incentives

Medical Representatives are given a fixed salary and a variable incentive pay. They call on doctors to communicate scientific product and disease information, treatment efficacy, results of clinical studies etc. They are given targets in terms of number of calls that they make to doctors in their respective assigned territories, number of scientific and promotional activities carried out as well as sales.

Payments to Drug Regulatory Authority of Pakistan (DRAP)

There are certain special payments made to DRAP for various purposes including:

i. Central Research Fund: Annual levy of 1% of Profit Before Tax

ii. New Drug Registration Fees

iii. Drug Registration Renewal Fees

iv. Drug Manufacturing License Fees

Payments to Healthcare Professionals

Pharmaceutical companies make various kinds of payments to Healthcare Professionals (HCPs)/Healthcare Organizations (HCOs) with respect to services obtained from them. These payments include honoraria for delivering lectures in conferences and symposia, Local Speaker Programs (LSPs) and Round-Table Discussions (RTDs) covering topics based on latest research in various areas of medicine, awareness programs for HCPs as well as general public.

Finance Executives should carefully review all payments to HCPs. Purpose of such payments should be clear to ensure that these payments are within the confines of ethical marketing practices. Payments to HCPs cannot be made to oblige or induce them to prescribe company's medicines and thereby increase sales.

Finance Executives should strengthen the process of approval of such promotional expenses spent in consultation with the compliance and medical departments to ensure compliance with applicable laws and regulations.

Sales Invoicing, Delivery and Receipt of Collection

Pharmaceutical companies generally sell their medicines on advance payment to their distributors.

Scientific Information

A Medical Affairs Department in any pharmaceutical company plays an increasingly important role in communicating scientific information to HCPs in an objective and ethical manner. It provides medical education on latest clinical research, treatment guidelines, new medicines, their medical benefits to patients and any risks of side effect.

The Department focuses on developing customer and patient insights about disease prevalence, their prevention and cure; translating evidence into meaningful information as well as communicating it to the doctors. Scientific information on the appropriate use of medicines and vaccines are also provided.

Clinical Trials

Clinical trials are undertaken to develop medical research evidence to understand efficacy of new medicines in treating diseases. Clinical trials are research studies that test how well new medical approaches work on people. Each study answers specific scientific questions and tries to find better ways for prevention, screening, diagnosis, or treatment of a disease. Clinical trials may also compare a new treatment to the one that is already available in the market.

Pharmaceutical companies engage leading hospitals and approved Clinical Research Organizations for clinical studies/trials on a specific medicine's efficacy in treatment of diseases. Hospitals enroll volunteers and/or patients into small study groups depending on medicine's type and their development stage.

1.2 Role of Pharmaceutical Companies, Opportunities and Challenges

No healthcare system in the world can deliver treatment and care to patients without supply of quality medicines. Both Healthcare systems and Pharma companies need to work together in ensuring affordable healthcare for all.

Opportunities for Pharma Industries

Market Attractiveness

Pakistan's large population with sub optimal access to quality medicines and high disease burden offers growth opportunities to pharma companies.

Export Potential

According to McKinsey study, with certain deregulation, Pakistan's export potential could reach one billion dollars which is currently less than 200 million dollars in Pakistan. India pharma exports are more than 20 billion dollars. Pharma Industry in Bangladesh and India are growing with exports more than 10 times of Pakistan. We have the ability, infrastructure and human resource, we need to optimize regulatory policies.

Bangladesh and India have many Food and Drug Administration (FDA) approved plants. However, we do not have a single manufacturing plant that is FDA approved. This impedes our export potential in developed markets.

Challenges for Pharma Industries

Price Controls

Pharma industry is largely import dependent; continuous weakness of Pak Rupee has resulted in high inflationary environment together with high utility cost. In such an environment price controls hurts margin and industry attractiveness.

Low margins make certain medicines not viable to market for pharma companies and they stop making them that results in shortage of medicines and distress to patient. Several multinational companies have exited because of low margins.

Recent introduction of inflation indexation pricing was welcomed by the industry, however new changes in price controls would hamper timely price adjustments.

Delay in New Medicine Registration

It takes significantly longer time to obtain registration for new research-based products. Delay in registration adversely affects patient's access to more effective new treatment.

Delay also impacts profitability due to Rupee erosion increasing import costs, companies sometimes do not launch those products. Patients end up paying higher price for those medicines coming through the gray channel.

Price adjustment for new medicine for increase in import cost would ensure a fair margin and incentive to introduce new research-based medicine that will be beneficial for patients.

Sourcing APIs and Way Forward

The pharmaceutical industry is highly dependent on import of active ingredients from neighboring countries such as China and India. Reliance of local pharmaceutical industry on India is estimated at 60%.

4. OIL & GAS EXPLORATION

Oil and Gas sector in Pakistan has seen phenomenal growth since the independence in 1947 when oil quantities produced were scarce. At that time there was no gas production. Over the past half century the petroleum industry has played a significant role in national development by making large indigenous gas discoveries. With looming energy crises and the ongoing growing demand for oil and gas in Pakistan, the exploration and production of oil & gas, or upstream has garnered considerable interest from investors (both local and foreign)

Oil and gas industry is categorized into three major segments namely:

- Upstream,
- Mid-Stream and
- Downstream.

Upstream sector, also known as Exploration and Production (E&P) sector, is associated with exploring and producing hydrocarbons (crude oil and natural gas).

Mid-Stream industry involves processing crude oil and natural gas into end user form, therefore, the activities of oil refineries, fertilizer plants and natural gas purification plants are included in mid-stream sector. A large part of midstream activities also includes transportation and storage of crude oil and natural gas. Oil refineries refine crude oil into various types of petroleum products such as motor spirit, diesel, kerosene oil, jet fuel, etc.; fertilizer plants convert natural gas into fertilizer and petrochemical plants convert oil and gas into various petrochemical products.

Downstream sector includes marketing and distribution of refined oil and gas to industrial, commercial and residential end users such as power plants, petrol pumps, various industries and household.

4.1 Major Players in Pakistan

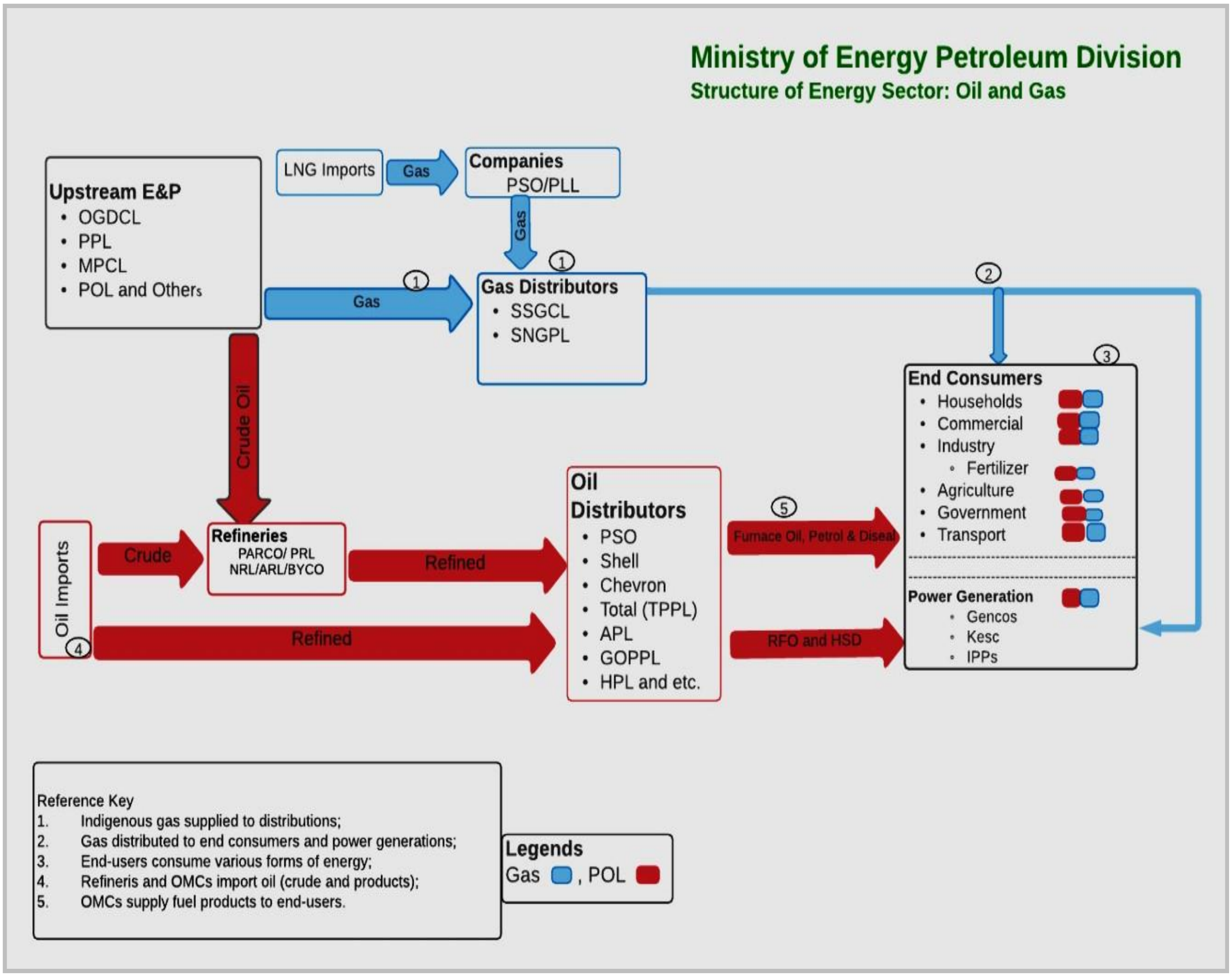
Following is the list of major players in Pakistan for Upstream/E&P segment:

1	ENI Pakistan	Foreign Company
2	Mari Petroleum Company Limited	Local Company
3	MOL Pakistan	Foreign Company
4	Ocean Pakistan Limited	Foreign Company
5	Oil & Gas Development Company Limited	Local Company
6	OMV Pakistan	Foreign Company
7	Pakistan Oilfields Limited	Local Company
8	Pakistan Petroleum Limited	Local Company
9	United Energy Pakistan Limited	Foreign Company

Source: Pakistan Energy book published in September 2019

Oil & gas sector is among the most impactful sectors of Pakistan's economy. The total energy supply during 2019 was about 86 million tons of oil equivalent. To understand the impact of gas contribution, indigenous gas is about 35% of the total energy supply.

Fig. 1. Oil and Gas Supply Chain



4.2 Petroleum Supply Chain

Upstream

Petroleum supply chain infrastructure in Pakistan starts from port facilities at Karachi. Crude oil, white-oil products, Low Sulphur Furnace Oil (LSFO) are received at the Karachi port, while LPG and High Sulphur Furnace Oil (HSFO) are received at the Fauji Oil Terminal at Port Qasim. The port facilities are connected to the tankage/storage facilities of the refineries and oil marketing companies (OMCs).

Similarly, oil explored and produced (E & P) locally is transferred from E & P companies to refineries, and from refineries to oil marketing companies, and from oil marketing companies to thermal power plants and other petroleum consumers (individuals, industries).

Midstream

In the midstream—the bulk of petroleum products required by Pakistan's market is transported by road, oil pipelines and railways.Refineries, Oil Marketing Companies (OMCs) and large consumers own terminals and storage facilities to receive and store crude oil and petroleum products throughout Pakistan to help in distribution of the oil products throughout the country.

Downstream

In the downstream oil sector, there are currently seven refineries and twenty-eight Oil Marketing Companies (OMCs) operating in Pakistan.

4.3 Gas Supply Chain

The supply chain of natural gas just like oil starts from the gas fields, but it is relatively simple as compared to the oil supply chain. Gas explored and produced is transferred to two main gas utilities Sui Northern Gas Pipeline Limited (SNGPL) and Sui Southern Gas Company Limited (SSGCL) via pipelines for further distribution to the end-consumers.

In comparison, the supply chain of imported LNG starts at the Port Qasim Karachi. The LNG imported is re-gasified at the plants installed at the port. The re-gasified LNG is then transferred via pipelines to the two utilities for further transmission.

4.4 Salient features of an Oil and gas exploration company

Land Acquisition

Large areas of land are required to carry out the E&P activities.

As stated above the subsurface (meaning something located beneath a surface and especially underground) property rights belong to the country, however, access to the surface (land) is obtained from the owners of the land which could be private land owners or the Government. Land is acquired via either purchase or rental/lease, short term or long term. During Exploration Phase, land is usually taken on short-term rental/lease, whereas, for Development and Production Phase, it is either purchased or taken on long-term rent/lease.

Acquiring land is quite intense work as sometimes the land is used for agriculture, industrial or residential purposes. Therefore, companies usually have a separate department for this.

Procurement

Most of the material required for drilling and setting up processing facilities is imported.

In case any item is imported temporarily (for example, an equipment/tool imported by a service company from other country to be used for a specific job and to be sent back to that country), it can be cleared by custom authorities against a corporate / bank guarantee without levying any import duty etc.

Health, Safety and Environment (HSE)

Being a highly technical industry dealing with inflammable/combustible products, Health, Safety and Environment (HSE) is of utmost importance for E&P company. Therefore, every company in the E&P industry has comprehensive HSE policies and procedures and exhibits a significant focus on HSE

Capacity building of the staff is done by providing regular HSE trainings such as sessions on emergency response, asset protection and process safety etc. HSE guidelines and procedures are developed and company staff and related staff is regularly trained based on these guidelines and procedures.

Training and Development

Being a highly specialized industry with continuous technological advancements, it is crucial to provide specialized training and development opportunities to staff. Most of the companies have a dedicated section within HR department or a separate training and development department for continuous training of the staff involved in the operations.

Finance, Accounting and Taxation

The finance function in E&P industry is similar to any other industry apart from some functions dedicated to some industry specific calculations, financial planning and tax related workings.

Social welfare

E&P activities in Pakistan are generally carried out in less populated and under-developed areas, which are in need of necessities such as water, electricity, clinics, schools and colleges. E &P companies have contributed for the last many years in the following areas:

- Provision of water resources for drinking and cleaning
- Primary and secondary schools and vocational training centers
- Building and managing small hospitals and dispensaries to provide health services to local communities
- Vaccination against communicable diseases such as Hepatitis B and C.