



Business, Management and Finance

Study Text

The Institute of Chartered

Accountants of Nigeria

ICAN 2021

ICAN

Business, Management and Finance

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Syllabus

FOUNDATION LEVEL

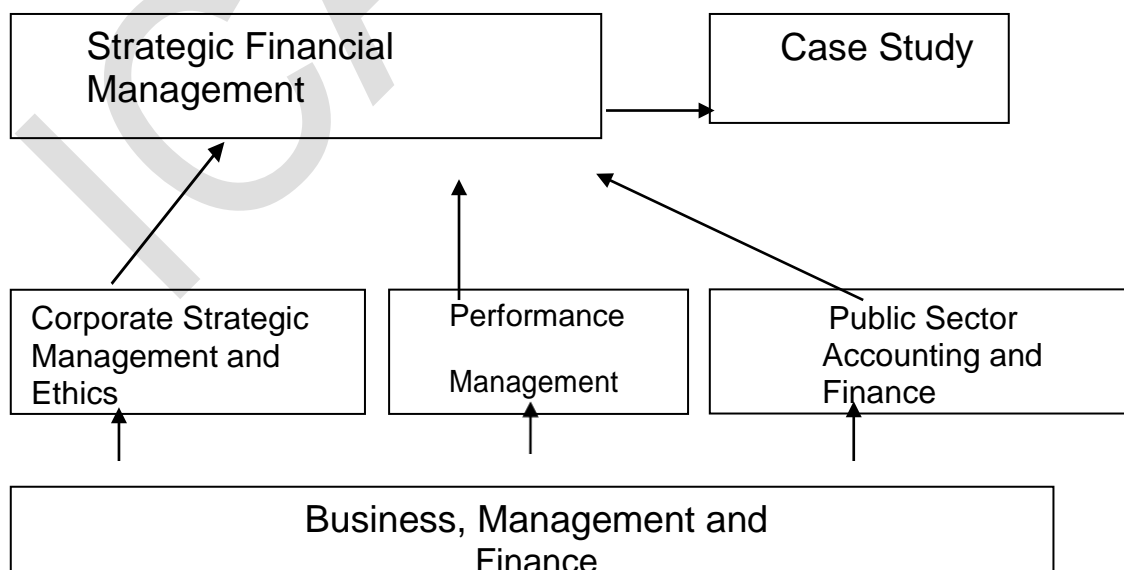
BUSINESS, MANAGEMENT AND FINANCE

Aim

An understanding of business environment (global and local), markets, financial markets, entities and organisations provides a foundation for business professionals. This subject revolves around a basic understanding of the purpose, objectives of businesses; issues of business ethics, governance, corporate social responsibility and sustainability.

Linkage with other subjects

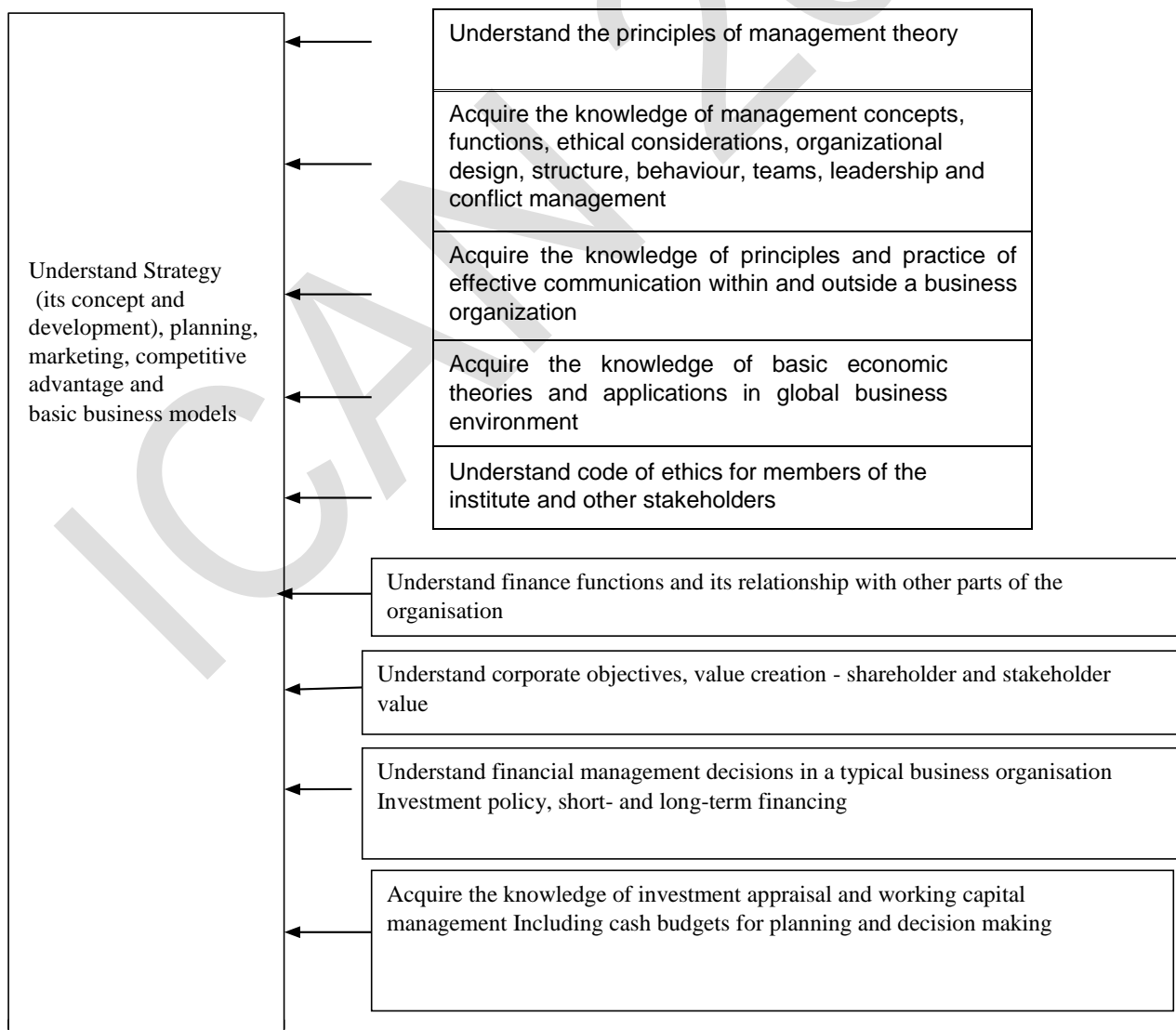
The diagram below depicts the relationship between this subject and other subjects.



Main competencies	
On successful completion of this paper, candidates should be able to:	
<input type="checkbox"/>	Explain the underlining principles of management theory in the context of concepts, functions, ethical considerations and recent developments in business management process;
<input type="checkbox"/>	Explain behavioural aspects of management control and the importance of organizational structure and design;
<input type="checkbox"/>	Understand the basic concepts of leadership and requirements for effective communication within and outside a business organization;
<input type="checkbox"/>	Understand issues associated with building, leading and managing effective teams in the effective management of organisational conflict;
<input type="checkbox"/>	Explain the concept of strategy, alternative approaches to strategy development towards sustainable competitive advantage;
<input type="checkbox"/>	Prepare and present cash budgets for planning and explain main financial management decisions; and
<input type="checkbox"/>	Understand the applications of basic economic theories and business planning to solving business environmental problems locally and globally for competitive edge.

Linkage of the main competencies

This diagram illustrates the linkage between the main competencies of this subject and is to assist candidates in studying for the examination.



Syllabus overview		
Grid		Weighting
A	Business processes and environment	25
B	The role of professional accountants in business and society	10
C	Management and organisational behaviour	35
D	The role of finance	30
Total		100

Detailed syllabus			Chapter
A	Business processes and environment		
	1	Nature of business, types and objectives	1
	a	Explain the nature, types and objectives of business organisation.	1
	b	Explain the basic characteristics, purposes, merits and demerits of the following types of business organisation:	1
	i	Sole proprietorship	1
	ii	Joint venture	1
	iii	Partnership	1
		General partnership	
		Limited partnership	
		Limited liability partnership	
	iv	Limited liability companies	1
		<input type="checkbox"/> Private	1
		Limited by shares	
		Limited by guarantees	
		Unlimited	
		<input type="checkbox"/> Public	1
	v	Non-governmental organisations	1
	vi	Public sector organisations	1
	vii	Alliances	1
	viii	Cooperative society	1
	c	Identify and explain the various business functions	2
	d	Explain the importance of business to its stakeholders	1
	e	Explain the different classifications of economic activities based on the following occupations	1
	i	Profession/vocation;	1
	ii	Employment; and	1
	iii	Business.	1
	f	State the merits and demerits of each of the occupations listed above.	1

Detailed syllabus			Chapter
A	Business processes and environment		
	2	Business and organisational structures and choices	2
	a	Explain the basic characteristics and purposes of the following organisational structures:	2
		i Centralised	2
		ii Decentralised	2
		iii Matrix and mixed	2
		iv Networks	2
		v Virtual arrangements	2
	b	Explain the advantages and disadvantages of each of the organisational structures listed above.	2
	3	The business environment	4
	a	Explain the meaning and importance of the following:	4
		i Globalisation/ International business	4
		ii Macro-economic/ National environment	4
		iii Micro-economic/ Markets and industries	4
		iv Stakeholders	1, 5
	b	Explain the concept of environmental scanning, its methods and importance.	4

B	The role of professional accountants in business and society		
	a	Explain from the perspective of the public interest, the role of professional accountants in business and society	10
	b	Explain the basic principles of ethics and its importance to professional accountants	10

Detailed syllabus			Chapter
C	Management and organisational behaviour		
	1	Basic management functions	
	a	Give various definitions of management.	2, 11
	b	Identify and explain types of management skills	11,12
	c	Explain the following basic management functions, their importance and application in the field of accounting:	11
		i Planning;	11
		ii Organising;	11
		iii Controlling;	11
		iv Coordinating;	11

Detailed syllabus				Chapter
C	Management and organisational behaviour			
	v	Directing; and		11
	vi	Supervising		11
	d	Identify and explain the various management roles		11
2	Management, individual and organisational behaviour			
	a	Explain the nature and significance of formal and informal organisation.		2
	b	Explain the role and importance of organisational culture.		3
	c	Explain the relationship between leadership and management.		11
	d	State the roles of individual and group behaviour in organisations.		13
	e	Identify and explain conflict management and various resolution mechanisms.		11
	f	Explain the nature and significance of team formation, development and management.		13
	g	Explain the concept of employee motivation and its relationship with productivity.		12
	h	State and explain the various management theories with emphasis on scientific, administrative and other modern management theories; such as Frank and Lillian Gilbreth's motion theory, Herzberg's Hygiene, Motivation factor theory and other related theories.		11
	i	Explain the uses of technology business modelling		
	k	Explain emotional intelligence		
	l	Explain social thinking		
3	Communication in business			
	a	Explain the basic elements of communication.		14
	b	Explain verbal and non-verbal communication.		14
	c	State the principles of effective listening.		14
	d	Explain organisational communication:		
		i	formal and informal	14
		ii	internal and external	14
	e	Explain methods of business communication.		14
	f	State the barriers to effective communication.		14
	g	State the different communication patterns.		14
	h	Explain the process and conduct at meetings.		14
	i	Explain the basic elements of report writing.		15
	j	Explain the process of electronic communication.		14

	4		Digital communication	
			Explain	
		a	Email systems and its utilisation	
		b	Website platforms and its utilisation	
		c	Uses and management of social media accounts	
		d	Digital marketing	

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Detailed syllabus			Chapter
D	The role of finance		
	1	Basics of business finance and financial markets	
	a	Identify the various sources of finance that are available to business organisations.	5, 6
	b	Explain the characteristics of the different sources of finance, stating their advantages and disadvantages.	5, 6
	c	Describe the characteristics of the financial market.	5, 6
	d	Explain finance functions and financial management objectives.	5
	e	Explain the following concepts:	
		i Covenants;	6
		ii Warranties; and Guarantees	6
		iii Indemnities	6
	f	Prepare a cash budget using given data.	5
	2	Investment decisions	
	a	Explain and apply the key tools of mathematics used in solving business finance problems:	7, 8, 9
		i Compound interest and simple interest;	7
		ii Discounting;	8
		iii Annuities;	7
		iv Present value of annuities; and	8
		v Sinking funds and amortisation.	7
	b	Identify and apply the following investment appraisal techniques:	8, 9
		i Accounting rate of return;	9
		ii Payback period;	9
		iii Discounted payback;	8
		iv Net present value; and	8
		v Internal rate of return.	8



Foreword

The business environment has been undergoing rapid changes caused, by globalisation and advancement in Information Technology. The impact of these changes on the finance function and the skills set needed by professional accountants to perform their various tasks have been profound. These developments have made it inevitable for the Institute's syllabus and training curriculum to be reviewed to align its contents with current trends and future needs of users of accounting services.

The Institute of Chartered Accountants of Nigeria (ICAN) reviews its syllabus and training curriculum every three years, however, the syllabus is updated annually to take cognisance of new developments in the national environment and global accountancy profession. The Syllabus Review, Professional Examination and Students' Affairs Committees worked assiduously to produce a 3-level, 15-subject ICAN syllabus. As approved by the Council, examinations under the new syllabus will commence with the November 2021 diet.

It is instructive to note that the last four syllabus review exercises were accompanied with the publication of Study Texts. Indeed, when the first four editions of Study Texts were produced, the performances of professional examination candidates significantly improved. In an effort to consolidate on these gains and to further enhance the success rates of students in its qualifying examinations, the Council approved that a new set of learning materials (Study Texts) be developed for each of the subjects. Although, these learning materials may be regarded as the fifth edition, they have been updated to include IT and soft skills in relevant subjects, thereby improving the contents, innovation, and quality.

Ten of the new learning materials were originally contracted to Emile Woolf International (EWI), UK. However, these materials were reviewed and updated to take care of new developments and introduced IT and soft skills in relevant subjects. Also, renowned writers and reviewers which comprised eminent scholars and practitioners with tremendous experiences in their areas of specialisation, were sourced locally to develop learning materials for five of the subjects because of their local contents. The 15 subjects are as follows:

Foundation Level		
1.	Business, Management and Finance	EWI/ICAN
2.	Financial Accounting	EWI/ICAN
3.	Management Information	EWI/ICAN
4.	Business Law	ICAN

Skills Level		
5	Financial Reporting	EWI/ICAN
6	Audit and Assurance	EWI/ICAN
7.	Taxation	ICAN
8.	Corporate Strategic Management and Ethics	EWI/ICAN
9.	Performance Management	EWI/ICAN
10.	Public Sector Accounting and Finance	ICAN

Professional Level		
11.	Corporate Reporting	EWI/ICAN
12.	Advanced Audit and Assurance	EWI/ICAN
13.	Strategic Financial Management	EWI/ICAN
14.	Advanced Taxation	ICAN
15.	Case Study	ICAN

As part of the quality control measures, the output of the writers and reviewers were subjected to further comprehensive review by the Study Texts Review Committee.

Although the Study Texts were specially produced to assist candidates preparing for the Institute's Professional Examination, we are persuaded that students of other professional bodies and tertiary institutions will find them very useful in the course of their studies.

Haruna Nma Yahaya (Mallam), mni, BSc, MBA, MNIM, FCA
Chairman, Study Texts Review Committee

A

Acknowledgement

The Institute is deeply indebted to the underlisted locally-sourced rewriters, reviewers and members of the editorial board for their scholarship and erudition which led to the successful production of these new study texts. They are:

Taxation

- | | | |
|----|----------------------------|----------|
| 1. | Enigbokan, Richard Olufemi | Reviewer |
| 2. | Clever, Anthony Obinna | Writer |
| 3. | Kajola, Sunday Olugboyega | Writer |

Business Law

- | | | |
|----|----------------------|-----------------|
| 1. | Oladele, Olayiwola.O | Writer/Reviewer |
| 2. | Adekanola, Joel .O | Writer |

Public Sector Accounting and Finance

- | | | |
|----|------------------|-----------------|
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| 2. | Osonuga, Timothy | Writer |
| 3. | Ashogbon, Bode | Writer |

Advanced Taxation

- | | | |
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| 2. | Kareem, Kamilu | Writer |

Case Study

- | | |
|---------------------------|-----------------|
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|---------------------------|-----------------|

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2.	Ezeribe, Chimenka	Writer
3.	Ikpehai, Martins	Writer

Soft Skills		
1.	Adesina, Julius Babatunde	Reviewer
2.	Adepate, Olutoyin Adeagbo	Writer

The Institute also appreciates the services of the experts who carried out an update and review of the following Study Texts:

Business Management and Finance		
1.	Ogunniyi, Olajumoke	

Management Information		
1.	Adesina, Julius Babatunde	
2.	Ezeribe, Chimenka	

Financial Accounting		
1.	Adeyemi, Semiu Babatunde	

Financial Reporting		
1.	Okwuosa, Innocent	

Performance Management		
1.	Durukwaku, Sylvester	

Corporate Strategic Management and Ethics		
1.	Adepate, Olutoyin Adeagbo	

Audit & Assurance		
1.	Amadi, Nathaniel	

Corporate Reporting		
1.	Adeadebayo, Shuaib	

Advanced Audit and Assurance		
1.	Okere, Onyinye	

Strategic Financial Management

1. Omolehinwa, Ademola

The Institute also appreciates the services of the following:

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Registrar/Chief Executive

The business organisation and its stakeholders

Contents

- 1 Types of organisation and organisation structures
- 2 Stakeholders of business organisations
- 3 Collaboration: alliances
- 4 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

A		Business processes and environment	
	1	The nature of business, types and objectives	
	a	Explain the nature, types and objectives of business organisation	
	b	Explain the basic characteristics, purposes, merits and demerits of the following types of business organisation:	
		i	Sole proprietorship
		ii	Partnership
		iii	Limited liability companies
			■ Private
			■ Public
		iv	Non-governmental organisations
		v	Public sector organisations
		vi	Alliances
		vii	Cooperative society
	d	Explain the importance of business to its stakeholders	
	e	Explain the different classifications of economic activities based on the following occupations	
		i	Profession/vocation
		ii	Employment
		iii	Business
	f	State the merits and demerits of each of the occupations listed above.	
	3	a	Explain the meaning and importance of the following
		iv	Stakeholders

Exam context

This chapter introduces students to the different types of organisation found both in business and the public sector. Students will learn the difference between organisations' objectives (profit vs. not-for-profit) and legal forms (e.g. sole trader / partnership / company). Students will also learn about stakeholders – who they are and what they want from an organisation. This is critical information for management as it provides context for them to make decisions.

By the end of this chapter students will be able to:

- Identify and explain the different objectives and legal forms of organisations;
- Describe with examples the main categories of stakeholder.
- Explain the different classifications of economic activities: profession/vocation; employment and business, and state the merits and demerits of each of these
- Explain how organisations collaborate in alliances to achieve competitive advantage.

1 Types of organisation and organisation structures

Section overview

- Types of organisation
- Joint venture
- Characteristics of different types of organisations
- Types of business entity
- Summary: characteristics of each type of business entity

1.1 Types of organisation

Accountants are employed by different types of organisation. Organisations can be divided into two main types:

- ❖ commercial organisations, and
- ❖ not-for-profit organisations.



Definition: Commercial organisations (businesses)

Commercial organisations (businesses) engage in business activities, with the purpose of making a profit.



Definition: Not-for-profit

Not-for-profit organisations exist for purposes other than making a profit. However, they must operate within the limits of the funding and cash that is available to them and will attempt to operate at a surplus (of income over expenditure).

Not-for-profit organisations can be divided into two main types:

- ❖ **public sector organisations:** these are government departments or organisations that are funded by the government
- ❖ **non-government organisations (NGOs):** these are not-for-profit organisations that are partly or wholly funded from non-government sources. NGOs. Charities and co-operatives are a type of NGO.



Example: Non-government organisations (NGO)

The term 'NGO' originated from the United Nations and is normally used to refer to organizations that do not form part of the government and are not conventional for-profit businesses.

NGO's are significant in Nigeria's vibrant social sector with presence in sectors such as the environment, health, education, justice, human rights, youth empowerment and gender development. Examples include:

- Access to Education for Children
- Action Aid International Nigeria
- Foundation for Skills Development
- Lagos Digital Village
- Murtala Mohammed Foundation
- Nigeria Health Care Project
- Women in Management and Business

Charities



Definition: Charity

A charity is a type of non-profit organisation that is concerned with non-profit and philanthropic goals as well as social well-being (e.g. charitable, educational, religious, or other activities serving the public interest or common good).

Co-operatives



Definition: Co-operative

A co-operative is a farm, business, or other organisation which is owned and run jointly by its members, who share the profits or benefits.

In Nigeria, co-operatives are governed by the Nigerian Co-operative Societies Act which mandates eligibility as follows:

- Agricultural societies must have 50+ members;
- A saving and credit co-operative must have 20+ members;
- Other types of co-operative societies need 10+ members.

Co-operatives are organisations in which there are members, and all members:

- ❖ are actively involved in its activities, and
 - ❖ share in the benefits that the co-operative provides.

There are different types of co-operative.

- ❖ In a workers' co-operative, a number of individuals co-operate to carry out related activities, such as operating a farm or a factory. They work for the co-operative and they share the benefits that the co-operative provides.
- ❖ A number of individuals might form a co-operative for the purchase and use of expensive equipment. Each member of the co-operative is entitled to some use of the assets. For example, a number of small farmers might form a co-operative to purchase and use expensive agricultural equipment.
- ❖ In a retail co-operative society, the members buy goods and services from the retail outlets of the co-operative society, and each year they receive a share of the profits that the society has made.

Co-operatives are more common in some countries than in others.



Example: The UK Co-operative Society

The UK also has a Co-operative Society, whose activities include operating a chain of retail stores and a commercial bank. Individuals can become members by shopping in the Society's outlets, and they receive a share of the Society's annual profits. The size of their profit share depends on the amount of profits that Society has earned and the amount of shopping they have done in the Society's stores.

Co-operatives may be either commercial businesses or not-for-profit organisations. If they are commercial businesses, the profits are shared by the members. In not-for-profit co-operatives, other benefits (such as the output produced by the co-operative) are shared by the members.



Example: Co-operatives in Nigeria

The types of co-operative in Nigeria include:

- ❑ Consumer co-operatives – established to provide affordable goods and services which are essential to the overwhelming majority of people.
- ❑ Credit co-operatives – providing savings and affordable loan services to its members.
- ❑ Agricultural and farmers' co-operatives – the most popular type of co-operative among Nigerians as the agricultural sector involves over 40% of the population (at the time of writing).
- ❑ Housing co-operatives – a type of co-operative enabling members to buy land, participate in building houses and invest in a real estate business.
- ❑ Fishing co-operatives – providing fresh or processed fish products as well as discounts for members to buy fishing nets and equipment.
- ❑ Multipurpose co-operatives – covering a broad range of needs and sectors. Specific examples of co-operatives in Nigeria include:
 - ❑ GreenLife Multipurpose Co-operative Society – providing agri-technology solutions to entrepreneurs and agricultural co-operatives;
 - ❑ Nasara Agricultural Co-operative Society – an agricultural association that provides agri-based entrepreneurship, empowerment and education;
 - ❑ Happy homes multipurpose co-operative society – established to provide affordable and accessible housing for its members;
 - ❑ Rehabilitation Village Farms Co-operative Society – a 30-member farmers' co-operative which aims to create employment and income generating opportunities for members and other smallholder farmers in Akwa Ibom state. Activities include oil palm plantation development, palm oil milling and the sale of crude palm oil, palm kernel and oil palm seedlings. The society also provides training and technical assistance to small-scale farmers in Akwa Ibom state.

Cooperatives offer a number of benefits to their members.

- ❖ Cooperatives exist for the benefit of its patron members who, as the owners, also have a direct financial interest in the organisation. This motivates members to pledge their support to the cooperative as both customers consuming the products and as managers/employees/volunteers in running the organisation.
- ❖ Cooperatives that require mandatory contribution promote a 'savings culture' that helps balance against consumption and spending beyond one's means. A mandatory contribution may be set up as compulsory periodic contributions such as wages or salary deductions. Adopting a 'savings culture' can be particularly difficult in low income environments where the immediate pressures to survive are immense. In such situations, the cooperative can help establish a culture of regular savings for future investment and growth.
- ❖ Cooperatives can assist individuals in accessing loans in the form of cash or goods. This is particularly helpful for low income earners unable to pledge collateral. An individual's contributions to the cooperative can serve as collateral and fellow contributors may be accepted as guarantors.

- ❖ There may be an opportunity for individuals to participate in the running of the cooperative. This will help them acquire knowledge and expertise in areas such as enterprise and project management i.e. transferrable skills they can use in future life and business.
Cooperatives also have some drawbacks.
- ❖ Cooperatives are membership groups run by their membership for their membership. There is a danger that a cooperative might be inefficiently run and whose managers lack the freedom enjoyed by businesses that are motivated by, and accountable to, the profit motive.
- ❖ Cooperatives may struggle to attract competent managers and other employees who may find higher-paid jobs in commercial businesses more attractive.
- ❖ Unlike owning shares which are freely traded on a public market, the membership stake in a cooperative can be difficult to transfer or exit

1.2 Characteristics of different types of organisations

All types of organisations have some common features.

They consist of more than one person. A two-man partnership is an organisation. Similarly, a sole trader's business is an organisation if the business owner has employees working for him (or her). The work of the different people in the organisation must be co-ordinated and given direction. In other words all organisations need to be managed. There are 'managers' in all types of organisation.

Each type of organisation has features that distinguish it from the other types of organisation. These features relate largely to:

- ❖ Purpose
- ❖ Ownership and management
- ❖ Funding
- ❖ Accountability
- ❖ Liability.

Purpose

The main objective of commercial operations is to earn a return for the owners. The return might be in the form of periodic payments (dividends) or capital growth (increase in market value). The primary business objective of commercial organisations is sometimes stated as the maximisation of shareholders' wealth.

It is also usual (but not essential) for commercial organisations to identify the nature of their operations – what they do to earn a return. For example, the purpose of an oil company might be to make a profit by drilling for oil and extracting oil; and the purpose of a commercial airline is to make a profit by operating air services.

The objectives of a not for profit organisation are usually to provide a service of some kind.

- ❖ Public sector organisations exist to provide a benefit to the public, such as good government or key services such as health, education, a police force, national defence, and so on.
- ❖ A non-governmental organisation is set up to pursue certain non- commercial objectives. For example, charities are set up for a particular purpose. This might involve providing extra service above that provided by

government in certain areas (e.g. mental health, protection of children, medical research, providing extra funding to hospitals). Charities also exist to help people in times of trouble. For example it is very common in many countries for there to be an appeal to raise money to help people in other countries during times of natural disasters.

The objectives of not-for profit organisations are often stated in terms of maximising benefits and this is expressed in terms of maximising value for money (often abbreviated to “VFM”. Value for money has three elements usually described as the 3 E’s (economy, efficiency, effectiveness).

- ❖ Economy refers to operating in a way that does not waste money.
- ❖ Efficiency refers to using resources in the most efficient way possible and getting the most out of them by skilfully avoiding wasted time and effort.
- ❖ Effectiveness refers to using resources and spending money so as to achieve targets and objectives.



Example: National Audit Office

The National Audit Office in the UK is a government body that assesses the value for money of government spending. This means that it examines other government bodies and activities to ensure that resources are being used in an optimal way to achieve intended outcomes.

The NAO defines the 3Es as follows:

- Economy: minimising the cost of resources used or required while having regard to quality – spending less;
- Efficiency: the relationship between the output from goods or services and the resources to produce them – spending well; and
- Effectiveness: the relationship between the intended and actual results of public spending (outcomes) – spending wisely.

Ownership and management

Commercial organisations in the private sector are owned by individuals or other organisations. Sole trader businesses have one owner; partnerships are owned by their partners; and companies are owned by their shareholders. Shareholders may be individuals or other organisations, such as other companies. .

Managers are in charge of the business operations on a day-to-day business. In sole trader businesses and small partnerships and companies, the owners may also be the managers. Larger companies have professional management, and most owners are investors holding shares.

Public sector organisations are owned by the government (as the representative of the general public) and managed by public service officials. Co-operatives are owned by their members.

Funding

Business organisations obtain the funds (finance) they need to operate from a variety of sources. Some types of organisation have more difficulty raising funds than others. For example, sole traders and small partnerships have less access to additional external funding than large public companies. A stock market company, for example, obtains its long-term funds from a mixture of reinvesting profits in the business, issuing new shares to investors (or as consideration for the acquisition of other companies) and borrowing.

Charities rely on a mixture of government grants and private donations for the money they need.

Public sector organisations obtain their money from the government, which in turn gets most of its money from taxation (and government borrowing).

Accountability

The management of an organisation is accountable to its owners for the performance and achievements of the organisation. 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 annual report and accounts.

Managers of public sector enterprises are accountable to government. Many are required to prepare reports on a regular basis the purpose of which is to allow monitoring of the enterprises performance.

Charities often prepare financial statements so that interested parties (stakeholders) can see how the charity has achieved its objectives and how efficiently it is operating.

Sole traders and partners in partnerships, when they manage their business personally, are accountable to themselves.

Liability

Liability refers to the liability of the owners of a business for the unpaid debts of their business. This is an important issue for commercial organisations. Liability is either unlimited or limited.

- ❖ Unlimited liability means that the owners of the business will be personally responsible for any unpaid debts (liabilities) of their business. A creditor can claim payment out of the personal assets of the business owner or owners if the business itself is unable to pay. Sole traders and traditional partnerships are businesses where the owners have unlimited liability.
- ❖ Limited liability means that the liability of the owners of the business for the unpaid debts of their business is limited usually to the amount of capital that they have already put into the business. If the business becomes insolvent owing money, the owners are not liable for the unpaid debts. Most companies are limited liability companies.

1.3 Types of business entity

A business entity is a commercial organisation that aims to make a profit from its operations. There are three main types of business entity;

- ❖ Sole proprietorship a sole trader
- ❖ Joint venture
- ❖ Partnership a business partnership
 - General partnership
 - Limited partnership
 - Limited liability partnership

Limited liability company a company (a limited liability company).

- ❖ Private
 - **Limited by shares**
 - **Limited by guarantee**
 - **Unlimited**
- ❖ **Public**

Sole proprietorship The business of a sole proprietor is owned by one person and usually managed by that person. Any individual, who sets up in business on his/her own, without creating a company, is a sole proprietor.

Sole proprietor businesses are usually small operations, but the owner might employ a number of employees who work for the business to earn a wage or salary, but do not have any share in the ownership of the business.

- ❖ Important features of a sole proprietorship are as follows: Unlimited liability. The owner of the business is personally liable for the unpaid debts and other obligations of the business. For example if the business owes a supplier ₦1,000 for goods it has purchased, but does not have the money to make the payment, the owner of the business can be made personally liable to make the payment out of his/her 'non-business' assets. The profits of a sole proprietor business are treated as income of the owner, for the purpose of calculating the amount of tax payable on income.
- ❖ As senior manager of the business, a sole proprietor personally takes the major decisions for the business, such as commercial decisions.
- ❖ Sole proprietors may borrow some money to help finance the business, typically by borrowing from a bank. However, losses from business operations are effectively personal losses for the business owner. The owner takes the decisions, and also bears the risk that the decisions may turn out badly.

Joint Venture

A joint venture is a business entity created by two or more parties. It is typified by mutual ownership, returns, risks and governance.

- (a) **Reasons for entering into joint venture arrangement:**
 - i. Access to a new or an emerging market;
 - ii. Improved efficiencies occasioned by combining assets and operations;
 - iii. Opportunity to share business risk; and
 - iv. Access to competence and skills.
- (b) **Advantages of a joint venture**
 - i. Provides opportunity to gain new insights and expertise
 - ii. Enables access to specialised technology, staff and other resources
 - iii. It is of a limited lifespan and short term commitment. In the event that the project fails, risks and costs are jointly shared
 - iv. Eradicates the risk of discrimination
- (c) **Disadvantages of a joint venture**
 - i. Flexibility can be restricted
 - ii. Degree of partners' involvement may not be equal
 - iii. Clash of cultures and management styles may impair the success of the venture
 - iv. It has unclear and unrealistic objectives

Partnership

A business partnership is an entity in which two or more individuals (partners) share the ownership of the business. Each partner contributes some funds ('capital') to set up the business. Like a sole trader, a partnership may have employees who work for the business, but have no share in the ownership.

Partners may have equal ownership rights in the business, or may own different proportions of the business.

Important features of a general partnership are as follows:

Unlimited liability. The owners of the business are personally liable as individuals for the unpaid debts and other obligations of the business. For example if the partnership owes a supplier ₦1,000 for goods it has purchased, but does not have the money to make the payment, the partners can be made personally liable to make the payment out of their 'non-business' assets. Each partner may be personally liable for all the unpaid debts of the business, not just his or her 'share' of the debts.

The profits of a partnership are shared between the partners in an agreed way, and each partner's share of the profits is treated as personal income, for the purpose of calculating the amount of tax payable on his or her income.

Partners in a partnership are often also involved in the management of the business. Sometimes there is a 'sleeping partner' who contributes capital to the business but is not involved in day-to-day management. The partnership agreement between the partners may then state that a sleeping partner should not be made personally liable for any unpaid debts of the business, and that the other 'active' partners accept any such liabilities among themselves.

Major decisions affecting the business are taken by one or more of the partners, depending on how responsibilities are shared between them. However, as with sole traders, and losses suffered by the business are losses for the partners themselves. The owners take the decisions, and also bear the risk that the decisions may turn out badly.

Since there is more than one owner of the business, with each of them involved in managing the business, there is inevitably a risk of disagreement between partners. For example if A, B and C are in partnership, Partner A may want to make a commercial decision, but Partners B and C might oppose it. If the disagreement is about an important matter, and the partners cannot reach agreement about what should be done, there is a risk that the partnership might break up. Partnerships can vary greatly in size, both in terms of size of business and number of partners.

Limited partnership

A limited partnership (LP) can be described as a type of partnership structure owned by two types of partners, namely general partner(s) and limited partner(s). It is an association of 20 persons or less set up with the intent of carrying on a profit-oriented business.

The general partner(s) hold all the privileges and tasks of the partnership administration and is held personally liable for any business debts, obligations and activities of the limited partnership. All partners in LPs are responsible for taxes on their share of the partnership income, rather than the partnership itself. Some law, real estate, accounting and finance firms adopt limited partnership structure.

Important features of a limited partnership include:

The limited partner invests money in exchange for shares in the partnership to get a share of the profits.

The limited partner is called a part-owner or passive owner of a partnership or a silent partner.

The law prohibits the involvement of limited partners in the operational management of the business.

The limited partner does not make operational decisions, but may inspect the books and examine the prospects of the firm.

As an investor, he has restricted voting power on the business of the partnership and his loss from the partnership operations is limited to the amount invested.

Limited liability partnership (LLP)

In Nigeria, a LLP is a newly created corporate structure, vested with a distinct legal entity separate from those of its partners. Partners in an LLP enjoy limited liability protection. An LLP combines the advantages of the corporate form of companies with the flexibility of a partnership. In many respects, an LLP is more similar to a company than to an ordinary partnership. LLP also combines the organisational flexibility and tax status of a partnership with limited liability for its members. Many professional firms in countries such as the UK, including major firms of accountants and auditors, have turned themselves into an LLP.

The main features of an LLP are as follows:

- ❖ An LLP is a corporation (corporate body). It has a legal personality, separate from its individual partners. In this respect, LLPs are similar to limited companies and different from ordinary partnerships.
- ❖ LLPs must be incorporated in much the same way as companies.
- ❖ The liability of all partners is limited to their capital investment in the partnership. An LLP, like a company, therefore, provides limited liability for its owners.
- ❖ Each member of the LLP is an agent and can bind the LLP.
- ❖ The business name of the LLP must end with the words Limited Liability Partnership or LLP.

For tax purposes LLPs are treated as a partnership. In other words, the profits of the partnership are not taxed directly, unlike the profits of a company. The individual partners in an LLP are taxed personally on their share of the partnership profits, which is treated as one of their sources of taxable income.

Private Companies

A small company is a company with a turnover of not more than ₦120,000,000 (one hundred and twenty million naira) and net assets not exceeding ₦60,000,000 (sixty million naira).

According to S. 18(2), a private company can be incorporated by one person. A private company is required to have a minimum issued share capital (MISC) of ₦100,000 of which at least 51% of its shares must be held by its director(s). Private companies must not have any foreigner, government or government corporation as a shareholder. It may hold general meetings virtually (S.240).

It is no longer mandatory for a company to have a company seal (S.98). Private companies can now have a single director. This significantly reduces the bottleneck of the previous requirement to have a minimum of 2 (two) directors, thereby making business registration easier and faster for qualified businesses.

Private companies are exempted from the mandatory appointment of a company secretary and auditors. Private companies with annual gross turnover of ₦25 million or less are exempted from companies income tax.

Where a private company has not carried out business since incorporation, CAMA 2020 exempts it from the requirements of the law relating to the audit of accounts in respect of a financial year. This provision is not applicable to insurance companies and banks or any other company as may be prescribed by the CAC.

Company limited by shares

A company (a 'corporation' in the US) is a special form of business entity. Nearly all companies in business are limited liability companies with liability limited by shares.

- ❖ Ownership of the company is represented by ownership of shares. A company might issue any number of shares, depending largely on its size. A very small company might have just one share of ₦1, whereas a large stock market (publicly quoted) company will have millions of shares in issue. If a company has issued 100 shares, ownership of 40 shares would represent 40% of the ownership of the company.
- ❖ Unlike a sole trader or a partnership, a company has the status of a 'legal person' in law. This means that a company can be the legal owner of business assets, and can sue or be sued in its own right in the law.
- ❖ A company is also taxed separately from its owners. Whereas the profits of a sole proprietor and business partners are all taxed as personal income of the business owners, the profits of a company are taxed as income of the company itself.
- ❖ Limited liability. A company has legal liability as a 'legal person'. This means that if the company owes a supplier ₦1,000 for goods it has purchased, but does not have the money to make the payment, the company alone is liable for the debt. The owners of the business – its 'shareholders' – cannot normally be made personally liable to make the payment. The liability of shareholders is limited to the amount of capital they have invested in the company. If the company's shares are 'fully paid' (which is normal) shareholders have no further financial liability for any unpaid debts or other obligations of their company. This limited liability of the company's shareholders for the unpaid debts of their company is a major reason why so many small businesses operate as companies, rather than as sole traders or partnerships.

Another feature of large companies is that they may have a large number of shares in issue, and a large number of shareholders. In large companies, the main shareholders are not the managers of the business. The managers (executive directors of the company) and owners are different persons. This is sometimes referred to as the 'separation of ownership from control'. This is not found in the businesses of sole traders or partnerships, where the owners are usually also involved in management.

The main operational decisions affecting a large company are therefore taken by their professional managers. Any bad decisions they make affect the company and its profits, but do not affect the managers themselves directly.

When shareholders are not the managers of their company, it becomes essential that information about the position and performance of the company should be reported regularly by the management to the shareholders. This is the main purpose of financial reporting.

However, there might be a risk that the managers of a company would make false reports to shareholders about the financial position and performance of the company. To reduce this risk, the laws on financial reporting and auditing are generally much stricter for companies than for other types of business entity.

Companies Limited by guarantee

A company limited by guarantee can be described as one having the liability of its members limited by the memorandum to an amount each of the members undertakes to contribute to the assets of the company, in the event of its being liquidated. A company limited by guarantee has a separate legal identity and can carry out activities in its name as well as institute and defend a lawsuit. The liability of the members is limited just as those of shareholders in a limited liability company, the only difference being that it is not linked to the value of shares since a company limited by guarantee does not issue shares.

Its memorandum of association (MoA) is specifically drafted for its type and has no share capital or shareholders like a normal limited liability company. A company limited by guarantee is owned by members, called guarantors, each of whom guarantees to pay a nominal amount in the event of the company's insolvency. The guarantors do not take profit from the business of the company as all surplus income of the company is ploughed back to promote its non-profit activities. It has a structure that is similar to that of a company limited by shares, in that directors are appointed to manage the company and may appoint a company secretary, if desired.

The permission of the Attorney General of the Federation ("AGF") is the main precondition for the registration of a company limited by guarantee section 26 (5). Where the AGF does not give his permission to the promoters within 30 days and there are no objections or other convincing reasons for the refusal, promoters can place an advertisement in three national daily newspapers welcoming objection from the public to the incorporation of the would-be company within 28 days.

Where there are no objections, the Corporate Affairs Commission (CAC) may give consent to the application and register the company without the AGF's permission. The minimum contribution of members of a company limited by guarantee is ₦100,000. The use of company seal is discretionary (S.98).

Other features of a company limited by guarantee:

- It is set up in the same way as normal limited liability companies.
- It is normally set up for non-profit purposes.
- It must include the suffix "limited" in its name.
- It has a distinct legal entity from its owner/guarantor.
- It must have at least one director and one guarantor (the director and guarantor can be the same person).
- Multiple directors and guarantors are allowed, unless restricted by the articles of association.
- Guarantors are protected by limited liability, implying that guarantors are not personally held responsible for any of company's debts. Hence, members are protected from being held liable in their personal capacity for the amount borrowed for business in the name of the company.

- The sum they each guarantee is the limit of their individual liability thus implying that members are only accountable to the extent of the guaranteed amount as mentioned in the memorandum of association of the company.

Unlimited limited companies

An unlimited liability company is one wherein the liabilities of the members or owners are unlimited to any amount (as stipulated in its memorandum). By implication, in the event that such a company becomes insolvent (its liabilities exceed its assets), and is eventually liquidated or wound up, it becomes mandatory for members of the company to contribute funds (in proportion to their shareholding) in order to settle the unpaid financial obligations of the company. However, it should be noted that the joint or several and non-limited liability of the members or shareholders of such unlimited company to meet the unpaid financial obligations of the company becomes applicable only upon formal liquidation of the company.

Other features of an unlimited liability company, include:

1. Unlike the limited liability company, the liability of the owners or members of the company are not limited to the amount that they have contributed. This is the main reason why such companies are described as unlimited liability companies, implying that there would be no limit to the losses that might have to be borne by the owners or members of the company.
2. It is mandatory to state the fact that the company is an unlimited company in its memorandum and articles (MEMAT).
3. The appellation "Unlimited" must end the name of the company.
4. Most unlimited liability companies are privately owned companies.

Public limited companies

A public company must be registered with the Corporate Affairs Commission (CAC). The nominal capital of a public company is ₦2,000,000 and must have been issued (allotted). Stamp duties are only paid on shares which have been issued. Other features of a public company as stipulated by the CAMA 2020, include the following:

- a) Public companies are obligated to carry out their meetings physically;
- b) 25% of the issued share capital of a public company must be paid up at all times;
- c) The use of common seal is optional;
- d) Appointment of company's secretary is mandatory;
- e) Directors are mandated to disclose their ages on appointment and other directorship appointments in other public companies;
- f) Public companies must have at least three (3) independent directors at all times
- g) A restriction on any person from being a director in more than 5 public companies at a time;
- h) Regulation of the allotment of shares to be carried out in accordance with the provisions of the Investment and Securities Act, ("ISA"), and the Federal Competition and Consumer Protection, Act ("FCCP, Act").
- i) This is to guard the interest of the company with respect to creepy acquisition of company's control;
- j) Appointment of auditor (s) during the annual general meeting of such companies is mandatory;
- k) Audited financial statement must be hosted on the company's website; and
- l) The ordinary business for annual general meeting (AGM) of a public company would include disclosure of remuneration of managers of the company, consideration of financial statements, declaration of dividends,

appointment and removal of directors, appointment and remuneration of auditors and election of members of audit committee.

There is a special kind of company called a 'public limited company'.



Definition: Public Limited Company (PLC)

A public limited company is able to sell its shares to the public and may be quoted on a stock exchange. The term "Public Limited Company" or "PLC" is included in the company name to denote that it is a public company limited by shares.

Unless a company is a PLC, it cannot offer to sell its shares to the general public, and any investor wanting to buy or sell shares in the company must do so in a private transaction. Although there are 'venture capital funds' and 'private equity firms' that might be interested in investing in a private company, it is generally difficult for a private limited company to raise substantial amounts of new finance, because it is difficult to find willing investors.

In contrast, PLCs are able to offer new shares to the investing public on a stock exchange (in Nigeria, the Nigerian Stock Exchange). This is why many PLCs are large companies with a large number of investors as shareholders.

However, PLCs must follow the rules of their stock exchange.

Financial reporting by sole traders, partnerships and companies

All business entities prepare some financial statements at the end of each accounting period, normally once each year.

- ❖ The financial statements of a sole trader are private and do not have to be disclosed, except to the tax authorities (and possibly also to a lending bank). These must be prepared according to accepted accounting principles and practice, but need not conform to all the requirements of accounting standards. Similarly, the financial statements of a business partnership are private and do not have to be disclosed.
- ❖ The financial statements of a company must be disclosed to all the shareholders of the company, and company law might require that the statements should also be filed with a government agency, where they can be accessed and read by any member of the general public. Companies whose shares are traded on a major stock market make their financial statements generally available to the public, often on the company's web site.

1.1 Classifications of economic activity based on occupation

Economic activities of individuals can be categorised by occupation and described using the following headings:

Profession/vocation;

Employment; and

Business.

Profession/vocation

A profession is an occupation involving the provision of a personal service of a specialised nature, based on a professional education, training and experience in a specialised role. Professionals are members of a professional body and work to professional standards and a code of ethical conduct set by this body. Many professionals provide services to a client, in return for a fee. (Some professionals choose to work for an employer, in which case they are employees. Some professionals establish their own business, in which case they come in the 'business' category of economic activity.)

The main features of a profession are:

A profession can be described as an occupation for which the individual has to acquire a special knowledge and skill.

Professionals are usually paid a prescribed 'fee' to render their services. Most professionals are regulated by a professional body, which frames the code of conduct to be followed by members of the profession, for example, the Institute of Chartered Accountants of Nigeria (ICAN).

Professionals typically acquire specialised knowledge from polytechnics, universities and specialised institutes such as the Institute of Chartered Accountants of Nigeria.

Professionals often establish their own firm and charge a fee for services rendered. Alternatively, professionals may opt for a paid job as an employee of an organisation.

The regulatory body has the authority to discipline any professional member that breaches the code of conduct of the regulatory body (e.g. ICAN). Where such a member has been licensed, the license can be withdrawn depending on the gravity of the offence committed.

Employment

Employment involves the provision of a service by an individual to an employer, under a contract of employment, in return for a wage or salary. The employer decides what activities the employee should undertake, and the employer follows the rules of conduct set by the employer.

The main features of employment are:

A person (known as an employee) works for another (known as an employer).

In return for the labour rendered, an employee receives a salary (usually paid monthly) or wages (usually paid on a daily or weekly basis).

There is usually an employment contract which binds both the employer and employee and a breach by either party permits the other party to take legal action for the enforcement of his/her legal right.

When employment specifies the acquisition of specialist skills or technical knowledge, a certain level of basic or technical education is expected.

The motive for seeking employment is to secure assured income by virtue of wages and/or salaries.

Either party can terminate the contractual relationship giving adequate notice as specified in the contract of employment.

Business

Individuals may establish their own business. A business is an organisation that is concerned with the production of goods or provision of services with the objective of making a profit. Businesses are classified into different types, such as industrial businesses, trading businesses and businesses that assist industrial and trading businesses, such as transport and warehousing, banking and insurance, advertising and so on.

The main features of business are:

The major objective of business is to make profit. This is considered important for the survival and growth of the business.

Business is an activity where a person engages in manufacturing or selling of goods and/or services.

The transaction must be continuous to be regarded as business. A single transaction is usually not treated as a business activity. For example, if a person sells his old television at a profit, this would not be regarded as a business activity. However, where he engages in selling television sets on a continuous basis, this shall be regarded as business activity.

Business involves the investment of capital before its commencement and regularly as may be required for the survival and growth of the business. Every business involves an element of risk.

Comparison of business, profession and employment

The following table distinguishes between business, profession and employment.

Basis	Business	Profession	Employment
Qualification	No specific qualification is required to commence a business	Certified professional knowledge is essential	Determined by the employer and specified in the job specification
Nature of work	Manufacturing, purchasing and supply, sale of goods and services	Rendering highly skilled and professional services	Performance based on job analysis
Establishment	Compliance with registration procedures and commencement	Membership of a specified professional body is required	Contract of employment usually forms the basis of employment
Capital	Capital investment	Capital investment	Zero capital

investment	is the bedrock of business and the amount required will be determined by the nature of operation and the size of the business	is required but not significant in most cases	investment
Returns	Profit	Professional fee	Wage or salary
Motive	The motive of business is to make profit	The motive is to render service and charge fees	The motive is to serve as a means of livelihood

Benefits and drawbacks

All three types of economic activity have their benefits and drawbacks.

Professionals and individuals in other specialised vocations contribute specialised skills, and in following the rules of their profession they contribute value to clients and individuals by providing service of a high standard. Some professionals contribute significantly to society and the economy; for example doctors and nurses contribute to the wellbeing of society and accountants support business by providing information. However, some professional tasks may be criticised for contributing little value to the real economy, whilst creating considerable personal wealth for the individuals concerned: for example, some aspects of banking and auditing may be criticised in this way.

Most businesses need employees to carry out their operations. Employment is therefore at the heart of the business economy. However, most employees do what they are asked to do by their employer, and do not contribute entrepreneurship to the economy. A growing economy needs entrepreneurs and innovation to sustain its growth.

Businesses provide entrepreneurship. They are also the source of much of the real value created by an economy. A criticism of businesses, however, is that many businesses have owners who do not contribute directly to the activities of the business. Shareholders of companies, for example, may not be involved in the activities of their company; but they benefit from the profits that the business makes.

2 Stakeholders of business organisations

Section overview

- Definition of a stakeholder
- Internal stakeholders
- External stakeholders
- The main stakeholders
- Stakeholder mapping: Mendelow's power/interest matrix
- Stakeholder conflicts of interest

2.1 Definition of a stakeholder



Definition

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 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:

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

2.2 Internal stakeholders

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

- ❖ Shareholders
- ❖ executive directors and senior managers
- ❖ other managers and current employees.

It might be appropriate to divide management and employees into sub-categories, where there are groups with differing interests and concerns. For example, managers and employees in different divisions of the company or in different functional departments might have different interests and concerns.

Shareholders/owners

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:

- ❖ Falling profits and a falling share price
- ❖ Lower dividend payments
- ❖ A proposal to invest in a major project where the business risk is high
- ❖ 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. All shareholders might be able to express their displeasure by voting against the directors at a general meeting of the company, although their rights and powers are restricted by company law.

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.)

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:

- ❖ their remuneration, which consists of basic salary, pension rights, cash bonuses and share incentive schemes
- ❖ power and status
- ❖ career prospects
- ❖ 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:

- ❖ pay
- ❖ working conditions
- ❖ job security
- ❖ job satisfaction
- ❖ quality of life.

2.3 External stakeholders

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

- ❖ lenders
- ❖ suppliers
- ❖ government
- ❖ customers
- ❖ local communities
- ❖ the general public, including special interest groups and pressure groups
- ❖ non-executive directors.

Lenders

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.

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

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

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

Government

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

- ❖ Businesses pay tax on profits, so government has an interest in company profitability.
- ❖ The government should want to create and maintain a strong economy. This depends partly (or largely) on new investments by business. Government might therefore want to encourage business investments.
- ❖ The government should want to achieve low levels of unemployment. Businesses are major employers.

- ❖ 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. The significance of the customer for marketing and business strategy will be explained later in this text.

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 shutdown by a major employer in an area has a knock-on effect for other businesses, which will lose trade and income.

Local communities may be interested in the impact of the business operation on the environment and ultimately on the health and economic wellbeing of the immediate environment.

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:

- ❖ public health, especially in the case of food manufacturers and manufacturers of drugs and medicines
- ❖ protection of the environment, reducing pollution, and creating 'sustainable businesses'
- ❖ corruption in business practices (such as bribery)
- ❖ the exploitation of the consumer through mis-selling and misleading descriptions of goods
- ❖ 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:

- ❖ they bring experience and knowledge to the board that they have gained outside the company, and which executive directors often do not have
- ❖ 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 (NEDs) 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.

2.4 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:

- ❖ is not a decision-maker, or
- ❖ is not a part of the permanent (full-time) infrastructure of the organisation, but
- ❖ 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:

- ❖ non-executive directors
- ❖ employees
- ❖ key suppliers
- ❖ 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: the power comes from an external source	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.

Source of power: the power comes from an external source	Example
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.
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.

Source of power: the power comes from an internal source	
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.
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.

2.5 Stakeholder mapping: Mendelow's power/interest matrix

The managers of a business organisation should manage its stakeholders, particularly those with the greatest influence. Stakeholder mapping is a technique that can help senior managers to assess their main stakeholders, and consider what should be done (if anything) to win the support of particular stakeholders for particular decisions.

One approach to stakeholder mapping is to evaluate each stakeholder group using a 2 × 2 matrix. One such matrix is a stakeholder power/interest matrix. This is sometimes called a Mendelow matrix, named after the person who 'invented' it.

The matrix can be used to identify the position of each group of stakeholders in a matter affecting the organisation. The matrix compares:

- ❖ the amount of interest that the stakeholder has in a particular issue, on a scale ranging from not at all interested (0) to very interested (+10), and
- ❖ the relative power of the stakeholder, on a scale from very weak (0) to very powerful (+10).

Interest of the stakeholder

		<i>Very low</i> (0)	<i>(5)</i>	<i>Very high</i> (10)
Power of the stakeholder	<i>Weak (0)</i>	Minimal effort	Keep informed	
	<i>(5)</i>	Keep satisfied	Key players	
	<i>Strong (10)</i>			

The recommended approach to dealing with the stakeholder group is indicated in each quadrant of the matrix. The key stakeholders are those who have considerable power or influence, and also a keen interest in the matter or decision that management is considering.

- ❖ If a stakeholder has very little power and very little interest in a matter, minimal effort is needed trying to keep the stakeholder informed or satisfied about the matter.
- ❖ If a stakeholder has very little power but a strong interest in a matter, the appropriate way to deal with them is to keep them informed about what is happening and why. The stakeholder should be kept informed even if they oppose what the organisation is doing.
- ❖ If the power of a stakeholder is strong but the stakeholder has very little interest in the matter, it is important to keep the stakeholder satisfied. It is essential to avoid any course of action that will increase the stakeholder's interest, and persuade the stakeholder to exercise its power.
- ❖ The most significant stakeholders are those with a large amount of power and a high level of interest in a matter. These stakeholders are key players and it is essential to obtain and keep their support.



Example: Mendelow 1

The board of directors of a major company wants to make a takeover bid for another company. Stock market rules require that the agreement of the shareholders must be obtained before any such takeover can go ahead.

In this situation, the shareholders are stakeholders with large power and a high level of interest. Clearly, the board of directors must ensure that they win the full support of the shareholders so that the takeover will go ahead.



Example: Mendelow 2

The directors of a company are planning to shut down an operations centre, because it is losing money.

The employees who will be made redundant or transferred to other jobs within the company are a stakeholder group that probably has relatively little power to affect the shutdown decision. However, their interest in the matter is strong. The directors should keep the employees fully informed about developments, what the company is planning to do, and how this will affect each employee personally.

2.6 Stakeholder conflicts of interest

The objectives of stakeholders differ, but need not be in direct conflict with each other. For example, shareholders want to receive a good return on their investment. This need not conflict with the objective of executive directors and senior managers to earn high remuneration, especially if their remuneration is performance-related. Employees want a secure job, good pay and good working conditions: these objectives are not inconsistent with the objective of making profits. Customers want value for the money they spend: business organisations make profits by meeting customer needs more successfully than competitors.

A business organisation is therefore normally able to meet many of the objectives of different stakeholders, provided that some compromises are accepted. However, in some exceptional cases, there might be a strong conflict of interests between stakeholder groups in a business organisation.



Example: Stakeholder conflicts of interest

The board of directors of a major company might set as an objective a 20% growth in annual profits. To do this, it might have to take the following measures:

- (a) reduce staffing levels and make a large number of employees redundant;
- (b) switch to different suppliers of key materials, who are able to supply the materials more cheaply because they use child labour;
- (c) increase output in a way that will substantially increase waste levels and carbon dioxide pollution.

In this example, the board of directors might face a strong conflict of interest with employees (about redundancies), the general public and customers (about buying from suppliers who use child labour) and the government, pressure groups and the public (about waste and pollution).

Avoiding serious conflicts of interest

A company's directors and senior managers should try to avoid serious conflicts of interest between stakeholder groups. One approach is to apply principles of good corporate governance and to recognise the corporate social responsibility of companies.

Corporate governance and corporate social responsibility are explained in a later chapter in this text.

3 Collaboration: Alliances

Section overview

- The nature of collaboration
- Collaboration and strategic alliances
- Collaboration and joint ventures
- Franchising
- Licensing
- Possible problems with collaboration: restricting competition

3.1 The nature of collaboration

In a competitive market, companies need to achieve a competitive advantage over competitors in order to succeed (and survive).

In some situations, companies might be able to achieve competitive advantage through collaboration with:

- ❖ suppliers or customers in the value network/value system
- ❖ other business entities in the value network
- ❖ some other competitors.

Collaboration with suppliers and customers can create additional value, in areas such as:

- ❖ product design: suppliers and customers might collaborate to improve the product design, by improving the design of product components or providing better raw materials
- ❖ delivery times: suppliers and customers might collaborate to improve the reliability and speed of delivery, for example through a just-in-time purchasing arrangement.

For example, if a supplier and purchaser collaborate on the supply of goods by allowing their IT systems to communicate, then the costs of ordering and supply will be reduced. Both parties can share in those savings and, additionally, switching costs are created which safeguard the supplier against competition.

The development of high definition (HD) television would not have been possible without co-operation between the manufacturers of televisions and media companies who will supply the programme content.

Finding ways of increasing value in the value network, through collaboration with other entities, has been discussed in an earlier chapter.

3.2 Collaboration and strategic alliances

Another way of trying to increase competitive advantage is to collaborate with other companies in the same industry, who might possibly be regarded as competitors. One form of collaboration is to create a strategic alliance.

A **strategic alliance** is an arrangement in which a number of separate companies share their resources and activities to pursue a joint strategy. By collaborating, all the companies in the alliance are able to offer a better product or service to their customers.

Examples of strategic alliances are in the airline industry where groups of airlines might form alliances in order to offer travellers a better selection of routes and facilities than any single airline could offer on its own. Strategic alliances have included Oneworld (British Airways, American Airlines and others) and Star Alliance (Lufthansa, Singapore Airlines and others).

The success of a strategic alliance depends on the members of the alliance not being in direct competition with each other. They are in the same industry, but serve different markets or market segments.



Example: Airlines

A strategic alliance of airlines enables the combined alliance to offer customers the ability to arrange journeys by air to and from most parts of the world with a single booking; however, the airlines do not compete on most routes.

A UK-based international airline might want to offer its customers linked flights from anywhere in the UK to anywhere in the US. Since it does not have a US flight network, it might enter into a strategic alliance with a domestic US airline. As a result of the alliance, it expects to be in a better position to compete against larger US airlines for transatlantic airtraffic.

A US domestic airline might want to offer its customers an all-in-one flight service from anywhere in the US to the UK. It can achieve this aim by forming a strategic alliance with the UK airline.

For example, a customer in the UK wanting to arrange a flight to a city in the US not serviced by British Airways might be able to book the journey through British Airways: the customer would then fly to the US on British Airways to New York and then switch to American Airlines for onward travel to the US city destination.

3.3 Collaboration and joint ventures

A joint venture is a formal venture by two or more separate entities to develop a business or an activity jointly. Many joint ventures are established in the form of a separate company which is jointly owned by the joint venture partners. No single partner being able to dominate and dictate the way that the company is run.

Joint ventures are frequently used for investing in a new business venture where:

- ❖ there is considerable risk
- ❖ large amounts of capital are needed
- ❖ a mix of skills is essential.

The joint venture allows the business risk and financing to be shared by the joint venture partners. The partners might be companies that compete in some markets of the world, but have agreed to collaborate in a particular venture.

Alternatively the joint venture partners might be companies in different markets, and do not compete with each other directly; however each partner brings special skills to the venture that will help to give it a competitive advantage.

When multinational companies are seeking to expand by investing in a different country, they might seek to do so by establishing a joint venture with a local company. There are several advantages in entering a foreign market in an alliance with a 'local' company.

- ❖ It might be a legal requirement for foreign companies setting up business in the country to operate as a joint venture with a local company.

- ❖ The local company management should have a better knowledge of business conditions and practices in the country.
- ❖ It is probably easier to succeed by forming an alliance with a local company than in competition with local companies. For example, the government might be a major customer, and it might have a policy of favouring domestic companies when it makes its purchase decisions.
- ❖ The local company might already have customers to which the new joint venture can sell its products.

Difficulties can arise with joint ventures, and lead to the eventual break-up of the partnership. This can happen when:

- ❖ one joint venture partner is perceived (by the other partners) not to be contributing adequately
- ❖ one joint venture partner wants to withdraw from the venture, or the joint-venture companies start to compete with each other instead of collaborating.

3.4 Franchising

Some business entities have been able to grow through franchising. This is another form of collaboration. The basic idea of a franchise is that a company develops a product with the following features:

- ❖ It is a standard product (or range of products), delivered to customers in a standard way.
- ❖ It has brand recognition, achieved through advertising and other sales promotion.
- ❖ Systems for delivering the product to customers are standardised (using standard equipment, and standard work practices).
- ❖ Customers want to buy it.

The most well-known examples of franchise operations are some of the fast-food restaurant chains, such as McDonalds. The company that originates the product, the franchisor, protects its patent rights or intellectual property rights over the product. It then sells the concept to franchisees who pay for the right to open their own store and sell the branded product.

- ❖ The franchisor supplies the product 'design' and the right to sell the product. It also provides a centralised marketing service, which includes extensive advertising and brand promotion. It also supplies other support services, such as business advice to franchisees.
- ❖ The franchisee pays for the franchise, and in addition pays a royalty based on the value of its sales or the size of its profits.

By buying into a successful franchise, a franchisee suffers much less risk than would be experienced setting up a business from scratch and can benefit from extensive marketing by the franchisor.

The franchisor receives a constant inflow of cash from new franchisees, as the operation expands, and is therefore able to grow by selling its business concept to a large number of other businesses, sometimes worldwide. Additionally, their head office is kept small because there is considerable delegation of day-to-day management to the franchisee.

However, the franchisor will always want to protect its brand name and to present a consistent appearance to its customers. This means that franchise agreements have very extensive rules governing franchisees' behaviour and they will also supply the products. Many franchisees find these rules and the monopoly supply of products very restrictive and frustrating.

3.5 Licensing

In a typical licensing agreement, a licensee is given permission by the licensor to make goods, normally making use of a patented process, and to use the appropriate trademark on those goods. In return the licensor receives a royalty. The licensee is exposed to relatively little risk and goods can be made wherever the licensee is located.

3.6 Possible problems with collaboration: restricting competition

The purpose of collaboration should be to gain competitive advantage in a market. However, it should not seek to create unfair restrictions on competition.

Governments in countries with advanced economies are generally in favour of 'free' competition in their national markets (and in international trade), although there are many exceptions to this general rule. When it has a policy of encouraging competition in markets, a government will seek to discourage actions by companies that will distort or reduce competition in their industry and markets. They might do this by making some forms of anti-competitive behaviour illegal.

In the UK, for example, the government seeks to ensure that there is sufficient competition in domestic markets so that consumers get a 'fair deal'. Some industries have special regulatory bodies, whose responsibilities include ensuring that the consumer is protected. For industries generally, the Office of Fair Trading is responsible for identifying cases where fair competition might be at risk and referring cases to a Competition Commission for investigation.

The UK's Competition Commission might be asked to investigate:

- ❖ a market, where the Office of Fair Trading suspects that competition is being prevented or restricted by anti-competitive behavior.
- ❖ a proposed merger or takeover (or merger that has already occurred), where it is suspected that a consequence of the merger will be a significant reduction in competition
- ❖ competition in a regulated industry, such as electricity, gas, water, telecommunications, postal services, broadcasting, airports and air traffic.

Firms within an industry might seek to reduce the strength of the competition, in order to increase their profitability. There are several ways of reducing competition; some of them illegal.

Cartels

A cartel is an arrangement between the rival firms in an industry to operate the same policies on pricing. By operating a price cartel, the firms are able to charge higher prices than if they competed with each other, and as a result make higher profits. Provided that the cartel includes all the firms in the industry (or at least all the major firms), they are able to exercise supplier power.

Price cartels are often illegal within a country, although an example of a successful major price cartel is the powerful Organisation of the Petroleum Exporting Countries (OPEC).

4 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Identify and explain the different objectives and legal forms of organisations
- Describe with examples the main categories of stakeholder
- Explain the different classifications of economic activities: profession/vocation; employment and business, and state the merits and demerits of each of these
- Explain how organisations collaborate in alliances to achieve competitive advantage.

Business and organisational structure

Contents

- 1 Types of business organisation
- 2 Basic concepts of organisation and management structure
- 3 Functional departments in business organisations
- 4 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

A	Business processes and environment	
	1	Nature of business, types and objectives
	c	Identify and explain the various business functions
	2	Business and organisational structures and choices
	a	Explain the basic characteristics and purposes of the following organisational structures:
		i Centralised
		ii Decentralised
		iii Matrix and mixed
		iv Networks
		v Virtual arrangements
	b	Explain the advantages and disadvantages of each of the organisational structures listed above.
C	Management and organisational behaviour	
	1	Basic management functions
	a	Give various definitions of management
	2	Management, individual and organisational behaviour
	a	Explain the nature and significance of formal and informal organisation

Exam context

This chapter continues the theme of the first chapter in introducing more fundamental business concepts. In this chapter students will learn about different types of business structure, basic concepts of organisation and management structure, levels of management, decentralisation and centralisation. The chapter closes with a description of each of the main functions found in a business.

By the end of this chapter students will be able to:

- Identify and describe the different types of business structures including entrepreneurial, functional, divisional, matrix, boundary-less, virtual and network;
- Explain the main advantages and disadvantages of each of these organisational structures;
- Explain the basic concepts of organisation and management structure including span of control, authority and responsibility, scalar chain, outsourcing, offshoring and shared services;
- Define centralisation and decentralisation and explain the advantages and disadvantages of each;
- Briefly describe the main business functions including research and development, purchasing (procurement), operations, marketing, administration and finance.

1 Types of business organisation

Section overview

- Formal and informal organisation
- Organisation structures
- Entrepreneurial organisation
- Functional organisation (departmental structure)
- Divisional organisation
- Matrix organisation
- Boundaryless and virtual organisation
- Network organisation

1.1 Formal and informal organisation

Every large business entity and not-for-profit entity has both a formal organisation and an informal organisation.



Definition: Formal organisation

A formal organisation is the organisation structure that has been created and maintained by its leaders. It can often be shown as an organisation chart, with job descriptions.

In addition to the formal organisation structure, there is also an informal organisation. This develops over time, but can change as some people leave the organisation and new people enter it.



Definition: Informal organisation

An informal organisation is a network of personal and social relationships. It develops from the way in which individuals meet and communicate with each other. They develop friendships and personal relationships, and they talk to each other as individuals rather than simply as other employees who are required to do a job. The focus of an informal organisation is people, not the work.

In an informal organisation, individuals begin to identify themselves with groups and these groups develop common rules of behaviour and normal ways of doing things ('norms').

The significance of informal organisation

When an informal organisation is strong, it may become just as significant as the formal organisation. Managers might need to consider how the informal organisation affects behaviour at work – and work practice – and try to manage it.

For example, there might be a formal procedure for doing a particular task. However, a group of individuals with strong interpersonal relationships might find a different way of performing the task, which is easier or more acceptable than the formal procedure.

The informal organisation might also affect attitudes to work – whether a group of individuals are keen to complete a task on schedule, or do a job well, or agree to work overtime, or whether they are collectively hostile to management and working conditions.

- Informal organisation can therefore support the formal organisation, and help to make working practices more efficient and effective.
- On the other hand, informal organisation might sometimes conflict with the formal organisation, such as when a group of employees are hostile to their work and their managers.
- Managers might try to make use of a positive informal organization by formalising some aspects of the informal structure, for example by changing work procedures or the methods used for communication.

1.2 Organisation structures



Definition: Organisation structure

'Organisation structure' is the framework within which the activities of people within the organisation are co-ordinated and managed.

Common forms of business organisation structure are:

- an entrepreneurial structure
- a functional (departmental) structure
- a divisional structure
- a matrix structure
- a boundaryless structure

1.3 Entrepreneurial organisation



Definition: Entrepreneurial organisation

An entrepreneurial organisation is managed by its entrepreneurial owner.

The main features of an entrepreneurial organisation are usually as follows:

- The entrepreneur-leader takes all the main management decisions, and he does not delegate decision-making to other people. He is closely involved in the day-to-day operations of the business.
- There is no formal management structure. Individuals report directly to the entrepreneur-leader, who tells them what to do.
- The entrepreneur-leader therefore dominates the organisation.
- The business operations are likely to be simple, because it is normally too difficult for a single person to manage a business whose operations are complex. For example, the business might make and sell a small number of products or may provide just one type of service to customers.

An entrepreneurial structure is often appropriate when a business is in the early stage of its life. In order to become profitable and grow, the business often needs a dominant personality to control it. As the business develops and grows larger, however, an entrepreneurial structure will become inefficient, and a more formal management structure/organisation structure is needed.

1.4 Functional organisation (departmental structure)



Definition: Functional organisation

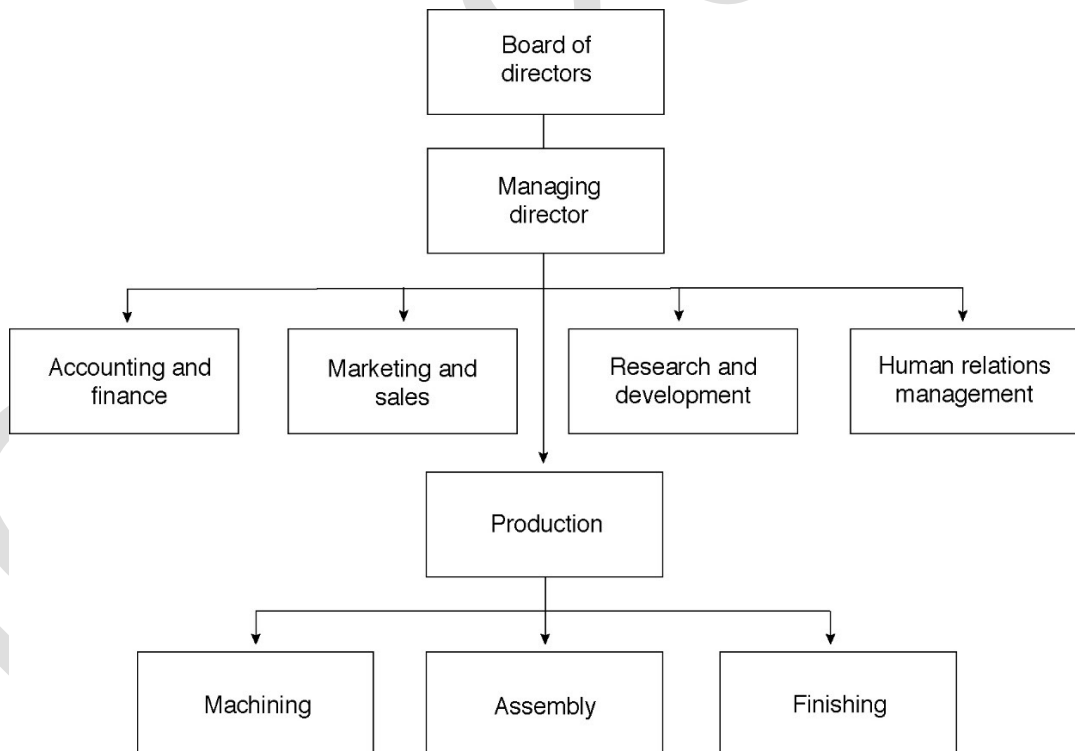
A functional structure is usually the next stage in the development of a business organisation as it grows in size. The organisation is sub-divided into specialist departments, with each department specialising in a particular type of activity ('function').

The nature of the functional departments varies according to the type and size of business. The functional departments in a manufacturing business might include buying (procurement/purchasing), manufacturing operations, sales and marketing, accounting, research and development, and so on.

Within each function, the organisation might be structured as different sub-functions. For example, the manufacturing department might have sub-departments for machining, finishing and assembly. The accounting department might have separate sections for book-keeping, cost accounting, payroll and internal audit.

Each function has its own management structure and its own employees.

A functional organisation structure can be shown in an organisation chart. A simplified organisation chart for a functional organisation is shown below.



Advantages and disadvantages of a functional organisation structure

A functional organisation structure has several advantages, but there are also disadvantages.

Advantages	Disadvantages
Specialist skills are concentrated into the same department, and employees in the department can become 'experts' in the work that they do.	When an organisation is divided into functional departments, 'head office' management has the task of co-ordinating the work of all the different departments.
Specialisation might improve efficiency, because specialists should be able to do their work more quickly than non-specialists.	Co-ordination of activities can be very difficult, especially in large and complex organisations. Problems with effective co-ordination are probably the most serious weakness of a functional organisation structure. For example, the completion of a project or a customer order depends on the work of several different departments, and no single function or functional manager has responsibility for the entire project or the customer order.
Specialisation should also improve the quality of the work that is done. Functional specialists should be capable of achieving more than non-specialists.	There is a risk that a functional organisation structure will encourage the development of bureaucracy, with too much emphasis on following rules and procedures.
When decision-making and other management responsibilities are delegated, a functional organisation structure is usually a sensible arrangement for businesses that are not very large.	Good communications are essential in order to co-ordinate functional activities effectively. However, each department might develop its own 'culture' and communication between departments might be poor. For example, scientists in the research and development department might find it very difficult to communicate with accountants. Production staff and sales staff might also have communication problems.
	An organisation structure based entirely on functional departments is probably inefficient when the business has widely-diversified products or services, and operates in a number of different countries or geographical regions.

1.5 Divisional organisation structure



Definition: Divisional structure

In a divisional organisation structure, the organisation is divided into a number of different divisions, sometimes called strategic business units or SBUs.

There are two main types of divisional structure:

- a **product division structure**: each division specialises in a different product or service (or range of products or services).
- a **geographical division structure**: each division sells the same products or services, but in different regions or geographical areas.



Example: Divisional structure

A manufacturer of motor vehicles might be organised on a divisional basis, with one division for motor cars and another division for trucks.

Similarly, a transport company might have separate divisions for bus travel services, railway services and air travel services. A postal services company might have separate divisions for letters and packages.

A geographical divisional structure is common in many multinational companies. For example, a manufacturer of soft drinks might have separate divisions for America, Europe, the Far East, Africa and Middle East and the Rest of the World.

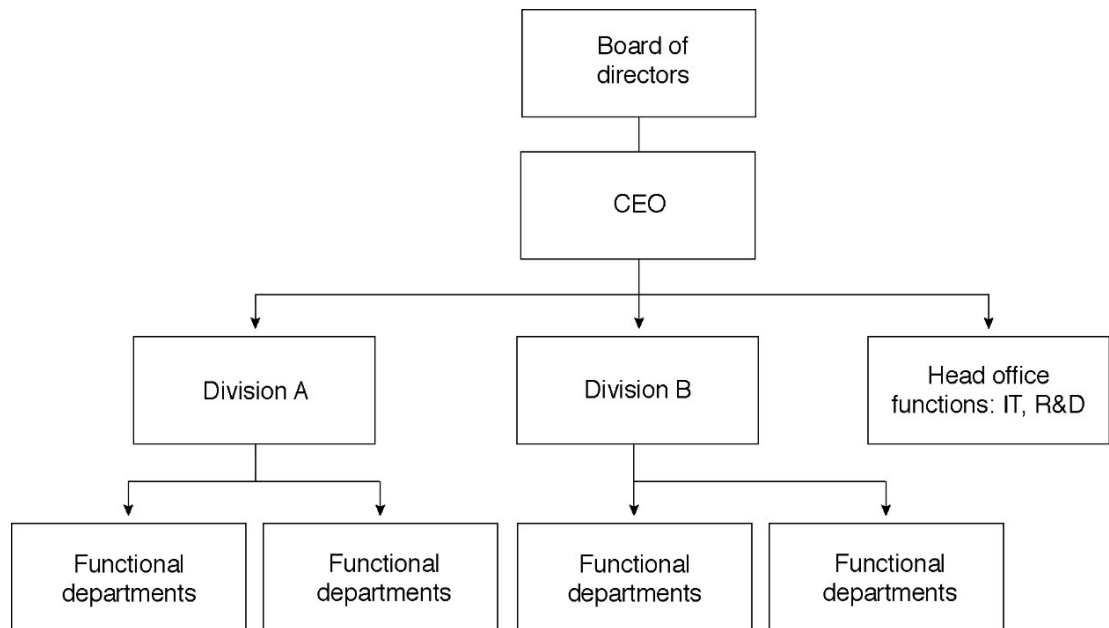
Authority is delegated from head office to the divisional management (led perhaps by a divisional managing director), and responsibility for the implementation of business strategy is mainly at divisional level.

The divisional managing directors usually have the authority to take many decisions without referring them first to head office.

Senior management at head office retain overall control of the business, and the divisional managing directors report to head office and are accountable to the senior management.

Each division usually contains its own functional departments, although some specialist functions might be centralised at head office. For example, a company with a geographical divisional structure might centralise research and development under the direct control of 'head office'. Similarly, in a company with either a product division structure or a geographical division structure, head office functions providing services to all divisions might include a corporate strategy department, a legal department, a public relations department, an information technology (IT) department, and so on.

A simplified organisation chart is shown below, for a divisional organisation with two divisions.



In practice, in large organisations each division is a company or a group of companies. 'Head office', which owns all the divisions, is called the parent company of the group. For the purpose of the examination, however, it should not matter whether divisions are all a part of a single company or whether they are separate companies within the same group of companies.

Divisional structures and responsibility for sales, profits, return on capital employed

Key features of a divisional organisation structure are that:

- A large amount of authority for decision-making is delegated to the management of each division.
- The divisional managers are accountable to senior management at head office, for the performance of the division.
- The performance of divisions is normally assessed in financial terms, such as profitability, return on capital employed and sales revenue.

Advantages and disadvantages of a divisional organisation structure

A divisional organisation structure is a form of decentralised organisation structure, in which some decision-making authority is delegated by 'head office' to local management who are closer to business operations. Divisional organisation, and a decentralised structure in general, has several advantages compared with a simple centralised functional organisation structure, but there are also disadvantages.

Advantages	Disadvantages
<p>Since most decisions are taken by the managers within each division, decision-making is usually quicker than in a similar organisation where decision-making is centralised at head office.</p>	<p>Each division has its own functional departments, such as sales and marketing and accounting. There is a risk that this duplication of functions will be more expensive.</p>
<p>Divisional managers are likely to be much more aware (than head office managers) of changes in the business environment for their product or geographical region. As a result, the organisation should be more capable of responding to new opportunities and new threats in the environment.</p>	<p>There might be a risk that head office will be larger than it needs to be, because most decision-making is done at divisional level. Head office might therefore result in unnecessary expense, unless it is reduced to a minimum efficient size.</p>
<p>The organisation can develop managers and employees with specialist knowledge and skills relating to their particular products or geographical area.</p>	
<p>Senior management at head office are able to control a diverse and complex organisation on the basis of the financial performance of each division.</p>	

1.6 Matrix organisation



Definition: Matrix organisation

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

It was suggested earlier that a weakness of functional organisation is that no single function has responsibility for a project when several departments are involved in the work.

The problem was recognised in the 1950s in the aerospace industry in the USA. Major projects and customer orders involved the design, manufacture and testing of aircraft and their different parts (engines, wings, fuselage and so on). Construction projects were often delayed by a failure in co-ordination between the different functional departments involved.

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 organisation or project management organisation was introduced to overcome the problem.

- Project managers were appointed with overall responsibility for individual projects or customer orders.
- At the same time functional managers, such as the management of engineering, production and sales and marketing, retained their authority and decision-making power.

In this way, a 'dual command' structure was created. In a matrix organisation, the traditional 'vertical' command structure based on functional departments has an 'overlay' of horizontal authority or influence. The project manager is responsible for co-ordinating the activities of the different functions. Horizontal relationships between individuals in different functions are as important as the 'traditional' manager-subordinate relationships within functional departments.

Some entities have developed a matrix organisation structure. The matrix organisation originated in the 1950s and 1960s, in entities where it was recognised that different functions within the entity needed to work closely together. Horizontal relationships across different functions were as important as the 'traditional' reporting relationship within functions.

A matrix organisation and a project organisation are similar in concept.

- With a project organisation, the project management comes to an end when the project ends.
- With matrix organisation, the matrix structure of authority and command is permanent.

An organisation chart for a matrix structure shows functional responsibilities in vertical columns, and cross-functional (project manager) responsibilities in a horizontal line across the different functions.

Functional managers	→	Production	Quality control	Design
Project managers ↓			↑ Responsible to quality control	
Project A				
Project B	←	Responsible to Project Manager B		Quality control expert
Project C				

In the diagram above, the person shown is a quality control expert and is responsible to the quality control manager for technical aspects of the job, maintaining quality systems and so on.

The person is also responsible to the manager of Project B. That manager will be concerned with completing the project in time, within the cost budget and to the proper standard.

Obviously conflicts can arise: the project manager might want to skip some tests to make up time, but the quality control department won't want to do that. Both can put the employee under some pressure. However the matrix structure should allow the employee to ask the two managers to discuss the problem, as it is plain that they are both involved.

Overall, matrix structures should:

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



Example: Matrix structure

Another example of matrix organisation is commonly found in universities.

A university has a traditional functional management structure. Within the teaching department there are functional specialisations for teaching, such as the engineering function, art and design function, business studies function, law school, and so on. Each teaching department has a head.

However, many courses at universities are multi-functional, and teachers for each course come from a number of different functional departments. For example, an accounting degree programme might use teachers from the business studies department, law faculty and economics department.

In addition to the functional management structure based on heads of faculty and heads of department, there is a course-based management structure in which individual lecturers are responsible for all aspects of a particular course or degree programme. For example, the course leader is responsible for obtaining and managing the teachers from different faculties or departments, finding the lecture rooms, marking the examinations, reporting absentee students to the administration department, and so on.

The main disadvantage of a matrix structure, however, is that it can be inefficient unless there is close cooperation and communication between the different managers. Individuals may get confused when they have to report to two different managers, especially when those managers cannot agree what the individual should be doing.

1.7 Boundaryless and virtual organisation

Boundaryless organisation



Definition: Boundaryless organisation

Many companies find that a flexible and unstructured approach is effective in running a company

A boundaryless organisation has an unstructured design. It is not defined by, or limited to, the horizontal, vertical, or external boundaries imposed by a predefined structure.

The approach was pioneered by Jack Welch the former chairman of General Electric who wanted to eliminate vertical and horizontal boundaries within the company and break down external barriers between the company and its customers and suppliers.

Boundaryless organisations may have the following features:

- Extensive use of teams who are given the authority to make decisions.
- Electronic rather than face-to-face communication. This allows teams to be built without geographical barriers.
- Removal of boundaries associated with such departmentalization, and organisational hierarchy.

Boundaries can be removed using virtual, modular or hollow organisational structures.

The virtual organisation



Definition: Virtual organisation

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

A virtual organisation is operated by means of:

- IT systems and communications networks – normally telephone and e-mail
- business contacts for outsourcing all operations.

Many small businesses operate as virtual organisations. For example, a house builder might operate his business from his home. When asked to build a new house, he can hire all the labour – 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 organisations, and marketing activities might be outsourced to an external agency.

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

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

Digital technology makes virtual organisation possible. However, because it has no tangible identity, it can lack culture, and people who work for a virtual organisation may not have strong loyalty towards it. Many may even work for several employers. This is a potential weakness, for example, of car ride hailing companies such as Uber.

Modular organisation

A modular organisation is often involved in manufacturing. They commission suppliers to produce parts of a final product. The modular organisation assembles these parts into the final product.

Hollow organisation

A hollow organisation is one which brings other corporations together. It does not manufacture, distribute or advertise goods or services. It simply exists to link other organisations that perform these functions.

An example of a hollow organisation is one which buys products from a manufacturer and uses independent distributors to deliver the product to the customers. It may call upon the services of a market research company, advertising agency and may even contract in its sales team.

1.8 Network organisation



Definition: Network organisation

A network organisation is a collection of autonomous units or firms that behave as a single larger entity.

Similar to virtual organisations, IT and communications are important for coordinating activities to maintain the shared brand.

The entities comprising a network organisation are normally legally independent entities, although not always. Some may be wholly owned subsidiaries.

Many of the global accountancy firms including PricewaterhouseCoopers, Deloitte, KPMG and Ernst & Young are in fact network organisations. These global organisations are groupings of numerous individual partnerships all sharing the same branding, codes of ethics and working practices.

Networks can be a very effective way of getting separate organisations or individuals to collaborate towards a common goal. However, as they are independent of each other, there may be problems with coordination. One part of the network may have only limited influence over what another part of the network is doing, especially when the other part of the network is in a different country.

2 Basic concepts of organisation and management structure

Section overview

- Separation of ownership and control
- The direction and management of a business
- Span of control
- Authority and responsibility
- Scalar chain
- Outsourcing and offshoring
- Shared services
- Strategic, tactical and operational management
- Centralisation and decentralisation

2.1 Separation of ownership and control

There is a separation in companies between the owners and the individuals who exercise effective control. In companies, control is exercised by the board of directors. In large companies, the major shareholders are investors and responsibility for directing and managing the company is given to the directors.

The board of directors are responsible for achieving the objectives of the company, and they should be accountable to the shareholders for the performance of the company under their leadership. In practice, accountability to shareholders takes the form (mainly) of presenting an annual report and financial statements, and possibly other reports, to the shareholders.

2.2 The direction and management of a business

Business organisations have both directors and managers. In some businesses, the directors and managers are the same people. This happens for example in many entrepreneurial businesses and business partnerships. However, directors and managers need not be the same individuals. The distinction between direction and management is perhaps most easily understood by looking at large companies.

Direction

The direction of a company is the responsibility of the board of directors, under the 'leadership' of the company chairman. A board of directors should have a list of matters that are reserved for its own decision-making that should not be delegated to the management of the company. The matters reserved for decision-making by the board should be those that are concerned mainly with **giving direction to the company** and **ensuring that its broad strategic objectives are achieved**. Many decisions at a **strategic level** are taken by the board, although strategy implementation is delegated to the company's management. They should include the following:

- Setting the strategic objectives for the business;
- Deciding the major business strategies;
- Making the more important investment decisions, such as approving major capital expenditure projects and major new acquisitions of other companies;

- Making any decision to withdraw from a market or shut down the production of a major product;
- Deciding any major new financing initiative, such as a new share issue or major borrowing programme, and setting total borrowing limits for the company;
- Deciding dividend policy.

The directors are accountable to the shareholders of the company for the direction they have provided, and for the success or failure of the company in achieving its strategic aims. They are also responsible to the shareholders for the overall management of the company.

Communications between a company and its shareholders are channelled through the board of directors or individual members of the board, such as the company chairman.

Management

Management is responsible for the operational activities of their organisation. Managers are also called 'executives'. They make strategy decisions that have been delegated to them by the board, and are also responsible for all decision-making at a tactical and operational level (unless operational decisions have been delegated even further to non-management employees). Management is therefore responsible for implementing the strategic decisions of the board of directors.

The leader of the management team in a company is usually the chief executive officer or CEO, who is also a member of the board of directors.

The term 'managing director' is also used in smaller companies. In large companies with a divisional structure, there may be a managing director for each division or strategic business unit (SBU) and the CEO is the overall head of the management team.

Separation of direction from management

In large companies, particularly large stock market (public quoted) companies, there has been a separation of direction from management, and the different responsibilities of the board of directors and the executive management team have been recognised.

- Some directors are also executive managers, and they have responsibilities for both the direction and management of their company. In large companies, for example, it is usual for several executive managers to be company directors, including the CEO and the finance director.
- However, some directors are not managers of the company. They are **non-executive directors** or NEDs, appointed from outside the company. The role of a non-executive director includes attending board meetings and some other committee meetings, but the role is not full-time. Typically, a NED might commit about 30 days each year to the company.
- The **company chairman** is often a non-executive and part-time appointment.

It is argued that executive directors have strong personal interests in their company, which provides them with most of their annual income. There is a risk that their decision-making could be affected:

- partly by the desire to protect personal interests and
- partly because they might have a narrow view of the strategic position of the company, since they spend most of their time working in it.

Independent non-executive directors can improve the strategic decision-making by a board, and help to give better direction to the company. This is because they do not have strong self-interest in the affairs of the company, and they can use their external experience and knowledge to contribute positively to strategic discussions at board meetings.

2.3 Span of control



Definition

The span of control refers to the number of subordinates for whom a manager is directly responsible and over whom the manager has authority. For example, if a manager has six subordinates who report directly to him, the span of control for that manager is six.

In an organisation structure, or in the organisation structure for a particular function or department, there is often a similar span of control for managers at the same level in the management hierarchy. For example, if a Grade 3 manager in the marketing department has four subordinates, it is often the case that the span of control for all managers at Grade 3 level in the marketing department is about four.

It is therefore often possible to describe an organisation structure as one that has either:

- a narrow span of control, where managers have only a small number of direct subordinates, or
- a wide span of control, where managers have a large number of subordinates reporting directly to them.

In the diagram A below, the span of control is 3, which is narrow. In diagram B, the span of control is 8, which is much wider.

Diagram A: narrow span of control

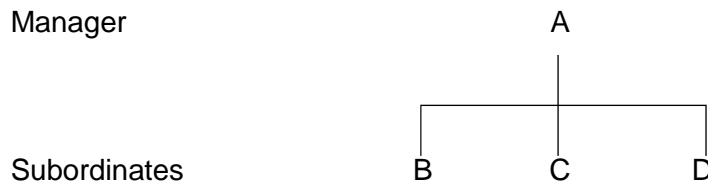
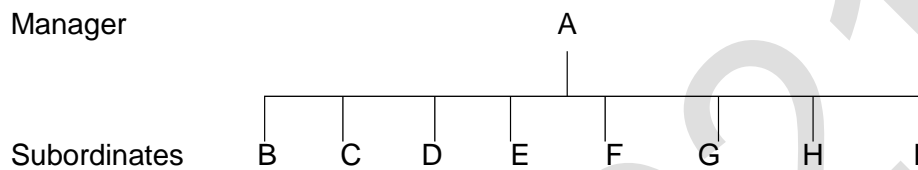


Diagram B: wider span of control



In some operations, the span of control might be very wide. For example, a supervisor in a telephone call centre might be directly responsible for a large number of call operators ('customer service staff').

Factors affecting the size of the span of control

When the span of control is narrow, a manager can spend more time with each subordinate, providing guidance and leadership, or monitoring the work that they are doing. A narrow span of control might therefore be associated with close supervision and management control over individual subordinates.

Alternatively, when the span of control is narrow, managers can spend less time on supervising subordinates and more time on technical work or other management tasks such as forecasting and planning.

When the span of control is wide, managers do not have as much time to spend with each individual subordinate. However, subordinates often take up much of a manager's time: the manager needs to give work to each subordinate and discuss operational problems, consider training and development for each subordinate, give performance reviews, discuss disciplinary matters or personal problems that the subordinate wants to resolve (such as arranging holiday dates or reporting grievances). The manager might have insufficient time for other responsibilities, such as planning and forecasting.

Several factors influence the most appropriate size of the span of control for a manager.

- The size of the organisation. In very small organisations, the span of control will be narrow because the number of employees is limited.
- The complexity of the work and the knowledge required to do the work. When the work is complex, or there is a high risk of mistakes by subordinates, a manager should give each subordinate a reasonable amount of time and attention, and should try to apply close control over the quality of the work. A narrow span of control might therefore be appropriate. When the work is fairly simple, a smaller amount of supervision is required and the span of control can be much wider.

- ❑ The geographical spread of employees. When employees are spread over a wide geographical area, the span of control should not be so wide that a manager spends most of his time travelling between the different locations where the subordinates are working, because excessive travelling time is often a waste of valuable management time.
- ❑ The type of individuals and the culture of the organisation. When employees are highly skilled and highly motivated, they can often be left to get on with their work without too much supervision. Responsibility for much of the decision-making might also be delegated to these individuals, making a wider span of control appropriate. However when employees lack confidence and are uncertain about what they should be doing, close supervision and a narrow span of control is more appropriate.

In some organisations, there is a culture in which employees are encouraged to use their initiative and make their own decisions, without having to wait to be told what to do. In these organisations a wider span of control is appropriate, compared to an organisation in which there is a culture of authoritarian management.

Disadvantages of a wide span of control and a narrow span of control

The disadvantages of a wide span of control and a narrow span of control are summarised in the following table.

Disadvantages	
Wide span of control	Narrow span of control
Manager spends much of his time managing people, and has not enough time for other responsibilities.	Supervision and control over subordinates might be excessive. Subordinates are not given as much decision-making authority as when the span of control is wider.
The manager might have insufficient time to spend with individual subordinates.	When the span of control is narrower than it needs to be, there will be an excess number of managers. This is inefficient and expensive.
Communication between a manager and a subordinate is likely to decrease as the span of control widens.	Close supervision might be demotivating for subordinates.

2.4 Authority and responsibility

Authority and delegation



Definition

Authority is the ability to give orders or guidance to others, and to expect the orders to be obeyed or the guidance to be followed.

In formal organisations, managers are given authority to make decisions relating to a certain area of the organisation's activities. Authority is delegated from top management. In a traditional bureaucracy, authority is delegated down the management hierarchy or line of command (the scalar chain).

The authority of managers is also associated with power. Managers in a position of authority also have power over the individuals who work for them, through the ability to reward or punish individuals, and through their control over resources of the organisation (such as control over spending decisions).

According to 'classical' management theorists of the early 20th Century, managers in a bureaucracy have a right to command others that comes from the authority they have been given, and individuals have a duty to obey the instructions of their manager.

A more modern view of management is that managers have authority delegated to them, but that they should exercise their authority through good communications with their employees, and through personal qualities of leadership.

Although management authority comes from delegation and the position of the manager in the organisation, individuals may exercise authority in other ways, such as:

- personal authority (the respect of others for the individual) or moral authority
- expert 'power'. An individual might have authority over others through the recognition by others of the individual's particular expertise or skills.

Responsibility and accountability

Responsibility is the duty of a manager to carry out the tasks and achieve the goals for which he or she has been given the delegated authority.

- Individuals should be responsible for the use of the authority that is given to them.
- Responsibility is exercised through accountability – a manager having to account for his performance to his or her superior, and to explain any poor performance or failure to carry out his responsibilities properly.

As stated earlier, one of Fayol's principles of effective and efficient organisation and management related to authority and responsibility.

- An individual should not be held responsible and accountable for aspects of work over which he has no authority.
- Authority can be delegated to subordinates, but responsibility cannot be delegated. A manager remains responsible to his own boss for the activities and performance of his subordinates.



Example: Authority

Authority has been given to the head of a sales and marketing department to manage the selling and marketing activities of the organisation. He has been given sales targets to achieve for the entire company. There are three sales regions, each with its own regional sales manager. These regional managers have authority over selling activities within their region and have sales targets for the region. The South Area sales region is divided into four sales areas, each with an area sales manager who has authority over selling activities within the area and who is given area sales targets.

Authority is delegated from the top management of the company to the head of the department. Authority is delegated further to the regional managers and then to the area sales managers.

The area sales managers should be held accountable for the sales that are actually achieved in their area, but should not be held responsible or accountable for sales in any other sales area. Responsibility and accountability should be matched with authority.

Although authority is delegated to the area sales managers, each regional sales manager should be accountable to the head of department for the sales in the entire region. Similarly, although authority has been delegated to each regional sales manager, the head of department is accountable to senior management for the sales of the company as a whole. This is because although authority is delegated, responsibility is not delegated.

2.5 Scalar chain

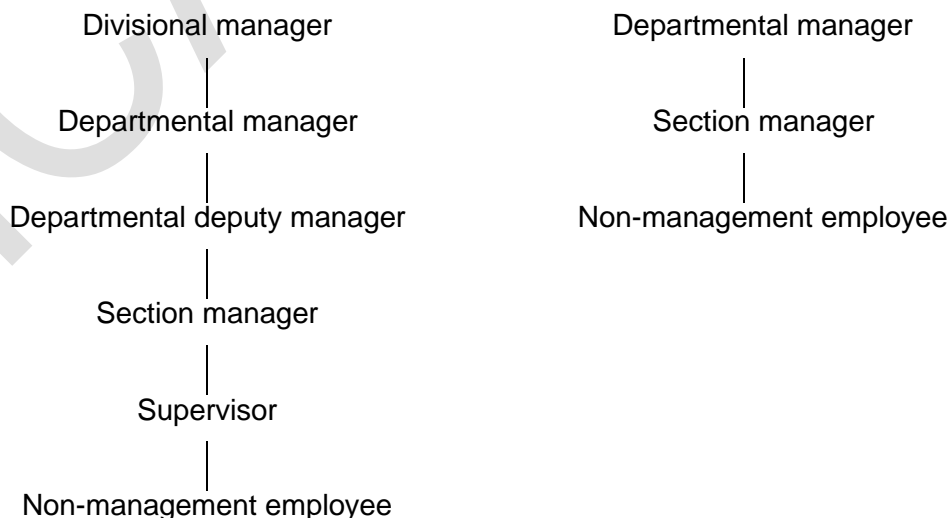


Definition

The scalar chain describes the number of different reporting levels through which communications are passed and decisions are passed in an organisation.

In a bureaucratic organisation, the scalar chain refers to the number of levels in the management hierarchy, between the most senior managers at the top of the organisation and ordinary employees at the bottom.

Two examples of the scalar chain are shown below.



The scalar chain in the example on the left is longer than the scalar chain in the example on the right, because there are more levels of management between the top and the bottom of the organisational hierarchy.

- The scalar chain might be described as the line of command within an organisation, through which senior management issue their instructions. For example, a divisional manager might give directions to a departmental manager, who then gives instructions to his deputy, who instructs a section manager who gives directions to a supervisor, who then instructs an employee.
- The scalar chain might also be described as the management structure that is used to delegate authority from senior management down to more junior management levels.
- It is also useful to think of the scalar chain in terms of formal communications and information flow within an organisation. Information can flow both ways, from senior management down to employees, but also up from junior management levels to more senior management.

Tall and flat organisations

Organisation structures might be referred to as being 'tall' or 'flat'.

- A tall organisation is one in which the scalar chain is long, and there is a large number of levels in the management hierarchy.
- A flat organisation is one in which the scalar chain is short, and there is only a small number of management levels.

The appropriate length of the scalar chain

The length and nature of the scalar chain should be appropriate to the particular business organisation, and should be neither too long nor too short. The purpose of an organisation and management structure should be to create an efficient and effective organisation, in which communications are effective.

- The scalar chain should normally be short in a small business organisation, because there should be no need for many levels of management in an organisation with only a small number of employees.
- In any organisation structure with several levels of management, the managers at each level in the organisation should be able to justify their existence. The salaries they are paid (and the other costs they incur) must be justified by the benefits they provide to the organisation.

The table below lists the disadvantages of having more or fewer levels of management in a large business organisation.

Disadvantages of tall organisations	Disadvantages of flat organisations
Communications between the top and bottom of the organisation might be poor. Information from top to bottom, or from lower levels up to the top, might be ineffective, slow or even non-existent.	In a flat organisation structure, there are fewer opportunities for career development through promotion. It might therefore be difficult to attract and retain talented young managers.
Senior management can become remote and far-removed from the business activities.	The business might rely too much on a small number of key individuals in the management structure.
The remoteness of senior management can create an 'us-and-them' attitude amongst non-management employees and junior managers.	There might be a lack of adequate supervision and control. This is because in a flat organisation, the span of control might be wide.
Managers at middle levels in the hierarchy might not add value. Their cost might exceed the benefits they provide to the organisation.	If there are not enough managers, there is a risk that the activities of the business will not be properly planned, co-ordinated and controlled.
Decision-making can be slow, where the decisions are considered at every level in the management hierarchy before they are implemented.	
There might be too many people managing a task that one individual could manage.	
It is more difficult to delegate decision-making to employees, and to 'empower' employees in a tall organisation.	

2.6 Outsourcing and offshoring



Definition: Outsourcing

Outsourcing is the practice of contracting work out to a third party supplier. Companies do this to take advantage of specialist external expertise to free up management time to concentrate on core activities. For example, a national food retail company might outsource its delivery work to a specialist transport company.



Definition: Offshoring

Offshoring means moving work and jobs outside the country where a company is based. A company might do this to take advantage of lower wages in the destination country or to take advantage of other incentives.


Definition: Offshore outsourcing

Offshore outsourcing describes what happens when a company contracts work out to a third party based overseas. The company supplying the outsourced services might be able to take advantage of lower pay rates in their home country and this would enable them to tender for the outsourced work at a lower fee than a company in the original country.

The following table compares the three approaches:

	Outsourcing	Offshoring	Offshore outsourcing
Involves	Contracting work out to an external organisation.	Assigning work to a facility in a different country.	Contracting work out to an external organisation in a different country
Advantages	Allows companies to take advantage of expertise. Frees up management time to concentrate on core competences	Cost reduction Access to a global talent pool.	Cost reduction Access to a global talent pool.
Disadvantages	Loss of control over the process Loss of in-house expertise (Companies often outsource low risk administrative activities that have little strategic significance, e.g. payroll).	Bad publicity for transferring jobs to other countries. Other risks include political risk, language differences and poor communication etc.	Bad publicity for transferring jobs to other countries. Other risks include political risk, language differences and poor communication etc.
Involves	Contracting work out to an external organisation.	Assigning work to a facility in a different country.	Contracting work out to an external organisation in a different country
Advantages	Allows companies to take advantage of expertise. Frees up management time to concentrate on core competences	Cost reduction Access to a global talent pool.	Cost reduction Access to a global talent pool.

2.7 Shared services



Definition

Shared services refers to the provision of a service by one part of an organization or group where that service had previously been found in more than one part of the organization or group. Thus the funding and resourcing of the service is shared and the providing department effectively becomes an internal service provider

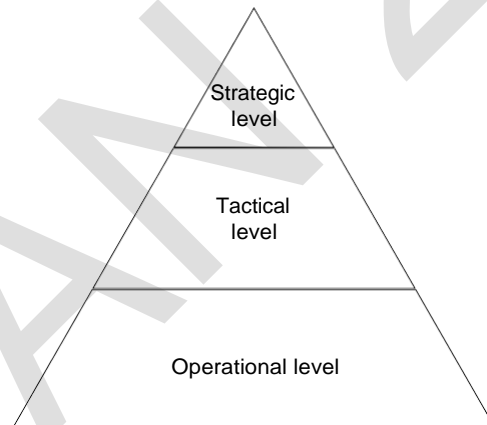
The shared service approach allows for a concentration of expertise and removal of duplication of effort. Shared services often include, accounting, human resources and treasury function.

2.8 Strategic, tactical and operational management

The decisions taken by managers within a business organisation can be categorised into levels. Robert N Anthony identified three levels of management activity:

- strategic level
- tactical level
- operational level.

He described these three levels of management as a hierarchy, with the strategic level at the top and the operational level at the bottom.



This diagram also indicates that decisions at the highest level (strategic decisions) are fewer in number or frequency than tactical decisions, as the most common type of management decision is taken – on a daily basis – at the operational level.

Strategic level

At the strategic level, management is involved mainly in setting objectives and policy-making for the organisation as a whole. At the strategic level, management is concerned mainly with the long term.

Business strategy should evolve continually, and new strategies should be developed to meet changing conditions in the business environment and product markets. However, large businesses usually have a repetitive cycle of strategy management that involves:

- Stage 1: strategic position analysis
- Stage 2: making decisions about strategic objectives and corporate strategy
- Stage 3: making decisions about business strategies to support corporate strategy
- Stage 4: implementing the strategies that have been selected.

Strategic position analysis involves a study of the business environment and how it is changing, to identify any threats or opportunities that might be emerging, and how these might affect future strategy. It also involves a study of the competition in the entity's markets, and the strengths or weaknesses that the entity has in relation to its competitors. One of the purposes of strategic position analysis is to recognise the competitive strengths ('competitive advantage') that the entity enjoys and should exploit.

Strategic objectives should be selected after a position analysis has been made. For a business organisation, selecting strategic objectives involves deciding on the products or services that the organisation should be providing and the markets in which it should operate, in order to obtain a suitable financial return.

Having decided the strategic objectives, decisions have to be made about **suitable business strategies** for achieving those objectives. For example, a company that has decided on a strategy of growth in a particular market or industry should then consider the most suitable strategy for achieving growth – internal development of the business, acquisitions of other companies or strategic alliances with other companies.

Decisions must then be made about how the chosen business strategies should be implemented. For example, a strategy of growth by acquisition will require a plan for financing the acquisitions, and implementation of the strategy will involve raising the finance required to make the acquisitions.

Tactical level

Strategies are usually long-term in nature, covering a period of several years. Strategic plans have to be converted into detailed plans of action, which are much more short-term in outlook.

Anthony suggested that below the strategic level of decision-making, there is a tactical level. At the tactical level, management is responsible for the formulation of plans and policies and for establishing standards.

If a strategic plan covers the next five years, tactical planning is concerned with the detailed plans of how to achieve the five-year targets, with particular emphasis on the next year or two. Examples of tactical plans include:

- annual budgets
- setting annual sales targets
- planning the activities needed to launch a new product on to the market.

At a tactical level, managers are also responsible for achieving the tactical planning targets, such as annual performance targets. There should be a system of regular performance reporting, so that actual performance can be compared with the planned targets, and targets can be compared with revised forecasts of what is now expected to happen.

Operational level

At an operational level, managers are involved with the detailed planning and control of operational activities. Operational plans are generally fairly short-term in nature, and include scheduling work. Control at an operational level might include supervision of employees and the inspection of finished work.

Levels of management and the organisation structure

Anthony's three levels of management are identifiable within large organisations as 'top management', middle management' and 'junior management and supervision'.

The roles associated with senior, middle and junior management can be broadly differentiated as follows.

Senior managers and top managers	Middle managers	Junior managers and supervisors
Set the organisation's objectives	Involvement in short-to-medium term plans	Work assignments within a fairly limited area of operations
Forecast and plan for the medium-to-long term	Functional responsibilities	Technical direction of work activities
Decide strategy	Co-ordination of activities of subordinates	Short-term planning
Establish policies	Co-ordination with other work groups and functions	Efficiency control, quality control, control of waste, avoiding unnecessary spending
Approve annual financial plans (budgets)	Monitoring and control	Measuring results, reporting to middle managers
Organise resources on a 'global' scale for the organisation	Reporting to senior management	Employee discipline and morale
Provide leadership and create the organisation culture		
Represent the company at a senior level		

These lists are indicative of what managers do at each level, but the lists are not comprehensive.

Although it is possible to link management levels with positions in a management hierarchy, this is not always what happens in practice. In smaller organisations, there might not be a middle management level. In an entrepreneurial

organisation, there might be just one manager, the owner of the business. When there is just one manager, management decisions at all three levels must be taken by the same person.

2.9 Centralisation and decentralisation

The terms 'centralisation' and 'decentralisation' refer to the extent to which authority within an organisation has been delegated.

- ❑ In a centralised organisation, a large amount of authority and decision-making responsibility is retained at the 'centre' of the organisation. This usually means that top management retains many of the control and decision-making powers.
- ❑ In a decentralised organisation, most authority and decision-making responsibilities have been delegated to others at a 'lower level' in the organisation. Top management allow others to make decisions, but monitor their performance and provide leadership.

There are different degrees of centralisation and decentralisation, ranging from the total centralisation at one extreme (where all decisions are taken by the top person) to total decentralisation at the other (where very few decisions are taken by top management).

Computer systems can support either a centralised or a decentralised management structure.

- ❑ In a centralised management structure, computer networks make it possible for information collected at lower levels of the organisation, or in distant geographical areas, to be accessed by managers at 'head office'. They can then use this information to make informed management decisions.
- ❑ In a decentralised management structure, information held on central computer files or databases can be accessed immediately by managers anywhere in the organisation, to help them with their decision-making.



Example: Decentralisation

With decentralisation, there is less need for a large management team at head office. An extreme form of decentralisation is a company where the head office consists of a small administrative group supporting the company chairman and chief executive officer.

The board of directors retain responsibility for some strategic decision-making, but the authority for most strategic decisions is delegated to the managers of strategic business units (SBUs). Head office sets financial targets and other strategic targets for each division, but the SBUs operate independently. The head of each SBU is accountable to head office for the financial performance of the division.

Head office is responsible for preparing the financial reports and accounts for the company, and for presenting these to the company's shareholders.

Advantages of centralisation and decentralisation

The extent to which decision-making is centralised or decentralised depends partly on the attitude of senior management and their philosophy of leadership. In addition, the efficiency and effectiveness of an organisation can depend on where management decisions are taken and whether authority is centralised or decentralised.

There are situations where decentralised decision-making is needed, because immediate decisions have to be taken at a local level to deal with events as they happen in the business environment and in the market place. There are also situations where centralised control is needed to ensure that standards and procedures are applied in the same way across the entire organisation.

Advantages of centralisation can also be described as disadvantages of decentralisation. Similarly, advantages of decentralisation can also be described as disadvantages of centralisation. The table below sets out the advantages of centralisation, and compares these with the advantages of decentralisation.

Advantages of centralised decision-making	Advantages of decentralised decision-making
Centralised management decision-making might give senior management more control over the activities of the business, so that activities are co-ordinated more effectively.	Management at a local level are able to respond more quickly to changes in business conditions and events. Decentralisation is usually desirable in a fast-changing and unpredictable business environment.
Centralised management is more effective at applying standardisation of products and procedures across the entire organisation. This can be important in some industries.	When a business operates over a wide geographical area, some decentralisation is necessary because head office managers are too far from the business operations. A global business, for example, operates in many different time zones.
With a centralised management structure, managers at head office are able to apply a 'corporate view' to the entire business, such as a view of business ethics and standards.	When decision-making is delegated to lower levels of management, conditions might be more favourable for encouraging innovation.
A centralised management structure might be cheaper than a decentralised structure, because fewer managers might be needed.	Delegating decision-making to lower levels of management can help to develop junior managers with initiative and talent, and prepare them for future promotion to more senior management positions.
In a centralised management structure, it is possible to use specialised management support teams for the entire organisation, such as IT specialists and business planning /forecasting specialists.	Delegation of authority and decentralisation might be necessary to reduce the workload of central management at head office.

Advantages of centralised decision-making

Some centralisation of management decision-making is essential where the business is trying to promote a global brand image.

Advantages of decentralised decision-making

Delegation of authority to more junior levels can help to motivate junior managers, who have more authority and are able to use their initiative instead of getting instructions about what to do.

In a diverse and complex business, some delegation is essential because head office management cannot understand the entire business in sufficient detail to control it closely. This is a reason why divisional organisation structures developed

3 Functional departments in business organisations

Section overview

- The main business functions
- Research and development
- Purchasing (procurement)
- Operations function
- Marketing function
- Administration function
- Finance function

3.1 The main business functions

Most business organisations have a functional structure. Even divisional structures and matrix organisations use functional management structures. The number of different functions and the type of functions will vary with the nature of the business operations and activities.

Most large companies have some or all of the following functions:

- Research and development;
- Purchasing (procurement);
- Operations;
- Marketing;
- Administration; and
- Finance.

Outsourcing functional activities

These functions are usually carried out by specialist departments within the company. However, some functions might be 'outsourced' to a separate company. For example a company might outsource all its book-keeping and accounting to a firm of accountants that provides book-keeping services for clients. Some administration activities, such as cleaning services and security, might be outsourced to specialist companies.

3.2 Research and development

A company is likely to have a research and development function when it needs to **innovate**, and continually produce new or improved products (or processes or services). For example, pharmaceutical companies have research and development departments for developing new medicines. Food manufacturers use research and development to develop new food products or 'healthier' contents.

A distinction can be made between:

- Pure research;
- Applied research; and
- Development.

**Definition: Pure research**

Pure research (also called basic research) is experimental work or theoretical work whose aim is to acquire new scientific or technical knowledge for its own sake. Pure research is not directed towards any specific application or use.

**Definition: Applied research**

Applied research is original investigations to gain new scientific or technical knowledge that is directed towards a specific use or purpose.

**Definition: Development**

Development is the use of scientific or technical knowledge to produce new (or substantially improved) products, services or processes. If the development work is successful, it will lead on to the commercial launch of a new or improved product or service, or the introduction of a new process into operational use.

Pure research is often carried out in the scientific or engineering departments of universities or in government-owned laboratories. Research in universities might be sponsored partly or wholly by a commercial company. However, companies might have their own research and development department for both applied research and development.

**Example: Research**

A research laboratory might conduct original research into the link between salt in foods and heart disease in humans. This would be pure research, because there is no specific aim other than to acquire new scientific/medical knowledge.

A research department might conduct research into how to reduce the amount of salt in a food product without affecting the taste of the product in a way that people do not like. This would be applied research, because the aim would be directed towards the production of food products with a lower salt content.

A research department might use knowledge that has been gained about reducing the salt content in food products to develop a new low-salt tinned soup. This would be product development. If successful, the development work will lead to the introduction of a new soup product to the market.

3.3 Purchasing (Procurement)

The purchasing department in a large organisation (also called the buying or procurement department) is responsible for purchasing goods and services from external suppliers.

Provided that the annual value of purchases is sufficient to justify the cost, there are several advantages in having a specialist purchasing (procurement) department.

- The purchasing department is staffed by buyers who should have special skills in buying, such as knowledge of how to negotiate the terms of a purchase contract with a supplier, and how to arrange the shipment of goods from another country.

- ❑ The purchasing department should maintain a record of potential suppliers for all items. Buyers should therefore know which suppliers to approach to ask for a price quotation or negotiate a purchase order.
- ❑ When all purchase orders from a company go through the same department, it might be possible to negotiate 'bulk purchase' discounts on the purchase price for ordering in large quantities.
- ❑ Buyers have the responsibility for ensuring that purchase orders are met, and that suppliers deliver the goods or services on time and to the required specification. When there is no purchasing department, there may be no individual in the organisation with special responsibility for 'chasing up' late supplies or making complaints to suppliers.
- ❑ When there is a purchasing department, it deals with all purchase orders. This has the advantage of applying control over buying from external suppliers. It prevents managers in all the functional departments from making their own decisions to buy supplies whenever they want to, from suppliers of their own choice. This should improve purchasing efficiency and help to prevent wasteful spending.

The system for purchasing might vary between different organisations. Usually, however, the procedure for making a purchase of goods or services is as follows.

- ❑ The department wishing to make the purchase prepares a purchase requisition. For regular items of inventory, the purchase requisition comes from the stores department for a re-supply of the item that is now running out of stock. The purchase requisition might be generated automatically by the inventory control computer system.
- ❑ Other purchase requisitions for unusual and non-recurring items (e.g. capital items such as a new computer) might come from the department that wants the goods or services. These are requests for the purchase of specified items. Each of these purchase requisitions must be signed by a manager in the functional department who has the authority to approve the purchase.
- ❑ The purchasing department uses the purchase requisition as its authority to make the purchase.
- ❑ For standard items that are purchased frequently the purchasing department will agree long-term contracts with favourable delivery, credit and discount terms. Contracts are typically negotiated with a small number of trusted suppliers who appear on an 'approved supplier list'.
- ❑ For non-standard items such as capital items (e.g. a new computer) the purchasing department will employ a number of controls to ensure only items required for use in the business are purchased, and then only on the most favourable terms. Controls might include:
 - Extra more senior manager approval needed on the purchase requisition above a certain monetary limit to re-confirm item is required for use in the business;
 - Price quotations to be sourced from three separate suppliers;
 - Extra more senior purchasing manager authorisation required above a certain monetary limit before a final order is placed.

3.4 Operations function

Every business has an operations function. The nature of this function varies according to the nature of the business.

Manufacturing businesses

In a **manufacturing business**, the operations function is manufacturing (production) and related activities.

- A manufacturing function includes not only the activities directly concerned with producing the finished manufactured item from raw materials and components, but also support activities such as engineering and maintenance work, production planning and control activities, and quality checking, inspection of finished goods and quality control.
- In some businesses, pollution control and waste disposal might also be important aspects of operations.
- Manufacturing operations convert raw materials and components (many provided by external suppliers) into a finished product. At any time, there will be some inventories of raw materials and components that have not yet been used in production. These are held in a stores department that might also be a sub-function within operations.

There are often several stages in the manufacturing process, and the manufacturing function may be sub-divided into sub-functions for each of the stages or processes.

Some manufacturing businesses produce standard products. These standard products might be produced to meet specific customer orders. However, some of the finished items are transferred to a finished goods inventory, so that future customer orders can be met from existing stock.

Other manufacturing businesses produce non-standard items, to meet specific requests from customers. The non-standard items are made to specifications provided by the customer. Each customer order is treated as a separate 'job' or 'contract'.

Service operations

In a **service business**, the operations function involves the provision of the service to the customer.

- Some services involve the provision of a service to the customer by employees of the business. Other services such as the provision of a telephone service, or providing electricity, gas or water supply, do not involve employees of the business, except for installation and repair work.
- Services provided by employees of the business might be carried out at the customer's premises or at the premises of the business. For example, car repairs are carried out at the workshop of the business whereas a large amount of auditing work is performed at the premises of the client.

Direct service operations might be divided into sub-functions. For example, a firm of accountants might have sub-functions for auditing, tax consultancy and management consultancy.

3.5 Marketing function

The marketing function within a business organisation is sometimes called the sales and distribution department. The activities in the marketing function vary according to the nature of the business and the way that it sells its products or

services. For example, a chemical manufacturer sells its products to other manufacturing companies. Its marketing activities differ from those of a theatre company that sells its entertainment services direct to the 'general public'.

The activities that might be included within the marketing function include the following.

- ❑ **Direct selling.** Sales representatives might be employed to make sales direct to customers. Direct selling by sales representatives can be expensive, because the salaries, sales commissions and expenses of sales representatives might be high. Direct face-to-face selling is therefore used only for large-value items where a large profit can be made with each sale. Manufacturers of consumer goods, for example, use sales representatives to sell their products to retail companies such as supermarket companies and department stores. Some businesses use direct selling by telephone, rather than direct selling by visiting the customer.
- ❑ **Advertising and sales promotion.** Many businesses use advertising and sales promotions to market their products or services.
- ❑ **Distribution** (sometimes called outward logistics). Marketing usually includes the activities involved in delivering products to the customer. This might involve the physical delivery of goods to the customer by truck. For retail companies, distribution usually involves persuading customers to visit retail stores to buy goods; however, many companies now use the internet to sell goods or services, and arrange for delivery by courier or by post.

Marketing is described in more detail in a later section.

3.6 Administration function

The administration function in a business organisation carries out all the tasks that are not performed by the other functional departments. The term 'administration' is also used to describe several different functional departments in large business organisations.

Examples of the work performed by the administration function are as follows.

- ❑ **Administration relating to employees.** In many businesses, this work is performed by a human resources management department (HRM department). Some years ago, it was called the 'personnel department'. A business organisation must maintain employment records for each employee and arrange for the training of existing employees. The HRM department is also usually involved in matters such as recruitment and selection of new employees, and dealing with redundancies, disciplinary matters and claims of unfair dismissal by employees who have been dismissed.
- ❑ Ensuring **compliance with regulations.** Many countries have regulations relating to health and safety at work. An administration activity is to ensure compliance with any such regulations.
- ❑ **Facilities management.** This is a term used to cover a range of administrative issues, including arranging for the security of buildings and other valuable assets, office cleaning services and the purchase and maintenance of the motor vehicles of the business.
- ❑ **Arranging insurance.** Business organisations are required to arrange certain types of insurance. In the UK for example, there is a legal requirement to arrange employer's liability insurance, which provides insurance cover against the risk of claims by members of the public for

injury caused to them by its employees. There is also a legal requirement for any business to insure its motor vehicles and drivers. Some types of insurance are voluntary, such as insurance of business premises against fire and theft.

3.7 Finance function

The main part of a finance function in a business organisation is the **accounts department**. The accounting function is described in much more detail in a later chapter.

Large companies might also have a **treasury department** within the finance function. The role of a treasury function is to manage the company's finances. Activities of the treasury function include:

- making sure that the business has the money it needs to pay employees, lenders and suppliers on time and to finance new investments
- managing the cash of the business: this is often the responsibility of a chief cashier and cashier's sub-department
- obtaining new funds from the financial markets, including the negotiation of new bank loans
- investing surplus cash
- arranging transactions for the purchase of foreign currency (for example to pay for purchases from other countries) or sale of foreign currency (for example to convert sales income in a foreign currency into domestic currency).

4 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Identify and describe the different types of business structures including entrepreneurial, functional, divisional, matrix, boundary-less, virtual and network
- Explain the main advantages and disadvantages of each of these organisation structures
- Explain the basic concepts of organisation and management structure including span of control, authority and responsibility, scalar chain, outsourcing, offshoring and shared services
- Define centralisation and decentralisation and explain the advantages and disadvantages of each
- Briefly describe the main business functions including research and development, purchasing (procurement), operations, marketing, administration and finance.

Organisational culture in business

Contents

- 1 Organisational culture in business
- 2 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

C	Management and organisational behaviour	
	2	Management, individual and organisational behaviour
	b	Explain the role and importance of organisational culture

Exam context

The efficiency of an organisation depends to a considerable extent on its culture. This chapter describes the different types of culture that may exist, and how culture affects the way in which organisations operate. The chapter closes with a discussion on culture from an international perspective.

By the end of this chapter students will be able to:

- Define culture;
- Illustrate different cultural traits in business using the models of popular theorists Schein and Handy;
- Discuss international perspectives on culture using Hofstede's cultural dimension theory

1 Organisational culture in business

Section overview

- Definition of culture: Organisational, corporate and group culture
- The significance of culture for management
- Factors that shape organisation culture
- Edgar Schein: three levels of culture
- Corporate culture: the views of Handy
- Hofstede: international perspectives on culture

1.1 Definition of culture: Organisational, corporate and group culture

In addition to having informal organisation, business organisations (and other types of organisation) also develop a culture.



Definition: Culture

A culture is a set of dominant beliefs, attitudes, values and norms that is shared by a number of people.

Edgar Schein suggested that employees working within a company have shared values, beliefs and ways of thinking: these interact with the policies, organisation structure and politics of the company's management system to create a corporate culture. Culture affects the expectations of employees within the company about what the company should achieve.

Schein argued that organisation culture is strong because it is regarded as something that helps the company to succeed. An organisation culture is a set of assumptions that a group of people working together have invented, discovered or developed by learning how to deal with problems that the organisation faces, internally and in its external environment. These assumptions work well enough to be considered valid; they are therefore 'taught' to individuals who join the organisation. New entrants therefore learn the culture of the organisation and become a part of that culture.

- ❑ **Organisational culture** refers to a set of beliefs, values and attitudes that is shared by everyone in the organisation. Within an organisation, organisational culture defines 'the way we do things around here'. Peters and Waterman argued that the most excellent business organisations are characterised by particular cultural attitudes and beliefs.
- ❑ **Corporate culture** refers to the way in which organisations are **managed**. This is different from organisational culture, which is the set of values shared by all the employees. (However, the term 'organisational culture' is often used with the same meaning as 'corporate culture'.)
- ❑ **Work groups** might also have their own distinct culture. Within the same business organisation, there may be several work groups, each with a distinct 'sub-culture'. For example, the culture in the sales department might be very different from the culture in the accounts department, and both these cultures may differ from the culture of the research and development department staff.

Differences in organisational culture are probably best understood by looking at different organisations with which you are familiar. It is widely understood, for

example, that business organisations are driven by a different set of priorities and concerns than not-for-profit organisations. However, if you visit two different companies in the same industry, you will probably find very noticeable differences in culture – the way people talk to each other, the way they deal with outsiders, their priorities and concerns.

How does culture differ from informal organisation?

Culture is deeply embedded within an organisation, and a common culture might be shared by everyone in the organisation. When new individuals join an organisation, they are 'taught' the organisation culture and learn to adopt it. In contrast, an informal organisation is no larger than the individuals who interact socially at work and the nature of the informal organisation can change when individuals leave or join.

Because culture is deeply-embedded, it is very difficult to change.

1.2 The significance of culture for management

Edgar Schein, a writer on organisation culture, has written: 'The concept of culture is still misunderstood in organisations, being treated too much as a superficial phenomenon'. He also wrote: 'Culture is really a very deep phenomenon and ... if managers/leaders are serious about changing culture, they must make an effort to understand how culture really 'works' and what it really is.'

An understanding of the culture of work groups is 'essential to leaders if they are to lead' (Schein). Managers need to understand the culture of the group or groups that they manage. By understanding the group culture, they can try to influence it and encourage positive attitudes to work.

Schein wrote: 'Building an effective organisation is ultimately a matter of meshing different sub-cultures by encouraging the evolution of common goals, common language and common procedures for solving problems.' He was the first person to use the term 'corporate culture'. He believed that successful managers develop a positive corporate culture.

1.3 Factors that shape organisation culture

A combination of factors shapes the culture of a work group or an organisation.

- Formal structure and size. To some extent, the culture of an organisation is affected by its size and its formal organisation structure.
- Leadership. The leaders of an organisation can influence culture, for example by stating the values of the organisation, and its goals and strategies.
- Environment. Culture develops as a way of responding and reacting to the environment in which the organisation operates.
- Events. Culture develops as a result of many events, and how a group or organisation has responded to those events.

The cultural web

An approach to analysing corporate culture has been suggested by Johnson and Scholes. They have suggested that there is a **cultural web** within every organisation, which is responsible for the prevailing culture, which they call the 'paradigm' of the organisation.

The cultural web consists of six inter-related elements of culture within an organisation.

- ❑ **Routines and rituals.** Routines are ‘the ways things are done around here’. Individuals get used to the established ways of doing things, and behave towards each other and towards ‘outsiders’ in a particular way. Rituals are special events in the ‘life’ of the organisation, which are an expression of what is considered important.
- ❑ **Stories and myths.** Stories and myths are used to describe the history of an organisation, and to suggest the importance of certain individuals or events. They are passed by word of mouth. They help to create an impression of how the organisation got to where it is, and it can be difficult to challenge established myths and consider a need for a change of direction in the future.
- ❑ **Symbols.** Symbols can become a representation of the nature of the organisation. Examples of symbols might be a company car or helicopter, an office or building, a logo or a style of language and the common words and phrases (‘jargon’) that employees use.
- ❑ **Power structure.** The individuals who are in a position of power influence organisations. In many business organisations, power is obtained from management position. However, power can also come from personal influence, or experience and expertise. The most powerful groups within an organisation are most closely associated with the core beliefs and assumptions in its culture.
- ❑ **Organisation structure.** The culture of an organisation is affected by its organisation and management structure. Organisation structure indicates the important relationships and so emphasises who and what is the most important parts of it. Hierarchical and bureaucratic organisations might find it particularly difficult to adapt to change.
- ❑ **Control systems.** Performance measurement and reward systems within an organisation establish the views about what is important and what is not so important. Individuals will focus on performance that earns rewards.

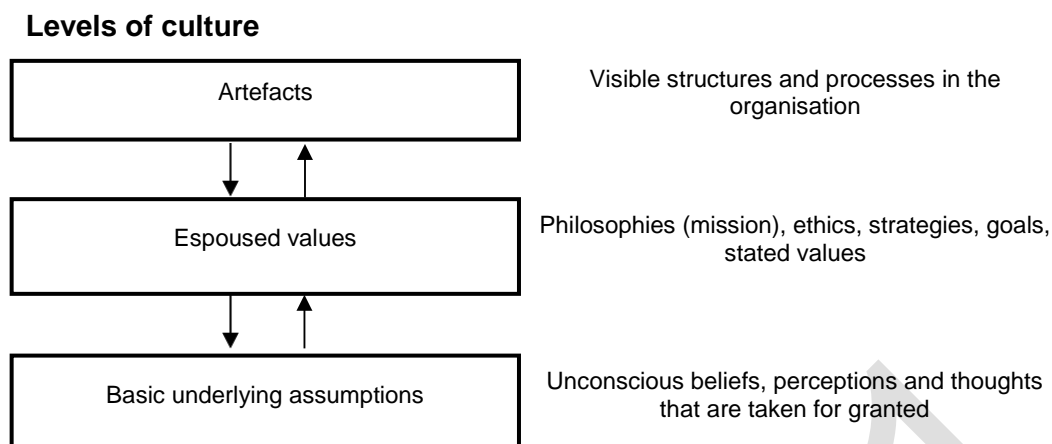
Together, the cultural web consists of the assumptions that are ‘taken for granted’ within the organisation as being correct, and also the physical manifestations of the culture.

1.4 Edgar Schein: three levels of culture

According to Schein, there are three levels of culture that members of an organisation acquire:

- ❑ The outer skin, or artefacts;
- ❑ The inner layer (or espoused values); and
- ❑ The paradigm (basic underlying assumptions).

These are inter-related and react with each other. However, aspects of culture, particularly artefacts, are often difficult to ‘interpret’ and understand.



The outer skin (artefacts)

At one level, the culture of a company is evident in what a visitor can see and hear by visiting the company.

- ❑ The facilities and surroundings in which employees work help to create culture. So too does the way that employees dress. For example, some organisations insist on office workers dressing formally. In others, even senior managers go to work in casual clothes, such as an open-necked shirt and jeans.
- ❑ Culture is also seen in the way that employees talk to each other and interact with each other. It can be heard in the language that individuals use when talking to each other, such as the use of 'jargon'.

The inner layer (espoused values)

A company might have a formal code of **ethical behaviour**, which is intended to shape the attitudes of all its members.

Stated values and **mission statements** are often expressed in general terms, such as 'providing a service to the community' and 'providing the best quality of service to customers'.

Culture might also be expressed in the goals and strategies of the organisation.

This level of culture can be influenced by the organisation's leaders.

The paradigm (basic underlying assumptions)

'Paradigm' is a term for the shared assumptions and attitudes about what really matters, that are taken for granted and rarely discussed. These affect the way that the organisation sees itself and the environment in which it operates, and is the real 'core' culture of the organisation. Unlike mission statements and codes of ethics, a paradigm is not written down, and it is difficult to identify or explain. The 'paradigm' has also been described as the reason why the organisation exists. A police force exists to catch criminals, and a school exists as a place for learning.

A paradigm has been defined (by Capra, 1997) as: 'a constellation of concepts, values, perceptions and practices shared by a community, which forms a particular vision of reality that is the basis of the way a community organises itself.'

Schein argued that changing corporate culture is very difficult. The 'outer skin' can be changed fairly easily, with a determined effort by management, but it is very difficult to change the paradigm.

1.5 Corporate culture: the views of Handy

Charles Handy (in his book *Gods of Management*) suggested that there are four different categories of corporate culture. He described these as cultural 'stereotypes':

- A power culture, also called a club culture and a spider's web culture
- A role culture
- A task culture
- A personal culture, also called an existential culture.

Power culture

In a power culture, there is one major source of power at the centre of the organisation. Power, authority and influence spread out from this central point, along functional or specialist lines, but control remains at the central point. Handy compared the power culture to a spider's web, with the spider at the centre controlling everything. Individuals closer to the centre of the web have more influence than individuals who are further from the centre.

A power culture is often found in small entrepreneurial organisations, where the boss is usually the founder of the business and also a dominant personality, who exercises close control over activities.

- A power culture is based on trust.
- The 'boss' maintains freedom of manoeuvre, and retains power, by writing very little down and relying on the spoken word.
- The 'boss' tries to influence other people through the force of his personality, and personal charm.

A problem with a power culture is that it depends on the character of the 'boss'. As an organisation grows in size, it becomes more difficult for one person to control everything. There is a risk that the organisation will become inefficient unless the corporate culture is changed. A power culture is therefore unlikely to be efficient for organisations of more than about 20 people.

Role culture

A role culture is probably the most readily-understood of the four corporate cultures. It exists in a bureaucracy, where the responsibilities of each individual are defined by the job that he or she has, the job definition and its position in the organisational structure. There is a traditional hierarchical structure to the organisation, and each job (role) has a specific function. The organisation relies on formal communications rather than informal communication.

A role culture has been compared with a pyramid of boxes, and each box has a job description. The boxes remain in place and the culture is unchanged when the individuals in the boxes leave the organisation and are replaced.

A role culture is probably best-suited to a large organisation in a fairly stable business environment, where employees are expected to do the job that they have been given, and where enterprise and initiative are relatively unimportant. People in organisations with a role culture are 'managed' rather than 'led'.

Task culture

In a task culture, the focus is on tasks and getting tasks completed in the most efficient and effective way, and the main aim is the successful solution of problems.

In a task culture, organisation is flexible. Work teams can be formed, disbanded when a task is completed, and then re-formed into new work groups to deal with new tasks. Individuals gain respect and authority from their knowledge and skills, rather than from their 'official role' within a work team. A task culture is typically found in project teams and development groups.

A task culture is well-suited to an organisation that is continually facing new problems and challenges. This is often found in rapidly-changing organisations and industries such as IT companies and knowledge-based industries. It is also found in building and construction companies. In these organisations, work groups are often formed to deal with a particular task, and disbanded when the task has been completed.

In a team culture, personal relationships matter, and individuals are 'led' rather than 'managed'.

Person culture

In a person culture, the entire organisation structure is built around one individual or a group of individuals. The rest of the organisation exists to serve the needs of the central individual. The culture is based on the view that the organisation exists to serve the talented individual or individuals.

It is unusual for an entire organisation to have a person culture, but small parts of an organisation might be structured in this way. Examples are organisations built around individuals in the sports or entertainment industries, small management consultancies, or parts of investment banks. Firms of lawyers (barristers in the UK) and small hospitals might also have a person culture.

In an organisation with a person culture, the central individuals may share some common resources, such as a small administrative support function. However, the individuals operate independently and have some dedicated support staff of their own.

Different cultures may exist in different parts of the same organisation. The culture of an organisation, or a part of an organisation, determines how it is managed, and how individuals within the organisation think and act.



Example: Handy

According to Handy's analysis of cultural stereotypes, which one of the following should be expected to adopt a task culture?

- (1) A government department with responsibility for collecting and publishing official government statistics.
- (2) The human resources management department in a large commercial bank.
- (3) The department of a consultancy firm that specialises in providing IT consultancy services to client firms.
- (4) A small fashion business that designs high-fashion clothes.



Answer

A task culture should be expected in (3), the department of a consultancy firm that specialises in providing IT consultancy services to client firms. The IT consultants are likely to work in teams, sharing their knowledge and expertise, to provide IT solutions for clients. The team members are likely to show respect for technical skills and experience among other team members, and there should be relatively little concern for seniority or job descriptions.

A role culture should be expected in both (1) and (2). The structure is likely to be hierarchical, with clearly defined job descriptions and responsibilities. This is certainly the case with a civil service department, but is also likely to occur in the HRM department of a large company such as a bank. Roles can be clearly defined. If individuals leave, the same position is easily filled by someone else to do exactly the same job.

A fashion business might have a task culture, where designers work in teams. However, it is more usual, especially in small firms, for the organisation to be dominated by the head fashion designer. Depending on the nature of the company, a fashion business might have a power culture (where the organisation is led by the entrepreneurial owner of the business) or a person culture, where the organisation is based on providing administration support to key persons (fashion designers).

1.6 Hofstede: international perspectives on culture

In the 1980s and early 1990s, Geert Hofstede added some useful views about the effect of national cultures on organisational culture. Hofstede argued that culture is a property of groups, not individuals. There is no such thing as individual culture. Culture is the collective programming of the mind that distinguishes the members of one group from the members of another group.

He argued that national cultures are different. As a result, the culture of business organisations in one country will differ from the culture of organisations in a different country.

Multinational companies face the challenge of trying to create a common organisational culture for an organisation that operates across national boundaries.



Example: Hofstede

Different national cultures mean that business practices that are considered perfectly acceptable in one country might be considered unacceptable in others. For example, the following business practices are acceptable in some countries but not in others.

- (a) Paying an adviser to discover loopholes in the tax laws, in order to avoid paying tax on business profits.
- (b) Inspecting the product of a competitor at a trade fair, and then developing a close copy as a rival product.
- (c) Paying a government official to speed up the completion of a bureaucratic procedure.
- (d) Giving a gift to the purchasing manager of a large company that buys your products.

Hofstede suggested that there are five dimensions to differences in organisation culture arising from differences in national culture.

- ❑ **Power-distance** dimension. This refers to the way in which power is dispersed within the organisation. When the power-distance dimension is low, this means that inequalities in the distribution of power within the organisation are minimised. When the power-distance dimension is high, inequalities in power are regarded as acceptable and those without power look to those with the power to make the decisions for the organisation. Writing in the 1980s, Hofstede suggested that the power-distance dimension was low in countries such as Sweden and New Zealand, and high in Latin American countries and in the 'Latin' European countries such as Spain and France.
- ❑ **Individualism versus collectivism** dimension. In some countries the interests of the individual come before the collective interests of the group. (Hofstede gave Australia and Canada as examples.) In other countries, concern for the group comes before concern for the individual. (Indonesia is an example.)
- ❑ **Uncertainty avoidance.** This is the extent to which a group feels threatened and endangered by unexpected and unfamiliar happenings. When a culture of uncertainty avoidance is high, work behaviour such as precision and punctuality are highly esteemed. (Hofstede gave Japan and South Korea as examples.)
- ❑ **Masculinity versus femininity.** In some countries there is a much stronger cultural acceptance of 'feminine' qualities such as modesty, intuition and quality of life, rather than aggressive 'masculine' qualities of aggressiveness and competitiveness. Hofstede gave the US and UK as examples of 'masculine' cultures.
- ❑ **Long-term orientation versus short-term orientation.** In some countries, there is a greater focus on short-term goals and short-term results, whereas in other countries there is a greater willingness to consider the longer term. Short-termism is a feature of organisation culture in the US and much of Western Europe.

2 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Define culture;
- Illustrate different cultural traits in business using the models of popular theorists Schein and Handy;
- Discuss international perspectives on culture using Hofstede's cultural dimension theory

The external environment

Contents

- 1 The nature of environmental influences
- 2 Political and legal factors affecting business
- 3 Macroeconomic factors
- 4 Microeconomic factors
- 5 Social and demographic factors
- 6 Technological factors
- 7 Environmental factors
- 8 International perspectives
- 9 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

A	Business processes and environment		
	3	The business environment	
		a	Explain the meaning and importance of the following:
		i	Globalisation/International business
		ii	Macroeconomic/National environment
		iii	Microeconomic/Markets and industries
		b	Explain the concept of environmental scanning, its methods and importance

Exam context

In this chapter you will learn about the external environmental factors that impact businesses. These are considered using a PEST (or PESTEL) analysis.

The external environment analysis is used to identify threats and opportunities for a business. A strategy can then be chosen that builds on a business's strengths whilst addressing its weaknesses.

By the end of this chapter students will be able to:

- Define the environment of an organisation and discuss how threats and opportunities can arise ('scan' the business environment');
- Explain how political and legal factors affect business;
- Explain how economic factors affect business including macroeconomic and microeconomic;
- Explain how social and demographic factors affect business;
- Explain how technological factors affect business;
- Explain how environmental factors affect business;
- Discuss international perspectives including globalisation.

1 The nature of environmental influences

Section overview

- The environment of an organisation
- The consequences of environmental change: threats and opportunities
- Understanding environmental factors

1.1 The environment of an organisation

The environment of an organisation is a term that describes anything outside an organisation that affects what it does or how it acts. There are many influences on an organisation that come from pressures and changes in its environment. These environmental influences differ according to the circumstances of the organisation.

Businesses should review the environment in which they operate, to identify changes that are happening or likely to happen, and to look for new business opportunities or environmental threats that might affect the business.

Monitoring the environment for changes, opportunities and threats is known as **environmental scanning**. It is an essential first step in strategic planning by business.

To provide a logical structure for analysing environmental influences and their effect on an organisation, it is often helpful to categorise these factors into different types.

One method of analysing environmental factors is to group them into four categories:

- P** – Political and legal factors
- E** – Economic factors
- S** – Social, cultural and demographic influences
- T** – Technological factors.

This method of analysing environmental factors is called PEST analysis.

(Concerns have grown over the last 20 years over the impact of industry on the physical environment, for example in terms of carbon footprint and use of resources. In modern analyses it is more common to use PESTEL analysis with “Environmental (Ecological)” being added and “Legal” given its own heading).

A second method of analysing the environment within which a firm operates is Michael Porter’s 5 forces model. This model identifies a firm’s industry as being a key aspect of its environment and attempts to take into account factors that influence attractiveness of different industries. This model is covered later.

1.2 The consequences of environmental change: threats and opportunities

Environmental factors can have a significant effect on a business organisation, and can affect its activities and profitability. Changes in the environment might affect the planning and other decision-making of a business organisation.

Management should monitor developments in the business environment, and should consider how the organisation should respond to changes and developments.

Environmental scan

PEST analysis involves considering all the environmental influences on the organisation, recognising which are the most significant, and deciding how the organisation should respond to these changes or developments. These influences can change over time. Understanding the environment should be an on-going activity.

This type of analysis is sometimes called an **environmental scan**.

When making an analysis of the business environment for an organisation, the initial task is to identify factors in the environment that create threats or opportunities.

- Threats.** These are factors in the environment that might prevent the organisation from achieving its business objectives.
- Opportunities.** These are developments that provide opportunities for the organisation, so that it can achieve its objectives more successfully.

Measures should be considered for reducing or removing significant threats.

1.3 Understanding environmental factors

You need to be aware of the influence of environmental factors on the activities of business organisations and how their decisions and actions can be affected by changes in the environment that provide threats or opportunities.

Environmental scanning is often associated with strategic planning and strategic information, although some awareness of the business environment is needed at all levels within an organisation.

This chapter describes some of the environmental influences on business organisations. You should understand, however, that it is impossible to provide a comprehensive description of environmental factors. They differ between organisations and according to circumstances.

Your understanding of the business environment can be improved by paying attention to news about political and legal developments, economic conditions, social changes and technological developments, and their potential effect on businesses.

2 Political and legal factors affecting business

Section overview

- The scope of political and legal influence on business
- Sources of legal authority
- Employment law
- Health and safety law
- Data protection law
- Competition law
- Law on contract and the sale of goods
- Consumer protection
- Responding to political and legal developments

2.1 The scope of political and legal influence on business

Politics and the law have an extensive influence in business affairs, and political decisions and changes in the law can affect just about any aspect of business activities. Multinational companies have the additional problem that because they operate in many different countries, their activities may be affected by political conditions and legislation in each of the different countries.

Here are just a few examples of political and legal factors that might affect business.

- ❑ **Nationalisation of industry and privatisation.** In some countries, industry is nationalised and owned wholly or partly by the state (the government). Occasionally, after a change of government, an incoming government decides to nationalise a business and take ownership of existing commercial business into ownership by the state. In other cases, a government might introduce a policy of de-nationalising an industry ('privatising the industry') and transferring ownership of state-owned businesses to commercial companies.
- ❑ **Transport and infrastructure.** Businesses rely on the transport system to move their goods (and employees), and the quality of the road transport system depends on the infrastructure of roads. Although the transport system might be operated by commercial companies, most of the road network and possibly also the rail network are state-owned. Government policy on transport and building roads or rail networks can have an important effect on business activity.
- ❑ **Education.** In most countries the government is responsible for most of the education system. Education policy affects the quality and skills of individuals who make up the work force of business organisations.
- ❑ **Environmental policy.** Business organisations might be affected by changes in the environmental policy of a government, such as policy to reduce levels of pollution in the air, water or land.
- ❑ **Taxation and subsidies.** Governments use taxation to raise income. They might also use taxation to influence behaviour, such as increasing tax on fuel in order to encourage a reduction in fuel consumption and increasing tax on the disposal of waste in order to encourage the recycling of waste.

Governments sometimes encourage particular activities by offering subsidies, such as subsidies towards the cost of particular skills training.

Here are some illustrative examples of how business can be affected by government policy and the law.



Example: Venezuela

Oil companies operating in the Orinoco region of Venezuela were required by the government to hand over majority ownership in their businesses to the state (the government).



Example: United States

A large shipment of corn to Europe from the United States was found to include genetically-modified corn. Although this was legal in the US, it was illegal in the European Union. The shipment had to be returned to the US.



Example: Nigeria

The *Nigerian Oil and Gas Industry Content Development Act 2010* ('the act') was introduced to increase indigenous participation in the oil and gas industry. The act prescribes minimum thresholds for the use of local services and materials and promotes the transfer of technology and skill to Nigerian staff and labour in the industry. The act also gives preferential treatment to all Nigerian companies operating in the industry.

At the time of writing similar legislation is being drafted to promote increased participation of Nigerian people and resources in the Nigerian construction industry (based on the above oil and gas act). The Local Content Bill for the Nigerian Construction Industry will help counter the dominance of foreign construction firms and supply chains in order to favour the use of Nigerian contractors, consultants, material and equipment suppliers.

2.2 Sources of legal authority

Business organisations need to recognise the different sources of legal authority that have the power to introduce changes in the law. The sources of legal authority vary between countries, but usually include the following:

- Supranational bodies
- National government
- Regional or local government that exercises some powers either because it has some independence from the national government or because some powers have been delegated to the regional government by the national government.

Supranational bodies

A supranational body is a body that has responsibility or oversight of more than one country. A supranational body in some cases has the power to impose decisions on a national government. To have the ability to impose its rules, a supranational body needs the formal support of national governments.

- In the European Union (EU), the member countries accept that legal measures introduced by the European Council must be introduced into the

national laws of each member country. (European Directives approved by the European Council must be incorporated in the national laws of each member country.) A supranational body such as the European Commission also has the power to impose certain decisions, including decisions relating to various business matters such as takeovers and monopolies.

- ❑ In West Africa the Economic Community of West African States (ECOWAS) has certain powers and influence over its constituent members (including Nigeria). The Council of Ministers enacts Regulations and Directives and makes Decisions and Recommendations. Regulations have general application and all their provisions are enforceable and directly applicable in Member States. Decisions are enforceable in Member States and Directives are binding on all Member States.
- ❑ The African Union (AU) is a larger and much newer organisation than ECOWAS representing over 50 African countries (compared to the 15 of ECOWAS). Whilst the AU includes a pan-African Parliament which aims to promote the coordination and harmonization of policies and laws of member states, the powers are not yet as onerous or binding (yet!) as those enjoyed by the EU or ECOWAS.
- ❑ In accounting, the International Accounting Standards Board is able to impose standard rules for financial reporting on companies in every country whose governments have agreed that these international accounting standards should be applied.
- ❑ Some supranational bodies attempt to influence activities in many countries but do not have the right to enforce their wishes. Examples are the United Nations and the World Bank.

2.3 Employment law

Each country has employment laws. The purpose of employment law is mainly to provide protection to employees against unfair treatment or exploitation by employers. Business organisations, as employers, are directly affected by employment laws. They need to be aware of the employment law in each country in which they operate, and understand the consequences of breaking the law or failing to comply with regulations.

Here are some of the aspects of employment law.

- ❑ **Minimum wage.** A country might have a minimum wage, which is the minimum hourly/monthly rate of pay that may be paid to any employee.
- ❑ **Working conditions.** A variety of laws and regulations might specify minimum acceptable working conditions, such as maximum hours of work per week or month. There might also be laws relating to a maximum retirement age and the employment of children. Working conditions are also covered by health and safety law, which is described in more detail later.
- ❑ **Unfair dismissal.** Employment law might give employees certain rights against unfair dismissal by an employer. In Nigeria and the UK, for example, an employee who is dismissed from work might bring a legal claim for unfair dismissal. The employer must then demonstrate that although the employee has been dismissed, the dismissal was not for a reason or under circumstances that the law would consider 'unfair'. When an employer is found guilty of unfair dismissal, it might be required to re-employ the individual who has been dismissed or (more likely) pay him or her substantial compensation.

- ❑ **Redundancy.** In many countries, dismissal of employees on the grounds of redundancy is not unfair dismissal, provided that discrimination is not shown in the selection of which individual employees should be made redundant. However, in the UK for example, law requires an employer to consider transferring an employee to another job before deciding that redundancy is unavoidable. (Failure to consider transferring employees to other work would mean that the dismissals for redundancy are unfair.)
- ❑ **Discrimination.** Some countries have extensive laws against discrimination, including discrimination at work. In the UK for example, employers can be held legally liable for showing discrimination against various categories of employee (or customer) and also for discrimination shown by employees against colleagues. There are laws against discrimination on the grounds of physical disability, gender, race, religion, sexual orientation and age.

Changes in any aspect of these employment laws could have significant implications for business organisations, especially those where labour costs are a significant proportion of total costs.

2.4 Health and safety law

Health and safety law provides rules and regulations about minimum health and safety requirements that employers must provide in their place of business and for their employees. Standards of health and safety law vary substantially between countries, although in countries with well-developed economies, health and safety standards are usually high.

Laws vary between different countries, and you should try to become aware of how the law applies in your own country. It is also important to recognise that health and safety regulations can impose significant requirements on employers, and the legal consequences of failure to comply with the regulations could be serious for the company or the directors, managers or employees responsible.

In the UK for example, employers are required by law to provide a safe place of work for their employees. A safe place of work is one where employees are not exposed to unreasonable physical dangers or unreasonable risks to health. In the UK, a safe place of work also means a place of work where employees are not subjected to discrimination or bullying. Risks to health and safety should be reviewed regularly, by means of formal risk assessments.

In addition to general laws about health and safety at work, there could also be detailed regulations specifying the minimum health and safety standards in particular types of industry or business, or particular types of business premises. For example, there could be specific minimum fire regulations for all buildings in which employees work. There could also be minimum health and safety regulations in particular industries, such as transport, food processing, building and construction and chemical processing.

There might also be voluntary health and safety codes that the government encourages but does not enforce as a legal requirement. In the UK, for example, there is a voluntary code of practice for employers aimed at reducing stress in the work place.

In a company, the board of directors has the ultimate responsibility for health and safety at work. Specialist health and safety officers might be employed by the company.

2.5 Data protection law

Some countries have fairly strict data protection laws. The purpose of data protection law is to **protect individuals** with regard to personal data about them that is held and used by other persons. Data protection legislation is designed to protect the private individual against others collecting, holding and using information about them without their permission.

Concerns about the adequacy of personal data privacy and data protection have become a widespread global issue, with companies collecting personal data about huge numbers of private data and using it or selling it on to other companies for personalised marketing purposes. Activities by major IT companies such as Google and Facebook have been a particular focus of concern.

As a result, some countries have introduced data protection legislation. It might be considered illegal, for example, that any organisation should be able to:

- gather and hold personal data about individuals without a justifiable reason, and
- make use of that personal data without the individual's permission.

Someone holding and using personal data about individuals should also be under a legal obligation to:

- make sure that the personal data is accurate, and
- ensure the security of the data, so that it is not made available to or accessed by any other person who does not have any right to have it.

Data protection laws apply to any person holding personal data about individuals. This includes business organisations, which hold personal data about employees and (often) customers.

In the European Union for example there are strict personal data privacy and data protection laws, known as the General Data Protection Regulation (2018). Under this legislation, anyone holding personal data about individuals must register this fact with a government department, and provide details of the type of information they hold and the reasons why it is used.

Organisations that hold and use personal data about individuals are required to comply with regulations relating to how the data is gathered, stored, kept secure from unauthorised access and used. Failure to comply with the regulations could expose an organisation to legal action by the individual concerned and/or the authorities.

In Nigeria, there is some protection for data privacy in the Constitution (section 37) which provides for the right to "protection of privacy of citizens, their homes, correspondence, telephone conversations and telegraphic communications." Some specific legislation for certain industry sectors also includes data protection rights for customers (such as the NCC Consumer Code in the telecommunications industry and the Credit Reporting Act in the credit industry. In spite of this, the use of personal data without individuals' consent for commercial purpose has been common, and individuals in Nigeria have had no effective rights in relation to their personal data and how it is collected, processed and used commercially.

However, at the time of writing, a Personal and Information and Data Protection Bill is under consideration by the National Assembly, and personal data protection may become a legal requirement.

2.6 Competition law

Some countries have laws to encourage fair competition in markets and avoid anti-competitive practices. Competition law is also known as anti-monopoly law.

Monopolies

There might be a law to prevent a company from acquiring monopoly control over a market. A 'monopoly' of a market is theoretically 100% control of a market, where only one entity supplies a product or service to the entire market. In practice, 'monopoly' is usually defined as a significant influence, such as control of over 30% of the market.

When a company has a monopoly of a market, it might engage in unfair business practices, such as charging higher prices than they would be able to charge in a more competitive market. The serious risk of anti-competitive behaviour from monopolies is the main reason for laws restricting them.

When a company grows to the point where it becomes a monopoly, a government organisation might carry out an investigation, with a view to deciding whether measures should be taken to protect the public.

Similarly, when two companies propose a merger that would create a new monopoly, a government organisation might investigate the proposed merger with a view to recommending whether it should be allowed to happen, and if so whether any conditions should be placed on the merger in order to protect the public.

In the UK for example, these investigations are carried out by a Competition Commission. However, in Nigeria and most other developing economies there is typically no effective mechanism to control monopolies.

Anti-collusion regulations

Collusion occurs when two or more business entities secretly agree to do something for their mutual benefit that is against the public interest. Typically it is a secret agreement to raise prices, and avoid competition on prices. In many countries, collusion is a criminal offence.

Price controls

In some countries, the government might impose price controls on certain key products or services, such as the price of essential services to consumers – water, electricity or gas. Official bodies might be established to monitor the activities of 'utility companies' (providers of water, sewage, electricity and gas services) and might have powers to restrict their activities. Official approval might also be required for any increase in prices.

Competition law in Nigeria

Nigeria has not had a competition law, except in some industry sectors (such as the Nigeria Communications Act 2003 and the Electric Power Sector Reform Act 2005). However, pressure for competition law increased with the privatisation of various state industries, and at the time of writing, Federal Competition and Consumer Protection Bill has been passed by the National Assembly (November 2017) but is awaiting Presidential approval to become law.

The Bill proposes the establishment of a Competition Commission to administer the Act and a Tribunal to handle disputes arising under the Act.

The Bill prohibits agreements that restrain competition, such as price fixing, price rigging and collusive tendering.

It also proposes to transfer the power to approve major transactions (mergers and acquisitions) from the Securities and Exchange Commission to the Competition Commission.

The President is to be empowered to regulate the prices of certain goods and services, on recommendation from the Competition Commission.

2.7 Law on contract and the sale of goods

Most countries have legislation in place that aims to protect consumers of goods and services. These measures include contract law and sale of goods legislation.

Contract law

A contract is a legally binding agreement between two 'parties'. When a contract is made, each party is obliged to carry out his part of the agreement. If one party fails to do what was agreed in the contract, the 'injured party' can take legal action for breach of contract.

This is important in commercial transactions as each party should know their respective rights and obligations and what might happen if they do not satisfy their responsibilities.

The detail of contract law will vary in different jurisdictions but usually there are three key elements of a simple legal contract:

- Offer and acceptance;
- An intention to create a legal relationship (a binding contract); and
- Consideration (what each party gives the other in the contract).

A general legal principle is that the parties to a contract are free to enter into an agreement without the interference of the law, and to decide the terms of the contract between themselves. This is known as the concept of **freedom of contract**.

There are however some specific areas where this freedom of contract may not apply:

- Consumer protection legislation applies to any contract involving a consumer where there is a credit arrangement (e.g. in the UK the Consumer Credit Act 1974). There is also a law to prevent one party introducing 'unfair terms' into a contract (e.g. in the UK the Unfair Contract Terms Act 1977);
- Employment contracts are governed largely by employment legislation; and
- 'Standard form contracts' are contracts where the terms are stated to the consumer on a take it or leave it basis. The consumer does not have an opportunity to negotiate terms. Contracts between consumers and large commercial organisations are nearly always of this kind, such as contracts for the domestic supply of water, electricity and gas.

Sale of goods legislation

The main piece of legislation in Nigeria relating to the sale of goods is the UK Sale of Goods Act (SGA) 1893, which was adopted as law in Nigeria before its political independence. Although some states have made small changes to this legislation, the SGA remains the main body of law in this area.

The SGA contains provisions relating to:

- When a contract for the sale of goods comes into existence (the key requirements are offer, acceptance and consideration);
- The obligations of the seller: (a seller of goods must own the goods and have the right to sell them);
- Rights and remedies for the seller in the event of non-payment by the buyer, or refusal by the buyer to accept delivery of the goods without just reason. The main remedies for a seller are legal action:
 - for payment of the agreed price for the goods; or
 - for damages for non-acceptance of the goods; and
- Rights and remedies of the buyer in the event of a breach of contract by the seller. The main remedy is action for damages (loss of profit) in the event of non-delivery by the seller or a breach of warranty by the seller. In some circumstances it is possible for a buyer to apply to the court for specific performance of the contract by the seller, but an order for specific performance is at the discretion of the court. (Breach of warranty is implied, for example, when goods are bought on description from a seller who deals in such goods: the warranty is that the goods should be of merchantable quality. Similarly there is an implied warranty that goods are fit for their intended purpose when the buyer has informed the seller what that purpose is and has relied on the seller's judgement that the goods are fit for this declared purpose.)

2.8 Consumer protection

There are various laws in Nigeria that include provisions for the protection of the consumer, and the government has established agencies such as the National Agency for Food and Drug Administration and Control (NAFDAC), the Standards Organization of Nigeria (SON), the National Drug Law Enforcement Agency (NDLEA) and the Consumer Protection Council of Nigeria (CPC). These have a responsibility to protect and safeguard the rights of the consumers against the unwholesome practices of producers and suppliers of goods and services in the country.

'Unwholesome practices' include for example the sale of sub-standard products, fake products or expired products to the detriment of consumers.

The Consumer Protection Council (CPC) seeks to protect consumers through both preventative and remedial actions.

- Market surveillance and enforcement. The CPC looks for violations that occur in relation to products in the market, and takes enforcement action where appropriate.
- It deals with complaints from consumers, and uses a variety of methods to resolve them (such as direct engagement, negotiation, mediation and in more serious cases investigation and administrative hearings).

- ❑ It carries out assessments of the quality of goods and services, and adherence to national and international standards.
- ❑ It seeks to educate consumers about their rights as consumers.

2.9 Responding to political and legal developments

Business organisations need to recognise the significant political and legal factors that affect their business, and they have to decide how these factors should affect what they do. They should be alert to:

- ❑ Changes or potential changes in each of these factors; and
- ❑ Changes in the significance of each factor, including the growing importance of factors that were previously relatively unimportant.

Lobby groups

Large companies often use lobby groups to represent their interests by communicating with politicians and government officials. A lobby group is a group of individuals or a specialist firm that actively represents the interests of a company with politicians, government bodies and government officials.

In the UK for example, companies use specialist firms to represent their interests by speaking to UK politicians and government officials, and also to officials in the European Commission (the managing government body of the European Union).

Lobby groups can help companies to argue either for or against proposed changes in the law, and to get politicians and government officials to understand the interests of the companies they represent.

3 Macroeconomic factors

Section overview

- Introduction
- Macroeconomics and macroeconomic policy
- Measuring activity in the national economy
- The economic cycle
- Impact of inflation
- Impact of unemployment
- Impact of economic stagnation
- International payments and international payments disequilibrium
- National economic policies
- International economic policies
- The impact of economic policy measures

3.1 Introduction

Economics is the study of the choices made by societies and by individuals and firms. Individuals and societies make use of limited economic resources ('scarce resources') to satisfy needs and wants.

The subject of economics might be split into:

- microeconomics; and
- macroeconomics.

Microeconomics

Microeconomics is concerned with the study of economic choices by individuals and firms, and how individual economic decisions are driven by prices, costs and 'satisfaction'.

Macroeconomics

Macroeconomics is the study of whole economies rather than individual buyers, sellers and firms. It is the study of the total economy or aggregate economy. It is concerned with issues such as employment and the level of unemployment, the amount of economic wealth that is created (measured by national income) and economic growth, and the rate of inflation.

It is more usual to study macroeconomics at a national or a regional level, but macroeconomics can also be studied at a global level.

There are links between macroeconomics and microeconomics. For example, if the level of unemployment in a national economy is very high, this will affect the availability of additional labour for individual firms within the economy.

3.2 Macroeconomics and macroeconomic policy

Macroeconomic policy

A government develops a macroeconomic policy. The aim of government economic policy is normally concerned with objectives such as achieving sustainable economic growth, full employment, stable prices (low inflation),

improvements in productivity, rising living standards and lower relative poverty and a sustainable balance of payments.

The main policy approaches used by governments to meet macroeconomic objectives are:

- ❑ Monetary policies – changes to interest rates, the supply of money and credit and also changes to the value of the exchange rate;
- ❑ Fiscal policies – changes to government taxation, government spending and borrowing; and
- ❑ Supply side policies designed to make markets work more efficiently.

Macroeconomics is concerned in finding answers to questions like the following:

- ❑ What causes the economy to grow over time?
- ❑ What economic indicators should we be tracking?
- ❑ What causes short-run fluctuations in an economy? How will they be restored?

It answers questions like these by analysing how something such as interest rates, will affect the level of activity in an economy.

3.3 Measuring activity in the national economy

'National income', 'gross national product' and 'gross domestic product' are all measures of total economic activity during a given time period, usually one year, for a particular country (or region). At this stage in your studies, you need not be concerned about the technical differences in how each is measured.

There are three broad approaches to the measurement of total economic activity during a given time period:

- ❑ **Expenditure approach.** One way of measuring economic activity is to calculate the total amount of spending there has been in the economy. This includes spending on consumption by individuals and firms, spending on capital investment and government spending.
- ❑ **Income approach.** Another way of measuring economic activity is to calculate the total income that has been earned by everyone in the economy during the period, such as income earned by individuals and profits earned by companies.
- ❑ **Output approach.** A third approach to measuring economic activity is to measure the value of output by all industries and other economic activity. This includes service industries as well as agricultural, mining, construction and manufacturing industries.

We do not need to go into the detail of how national income or gross national product is calculated using each of these approaches. In practice, the three approaches produce different 'answers' because of the problems of government statisticians in collecting complete and accurate data. In principle, however, the three approaches to calculating national income should all produce the same figure.

The expenditure approach to calculating economic activity

The expenditure approach to the calculation of national income or gross national product can be presented as a fairly short equation. This equation provides some insight into how a national economy can grow, and key factors that affect economic growth.

$$\text{Economic activity (AD)} = C + I + G + (X - M)$$

where:

C = the amount of **consumption** on goods and services

I = the amount spent on **investment** in long-term assets

G = the amount of **government spending**

X = the amount of **exports** of goods and services

M = the amount of **imports** of goods and services

(X – M) is the difference between exports and imports of goods and services, and this is sometimes referred to as the balance of payments.

Economic activity in this formula is sometimes called **total demand** or **aggregate demand** (AD) in the economy.

Government economic policy aims

The main aim of government economic policy is usually to increase economic wealth and achieve something close to full employment. If economic growth and full employment are achieved, the wealth of the country as a whole will increase, and everyone benefits. A government economic policy aim is therefore to increase aggregate demand in the economy, and achieve a steady annual growth in national income.

Economic activity, and so economic wealth, is increased as a result of an increase in any of the items in the equation above. AD is increased by any increase in consumer spending, investment, government spending or increase in the balance of payments (X – M). However, the issue is not so simple, because increases in any item in this equation might lead to a reduction in other items. For example:

- ❑ An increase in government spending G provides an increase in national income, but if the extra government spending comes from higher taxation, and the higher taxation leads to falls in consumption C and investment I, the end result might not be beneficial.
- ❑ Similarly an increase in consumption will provide an increase in national income, but the extra money spent on consumption might be diverted from spending on investment (so I will fall), or the goods might be purchased from other countries (so M will increase) or might be goods that would otherwise have been exported (so X will fall).

A link between national income growth and inflation

Another problem is that there are limits to the annual rate of increase in national income that can be achieved. A country should be able to increase the total output from its economic activities, but does not have the resources to grow in 'real terms' above a certain rate.

For example, national income can be increased by getting more unemployed people into work, because these individuals will then become productive and will create economic wealth. However, reducing unemployment by 1%, say, is unlikely to increase national income by more than 1%. National income can also be increased by introducing more new technology into business: however, the introduction of new technology takes time, and will only help to improve national income gradually.

When total spending in the economy increases at a faster rate than the economy can grow in real terms, the inevitable result is price inflation. For example, if

national income (as measured by total expenditure in the economy) grows by 8% but the 'real' economy – for example actual output of goods and services – increases by just 2%, the difference of 6% must be inflation – higher prices rather than higher output.

3.4 The economic cycle

The economic cycle is a term used to describe how, in general, the national income of a country increases or falls from one year to the next.

- ❑ When national income increases from one year to the next, there is **economic growth**.
- ❑ When national income falls from one year to the next, there is **economic recession** (or in extreme cases, economic decline).

An economic cycle consists of several years of economic growth, with national income each year being higher than in the previous year, followed by economic recession, which is a period of years during which national income is falling.

Government economic policy usually tries to achieve continued economic growth, but if recession becomes unavoidable, policy is then aimed at making the recession as short and as minor as possible.

3.5 Impact of inflation

Inflation is the increase in price levels over time. The rate of inflation is measured using one or more price indexes or cost indexes, such as a consumer prices index or a retail prices index or an index of wages costs.

Businesses are affected by inflation, because inflation means that they have to pay more for resources, such as materials and labour. They will try to pass on their extra costs to their customers, by raising the prices of their own goods and services. Individuals have to pay higher prices for goods and services, so they need more money to pay for them. If they are in work, they might demand higher wages and salaries.

The 'inflationary spiral' can go on indefinitely, with increases in materials and wages pushing up prices of finished goods, which in turn leads to higher wages and materials costs.

It is also recognised that the rate of inflation is affected by **inflationary expectations**. This is the rate of inflation that businesses and individuals expect in the future. Inflationary expectations affect demands for wage rises, and decisions by businesses to raise their prices.

Implications of high inflation and inflationary expectations for the national economy

Inflation also has implications for the national economy and economic growth.

- ❑ Increases in national income are the result of two factors:
 - An increase in the 'real' quantity of goods and services produced and the 'real' spending on goods and services; and
 - Increases due to higher prices and costs.
- ❑ It is possible for measured national income to increase when the real economy is in recession. For example, suppose that measured national income increases from one year to the next by 3% but inflation during the year was 5%. This indicates that the 'real' economy has gone into recession, and is 2% lower.

- ❑ Experience has shown that when the rate of inflation is high, and inflationary expectations are high, the 'real' economy is likely to stagnate or go into recession.

A government might therefore take the view that some inflation is unavoidable (although in some countries there has been deflation – a fall in retail prices). However, the rate of inflation and inflationary expectations should be kept under control, to give the 'real economy' an opportunity to grow.

Implications of inflation for the distribution of wealth

However, although some inflation might be unavoidable, it has unfortunate social and economic implications, because it results in a shift of economic wealth.

- ❑ In a time of inflation, debts such as bank loans fall in real value over time. Borrowers gain from the falling real value of debt. At the same time, lenders and savers lose because the value of their loan or savings falls. For example, an individual with cash savings might be earning 3% after tax when inflation is 5%: if so he is losing 2% in real terms each year. The effect of inflation is therefore to shift wealth from savers and lenders to borrowers.
- ❑ Another effect of inflation is to reduce the real value of households on fixed incomes or incomes that rise by less than the rate of inflation each year, such as many pensioners. The rich might get richer (because their income is often protected against inflation, for example by salary rises) whilst the poor get poorer.

3.6 Impact of unemployment

When there are many people who are unwillingly out of work, this means that there are not enough jobs for the people who want them. Business organisations ('firms') could take on more labour if they wanted to, but they choose not to.

When there is economic recession and demand for goods and services is falling, many firms will make some employees redundant because their profits are falling and some aspects of their business are no longer profitable.

High levels of unemployment are unwelcome in an economy because:

- ❑ Individuals who want jobs cannot get them (and high unemployment is damaging to society and the welfare of the people); and
- ❑ Economic growth is less than it could be: if the unemployed individuals could be given work, output in the economy would increase and there would be economic growth.

A **very low level of unemployment** might also be unwelcome because:

- ❑ Firms that want to take on more labour might struggle to find suitable people; and
- ❑ The shortage of labour might push up the cost of wages and salaries.

An additional problem is that although the level of unemployment might be high, there could be a **shortage of skilled labour**. As the technological complexity of industry increases, the demand for low-skilled jobs might fall even as the demand for skilled labour rises. A shortage of skilled labour can only be overcome through:

- ❑ Better standards of education;
- ❑ More training; and

- ❑ If necessary, moving jobs to other countries where there is a better supply of skilled labour.

Types of unemployment

Unemployment can be analysed into categories. These are some categories that might be used for analysis.

- ❑ **Transitional unemployment.** This happens when an employee has left one job in order to start at another. If there is a gap of time between leaving one job and starting the next, this is transitional unemployment. For example, a teacher might leave a job at one school in order to start at another school in three months' time. During the three month gap, unless one of the schools pays him, he is transitionally unemployed.
- ❑ **Frictional unemployment.** This is short-term unemployment when individuals are dismissed from their work, for example because they have been made redundant or because they did not like the job they were doing. It might take them a little time to find a new job. Until they do, they are unemployed. However, the unemployment should not last long.
- ❑ **Structural unemployment.** This is unemployment that arises because of a significant change in the structure of the economy, and in particular decline and collapse of industries that used to be major employers. For example, there might be structural unemployment because the mining industry used to employ many people, but is now in decline. When an industry goes into decline and large numbers of people are made unemployed, the consequences can be very serious. Finding new jobs in other industries for all the unemployed workers can take a very long time. There might be a demand for labour in other industries and other parts of the country, but the unemployed people available for work are of the wrong type, and have the wrong skills, or are in the wrong part of the country and do not want to move their home.
- ❑ **Technological unemployment.** This occurs when technological changes mean that some types of workers are no longer needed, so that large numbers are made redundant. The new technology replaces manual labour. This can happen when manufacturing processes are automated. Technological unemployment can add to structural unemployment.
- ❑ **Regional unemployment.** This is unemployment in a particular region of the country. Levels of unemployment can vary from one region to another, especially when there is no **mobility of labour** and individuals are reluctant to move to other regions to find work.
- ❑ **Seasonal unemployment.** This is unemployment, often within a particular industry, because the demand by firms for labour is higher at some times of the year than at the other. For example, the demand for agricultural labour might be very seasonal, and there might be high levels of unemployment in the industry in the low-season periods.
- ❑ **Cyclical unemployment.** When the national economy is growing, demand for labour increases and unemployment should fall. When the economic cycle goes into recession, the demand for labour falls and unemployment increases. Governments try to deal with cyclical unemployment by managing the economy and trying to achieve real economic growth.

3.7 Impact of economic stagnation

Economic stagnation occurs when national income is not increasing, but economic activity is at a much lower level than it could be. Economic growth should be possible, but is not happening.

A feature of economic stagnation is under-used economic resources, such as land and capital equipment. Unemployment is high and there is little or no new capital investment. Companies do not want to invest large amounts of money, because they see no way of making a satisfactory return.

When a country or region of the world suffers from economic stagnation whilst other countries are enjoying economic growth, it is becoming more poor relative to those other countries. Households may therefore live in relative poverty, and many individuals might look for ways of migrating to other countries where economic wealth is greater.

Depressed countries of the world that suffer from economic stagnation often need help from wealthier countries to develop their national economies.

Worldwide economic recession: protectionism

When the rate of economic growth in the world as a whole is falling, individual countries might still try to increase their own national income. However, if the world economy is not growing, any increase in a national economy has got to be at the expense of other national economies.

This can create a risk of 'trade wars' and 'protectionism'. Protectionism takes the form of government measures to discourage or prohibit imports of foreign goods.

In many countries, some industries are protected against foreign competition by government measures against imports, such as:

- The imposition of **high import taxes** on goods coming into the country;
- Setting **quota limits** on the amount of goods that can be imported; and
- Putting a **ban on imports** of some types of goods.

Attempts to promote 'free trade' internationally are promoted by the World Trade Organisation (WTO).

3.8 International payments and international payments disequilibrium

International payments

International payments are the flows of money between different countries. The main elements of international payments are:

- Payments arising from international trade in goods and services (which might be referred to as the 'balance of trade' or 'balance of payments'); and
- Movements of capital between countries.

For every country a surplus or deficit on trade in goods and services = Net outflow or inflow of capital.

For example, if a country has a surplus of \$10 billion on its foreign trade in goods and services, it also transfers \$10 billion in capital flows to other countries. Similarly a country with a deficit of \$25 billion on its trade in exports and imports receives net transfers of \$25 billion in capital.

International payments and foreign currencies

Payments between different countries (unless they are in the same currency area, such as the Eurozone in Europe) give rise to an exchange of currencies. Here are just two examples.

- ❑ A UK company buys goods from a US supplier and agrees to pay in US dollars. There is an international payment in dollars from the UK buyer to the US supplier. To make the payment, the UK buyer has to arrange with a bank to buy US dollars in exchange for pounds sterling in order to make the payment. The trade in goods leads to a transaction in British pound/US dollar.
- ❑ A German investor decides to invest capital in the US. There are different ways of investing. One is to buy shares in US companies or US government bonds ('Treasuries'). To make these investments, the German investor has to pay for them in US dollars. To obtain the dollars to make the purchase, he has to sell some euros. The international investment therefore leads to a transaction in euros/US dollars.

International payments disequilibrium

In an ideal world economy, each country would achieve equality between the value of its exports and the value of its imports. When this happens, there is also equality between inflows and outflows of capital. In practice, however, this ideal state is never achieved:

- ❑ There are always some countries that have a surplus on their balance of payments between their exports in goods and services and their imports; and
- ❑ There are always some countries that are net recipients of international capital, and some who transfer capital to other countries.

Disequilibrium in international payments occurs when these imbalances between balance of trade and international capital flows become excessive. This is the current situation at the time of writing, with regard to the United States and China in particular.

- ❑ The United States has a very large balance of payments deficit in its trade in goods and services. It imports far more than it exports. This huge deficit is financed by capital investments in the US dollar by other countries, particularly China.
- ❑ China has a very large surplus in its balance of trade in goods and services, exporting far more than it imports. This huge surplus is invested in other countries, particularly the US. Investments in the US include purchases of US government debt (Treasury bonds).

A serious concern is that such a large disequilibrium in international payments cannot continue indefinitely. There will presumably come a time when people and governments in other countries will decide to stop investing in US dollar capital assets. If the capital flows into the US fall, the US will have to cut its balance of payments deficit in goods and services. If the US stops importing goods and services from other countries, this could have a devastating effect on the economies of exporting countries and on world trade generally.

Foreign exchange rates and international payments disequilibrium

In theory a disequilibrium in international payments could be rectified by a change in foreign exchange rates, and a fall in the exchange value of the currency of countries that have a deficit in their balance of payments in goods and services.

If there is a fall in the value of the exchange rate, a currency becomes cheaper relative to other currencies.

- Exports from the country therefore become relatively cheaper and buyers in other countries will buy more of them.
- Imports from other countries become relatively more expensive. Domestic buyers will therefore buy fewer imported goods (and might switch to buying more domestically-produced goods).
- If exports go up and imports fall, the balance of payments position in goods and services will improve.

However, a very substantial change in foreign currency exchange rates is needed to rectify a very large disequilibrium in international payments.



Example: International payments

There is considerable concern about the international payments disequilibrium affecting the US dollar.

A fall in the value of the dollar would damage the wealth of foreign investors in the dollar. For example, suppose that a Nigerian investor buys US assets costing \$1 million when the exchange rate between the dollar and the naira is US\$1 = ₦400. The investment would cost ₦400 million and would be worth \$1 million.

Now suppose that there is a sharp fall in the value of the dollar, so that US\$1 = ₦300, and there is no change in the dollar value of the investment. To the Nigerian investor the investment is still worth US\$1 million but if he cashed it in and exchanged the dollars back into naira, he would receive only ₦300 million. He would have lost ₦100 million.

3.9 National economic policies

A national government has responsibility for economic policy, and the aims of a country's economic policy are usually economic growth and possibly also full employment. Economic growth is usually given priority, because a reduction in unemployment should follow on from economic growth.

Economic growth should be 'real growth'. Some inflation is probably unavoidable in order to achieve economic growth, but real growth is achieved if the increase in national income each year exceeds the rate of inflation. Although a government has an ultimate economic objective – sustainable growth and full employment – it needs to establish intermediate economic targets. In other words, in order to achieve economic growth it might be necessary to achieve some other economic targets first, such as:

- a low rate of inflation: with high inflation there is a risk of economic recession and also a fall in the exchange rate for the country's currency
- a stable exchange rate (or a target exchange rate against major world currencies such as the US dollar or euro).

Fiscal policy

Fiscal policy is government policy on taxation, spending and government borrowing. Government spending is a part of national income, but in order to spend a government must raise the money in tax, and borrow any excess of spending over tax revenue.

A government might also try to encourage investment by the private sector (companies). It can try to do this by offering special tax incentives or subsidies

(cash payments). In the UK for example, government policy includes a 'private finance initiative' which encourages private sector investment in state investments, such as the state transport system, and state schools and hospitals.

Monetary policy

Government uses monetary policy as well as fiscal policy. Monetary policy involves trying to establish monetary conditions that will be favourable to economic growth.

In the US, Euro zone and UK, monetary policy is similar. The government seeks to encourage long-term economic growth by keeping the rate of inflation within limits. The rate of inflation is managed through control over interest rates.

The effect of managing interest rates

In Nigeria, the US, Eurozone and UK the management of interest rates is the responsibility of the central bank. The central bank is able to control short-term interest rates (on the dollar, euro or sterling respectively) and can raise or lower interest rates as it considers appropriate.

If the central bank is concerned about rising inflation, it can raise short-term interest rates. When the central bank raises its own interest rates, other commercial banks do the same to their interest rates.

There is then a **transmission mechanism** that slowly works through the national economy. The effects are by no means immediate, and a change in interest rates could take months, if not two years or more, to have an eventual effect. In principle, however, higher short-term interest rates will mean that borrowers have to pay more interest to borrow (and in Nigeria and the UK, borrowers with variable interest rate mortgage loans on their homes are affected immediately). Higher short-term interest rates could eventually lead to higher long term investment rates, and the market value of investments in shares and bonds might fall. Higher borrowing costs might make some individuals and companies less willing to borrow. If individuals are borrowing less and everyone feels less wealthy, spending on consumption will also fall (both domestically-produced goods and imports). All these changes might take some of the inflationary pressures out of the economy.



Example: Fiscal vs. monetary

When a government is satisfied that inflation is under control, but is dissatisfied with the slow rate of economic growth, it might consider several measures to boost the economy in order to increase national income and reduce unemployment.

- ❑ It might use **fiscal measures**. It could borrow money and spend the money it has in order to invest in economic activity, such as new capital projects (a new railway line or a new runway at the country's main airport). **Higher government spending** in order to increase economic activity is sometimes referred to as 'Keynesian economics' after the famous 20th Century economist John Maynard Keynes.
- ❑ It might use **monetary measures**. If it manages the economy through interest rates, it would **reduce short-term interest rates**. In time, this would work through the economy (by means of the transmission mechanism). Eventually, there might be more consumption spending and investment in capital projects.

Economic policies to achieve social or environmental objectives

It is worth remembering that governments sometimes use economic policies to achieve political, social or economic objectives.

For example, the countries of the United Nations might agree to a trade embargo with a specific country, in order to persuade that country to change its policies. An example is the UN trade embargo against Iran from 2006, which was intended to persuade Iran to abandon its nuclear power development programme.

Governments might also try to discourage unhealthy behaviour through taxation, for example by imposing high levels of taxation on tobacco (smoking).



Example: Deep sea fishing

The US government tried to persuade the World Trade Organisation to issue a ban on subsidies for deep sea fishing. The purpose of such a ban would be to make deep sea fishing less profitable, and so help to preserve the world's stocks of deep sea fish.



Example: Nigerian fuel subsidy

Successive Nigerian governments adopted a policy of subsidising imported petroleum products as Nigerian oil refinery capacity was unable to satisfy domestic demand. The policy was intended to maintain low fuel prices and hence promote the accessibility of transport and infrastructure to the wider population as well as reduce production costs in industry.

The cost to the Nigerian government of maintaining the subsidy escalated significantly in the first decade of the 21st century as global oil prices rocketed. Furthermore:

- ❑ The regulatory framework used to enforce the subsidy was weak and suffered from a lack of transparency. This led to a number of alleged incidences of misappropriation of subsidy funds and also of subsidised petrol being sold at a premium in neighbouring countries;
- ❑ There was a lack of incentive to make Nigerian refineries more efficient; and
- ❑ The IMF and World Bank did not fully support the subsidy and felt it was potentially stifling Nigeria's long-term development.

The subsidy was removed in 2012 with the Nigerian government citing the removal of the subsidy as being an integral part of its medium term fiscal framework. It is still too early to fully understand the full economic impact of the removal of the subsidy, although the following outcomes are all possible:

- Deregulation and removal of the subsidy leads to initial inflationary pressures;
- As the market opens to investors, significant capital will flow into the downstream sector and more private refineries will open for business in Nigeria; and
- Eventually the market will self-regulate and prices for refined petroleum products and related goods and services will revert to natural market levels as competition forces prices down.

Other benefits may include:

- Less pressure on foreign reserves;
- Government gains access to funds to develop infrastructure;
- Borrowing reduces;
- Encourages local investment and FDI (foreign direct investment) in the oil sector; and
- Reduces the import of refined products significantly in the medium to long-term.

3.10 International economic policies

Wealthy economic nations recognise the need to help poorer countries to develop their economies and efforts are made (with varying degrees of success) to provide help. Much help is provided through supranational organisations such as the World Bank (however, international aid is provided in a variety of ways).

When a supranational organisation develops a policy for providing economic aid to developing countries, the main policy targets are often as follows:

- Investment in infrastructure, such as roads and railways and investment in the development of systems of telecommunication and for supplying energy and water (dam construction, irrigation systems and so on).
- Investment in education and health, to improve standards of the national labour force.
- Capital investment in particular industries. This could involve investment in the development of major industries or in providing economic support to small producers, such as small farmers. If there is investment in economic infrastructure, and improvements in labour skills, multinational companies might become interested in increasing their investment in the countries concerned.

3.11 The impact of economic policy measures

Macroeconomic policies of government, and changes in the condition of the national and world economies, affect businesses and individuals directly.

As you should imagine, firms and individuals will react to economic changes according to the circumstances and the nature of the change.

**Example: Economic policy 1**

The government raises tax on income from 20% to 25%. How would you expect individuals or households to react?

**Answer**

Higher taxation means less after-tax earnings available for spending. Individuals must either reduce their consumption or borrow more. In practice, at least for the short term, they might do both.

**Example: Economic policy 2**

The government increases interest rates from 4% to 5%. How would you expect companies to react?

**Answer**

Companies are only affected if they borrow money at a variable rate of interest from their bank, with a bank loan or overdraft.

After a large increase in interest rates, they might try to borrow less (but reducing borrowings might take some time). They might try to pass on some of the higher costs to customers by raising the prices of their products or services. Or they might try to cut some costs, such as reducing labour costs by making some employees redundant.

**Example: Economic policy 3**

A company believes strongly that the national economy will grow strongly in the next few years, and that profits in its own industry and markets will grow. What do you think the company should do?

**Answer**

The company should review its strategic position, and consider increasing its investment in the industry.

4 Microeconomic factors

Section overview

- Introduction
- Demand and supply
- Price elasticity of demand
- Elastic and inelastic demand
- Factors influencing demand (determinants of demand)
- Costs
- Types of competition

4.1 Introduction

Microeconomics is concerned with the behaviour of people (often described as households) and entities within an economy. These participants in the economy buy and sell goods and services from each other.

Microeconomics involves the study of the behaviour of households and firms in order to understand how they make decisions. It is an attempt to explain and understand what drives buying and selling decisions.

Microeconomics examines how these decisions and behaviour affect the supply and demand for goods and services, which determines prices, and how prices, in turn, determine the quantity supplied and quantity demanded of goods and services.

A market is a group of buyers and sellers of a particular good or service. The terms supply and demand refer to the behaviour of people as they interact with one another in markets:

- Buyers determine demand; and
- Sellers determine supply.

4.2 Demand and supply

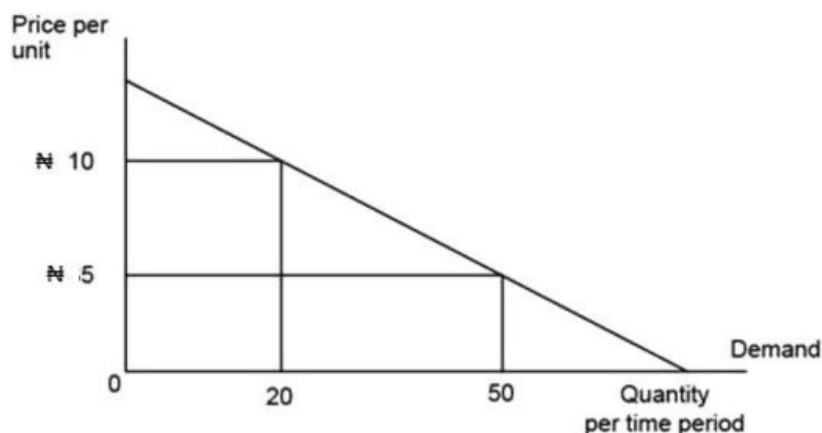
Demand

Demand refers to the number of units of a particular item (or the amount of a type of service) that customers buy at a given sales price. Price change causes a change in demand.

The law of demand says that:

- A decrease in price leads to an increase in demand; and
- An increase in price leads to a fall in demand.

Demand for a good or service is the total demand from all participants in a market. This can be represented as a plot of quantity demanded against price. Such plots are known as demand curves. A simple demand curve is shown below.



This curve shows that the demand for the good in a particular time frame is 20 units if the price is ₦10 per unit but would increase to 50 units if the price was ₦5 per unit.

Demand curves are downward sloping from left to right. A change in price causes demand to move along the curve.

Supply

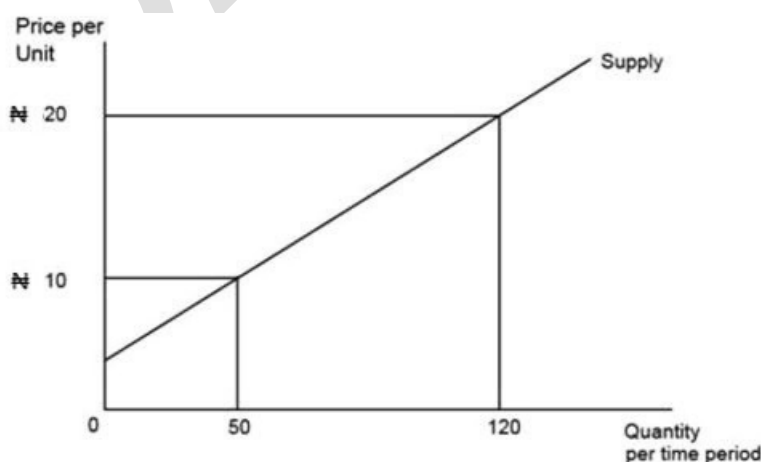
Supply refers to the quantity of the product (or service) that suppliers are willing to sell at any given sales price.

The law of supply says that:

- The quantity of a good that suppliers are willing to sell rises when the price of the good rises; and
- The quantity of a good that suppliers are willing to sell falls when the price of the good falls.

Supply is the total supply from all businesses. Higher prices will attract more suppliers into the market and encourage existing suppliers to produce more. Lower prices will deter some suppliers, and might drive some out of business if the price fall results in losses.

This can be represented as a plot of the quantity that suppliers are willing to supply at a given price. Such plots are known as supply curves. A simple supply curve is shown below.



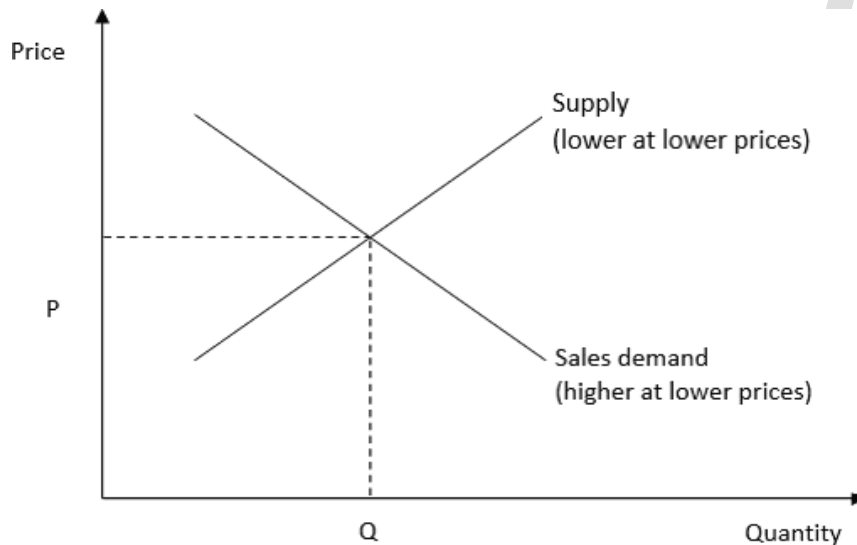
Suppliers are only willing to supply 50 units at a price of ₦10. However, if the price increases to ₦20 suppliers would supply 120 units.

Note that supply curves are upward sloping from left to right. A change in price causes supply to move along a curve.

Market pricing mechanism

The sales price for a product in a market is determined by the interaction of demand and supply. This is known as the market price mechanism.

A simple graph of supply and demand is shown below. In this diagram, the equilibrium price level is the sales price that would become established in the market if the factors that affect supply or demand did not change. Here the price would be P and the total sales demand for the product would be Q units.



Occasionally, sales demand for a product might rise to such a high level that producers in the market are unable to meet the demand in full. Until production capacity can be increased, this situation could result in very large price rises and very high profit margins for producers.

An example of demand exceeding supply capacity has been the market for oil on occasions in the past. Oil suppliers are unable to alter their output volumes quickly, so a large increase in demand for oil can result in very large price increases, at least in the short term.

4.3 Price elasticity of demand

The price elasticity of demand (PED) is a measurement of the change in sales demand that would occur for a given change in the selling price.

Within a market as a whole, there is an inverse relationship between selling price and sales demand. At higher prices, total sales demand for a product will be lower. For individual companies in a monopoly position in their market (or niche of the market) the same rule applies: if prices are raised, demand will fall.

The price elasticity of demand (PED) is measured as:

$$\frac{\text{The change in quantity demanded as a percentage of original demand}}{\text{The change in sales price as a percentage of the original price}}$$

The change in sales price as a percentage of the original price

Price elasticity of demand has a negative value, because demand rises (positive) if the price falls (negative), and demand falls if the price rises.



Example: PED

The following estimates have been made of total sales demand for product X:

- An increase in the price from ₦9 to ₦10 will result in a fall in daily demand from 2,000 to 1,600 units
- A fall in the price from ₦5 to ₦4 will result in a rise in daily demand from 8,000 to 9,000 units.

Required

Calculate the price elasticity of demand for product X at a price of:

- (a) ₦9
- (b) ₦5



Answer

- (a) If the price is increased from ₦9 to ₦10

The change in quantity demanded as a percentage of original demand
 $= -400/2,000 = -0.20$ or -20% .

The change in price as a percentage of the original price $= \frac{1}{9} = +0.111$ or $+11.1\%$.

$PED = -0.20 / +0.111 = -1.8$.

- (b) If price is reduced from ₦5 to ₦4

The change in quantity demanded as a percentage of original demand
 $= +1,000/8,000 = +0.125$ or $+12.5\%$.

The change in price as a percentage of the original price $= \frac{1}{5} = +0.20$.

$PED = +0.125 / +0.20 = +0.625$.

The above example illustrates that price elasticity of demand for a given product varies at different points on the demand curve. A product does not necessarily have high or low price elasticity of demand at all price levels. The same product might have a high price elasticity of demand at some sales prices and low price elasticity at other prices.

4.4 Elastic and inelastic demand

Total sales revenue is found as $P \times Q$ (price multiplied by quantity). Price elasticity of demand affects the amount by which total sales revenue from a product will change when there is a change in the sales price.

An understanding of the price elasticity of demand for products can help managers to make pricing decisions.

Sales demand for a product could be either elastic or inelastic in response to changes in sales price.

- Demand is elastic if its value is above 1. (More accurately, demand is elastic if its elasticity is a figure larger than -1 .)
- Demand is inelastic if its value is less than 1. (More accurately, demand is inelastic if its elasticity is a figure below -1 , between 0 and -1 .)

Profit might increase or decrease when the sales price is changed, depending on changes in total costs as well as the change in total revenue.

Elastic demand

Demand is said to be elastic when a change in price has a big impact on demand.

If demand is highly elastic (greater than 1, ignoring the minus sign):

- Increasing the sales price will lead to a fall in total sales revenue, due to a large fall in sales demand, and
- A reduction in the sales price will result in an increase in total sales revenue, due to the large rise in sales demand.

If demand is elastic, an increase in the sales price will lead to a fall in total sales revenue. If managers are thinking about an increase in the sales price, they will have to consider whether the fall in total costs (due to the lower volume of sales) will exceed the fall in total revenue.

If demand is elastic, reducing the sales price will increase total sales revenue from the product, but total sales volume will increase. The effect, as with raising sales prices for a product with high price elasticity of demand, could be either higher or lower total profits. There is a risk that if one company reduces its sales prices and elasticity of demand is high, this could lead to a 'price war' in which all competitors reduce their prices too. At the end of a price war, all sellers are likely to be worse off.

Companies might try to reduce the price elasticity of demand for their products by using non-price methods, such as improving product quality, improving service and the use of advertising and sales promotions.

Inelastic demand

Demand is said to be inelastic when a change in price has only a small impact on demand.

If demand is inelastic (less than 1, ignoring the minus sign):

- Increasing the sales price will result in an increase in total sales revenue from the product, because the fall in sales volume is fairly small; and
- Reducing the sales price will result in lower total sales revenue, because the increase in sales demand will not be enough to offset the effect on revenue of the fall in price.

If demand is inelastic, reducing the sale price will lead to lower total sales revenue. Sales demand will increase, and so the costs of sales are also likely to increase. Profits are therefore likely to fall.

If demand is inelastic, raising selling prices will have a small effect on demand and will result in higher sales revenue. There will be a small reduction in the number of units sold so total costs will fall. Higher revenue and lower total costs mean higher profits. If management believe that sales demand for their product is price-inelastic, they might therefore consider raising the sales price.

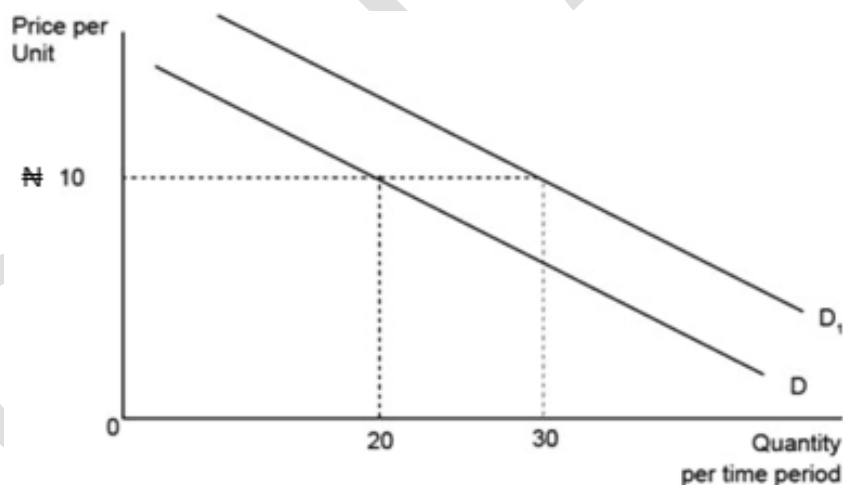
Governments raise revenue by taxing goods for which there is an inelastic demand. Such goods include cigarettes and fuel. Cigarettes are addictive and fuel is a necessary for everyday life. In each case an increase in price through additional taxation should not result in a fall in demand.

4.5 Factors influencing demand (determinants of demand)

Price of a good is the main determinant of the level of demand. A change in the price of a good causes demand to increase (demand is said to extend) or fall (demand is said to contract) and this is reflected as movement along the demand curve.

Other factors also change demand. Any change in demand brought about by a change other than the good's own price is called a change in the conditions of demand.

Changes in the conditions of demand are represented by a shift in the demand curve and are referred to as an increase or decrease in demand. This is shown diagrammatically below:



The original demand curve is shown as curve D. It shows that 20 units are demanded at a price of ₦10. A change in a condition of demand has moved the whole curve to the right. This means that some factor has caused demand to increase at a given price. This factor means that 30 units are now demanded at a price of ₦10.

Key conditions of demand include:

- Price of substitutes; and
- Price of complements.

Price of substitutes

It is often the case that movements in the demand for another good will impact upon the demand for the good that is being studied. When these goods are in competition with each other when it comes to the consumer decision, these are known as substitute goods.

A rise in the price of a good will lead to a fall in demand for that good but an increase in demand for its substitute.



Example: Substitutes

Consider the market for toothpaste.

Suppose that there are only two brands available and that initially, both are priced at ₦20 a tube. If the price of Brand A increases to ₦30 then the demand for Brand B would be expected to increase.

Price of complements

Two or more goods which are consumed together are described as complements.

A rise in the price of a good will lead to a fall in demand for that good and a fall in demand for its complement.



Example: Complements

Consider the market for hockey sticks and hockey balls. These products complement each other: if people buy hockey sticks, then they are likely to buy hockey balls too, in order to play a game.

Let's suppose that the price of hockey sticks increases from ₦50 to ₦100. As a result, fewer hockey sticks are purchased, and consequently the demand for hockey balls decreases.

Cross price elasticity of demand

We saw above that a change in price of one good can lead to a change in demand of another. Cross price elasticity of demand is a measure of the responsiveness of demand for a good A in relation to a change in price of good B.

The cross price elasticity of demand (PED) is measured as:

$$\frac{\text{The percentage change in quantity of Good A demanded}}{\text{The percentage change in price of Good B}}$$

The percentage change in quantity of Good A is measured as:

$$\frac{\text{New demand for Good A} - \text{old demand for Good A}}{\text{Average of old and new demand}}$$

The percentage change in price of Good B is measured as:

$$\frac{\text{New price for Good B} - \text{old price for Good B}}{\text{Average of old and new prices}}$$

Cross price elasticity of demand for substitutes

A substitute good has a positive cross price elasticity of demand



Example: Cross PED for substitute goods

Suppose the quantity of milk chocolate (Good A) demanded decreases from 100 to 90, when the price of dark chocolate decreases from ₦5 to ₦3. The calculation would be as follows:

Percentage change in quantity of milk chocolate:

$$\frac{90 - 100}{(90 + 100)/2} = \frac{-10}{95} = -10.5 \text{ or } -10.5\%$$

Percentage change in price of dark chocolate:

$$\frac{3 - 5}{(3 + 5)/2} = \frac{-2}{4} = -0.50 \text{ or } -50\%$$

Cross price elasticity of demand:

$$\frac{-10.5\%}{-50\%} = 0.21\%$$

The positive sign means that the products are substitutes, and that the absolute number is less than one means that the relationship is inelastic.

This means that quantity of milk chocolate demanded is not particularly sensitive to the price of another good: dark chocolate. This could be because those who consume dark chocolate are quite loyal to their type, and would not want to switch unless there was a significant price change.

Cross price elasticity of demand for complementary goods

A complement good has a negative cross price elasticity of demand



Example: Cross PED for complementary goods

Suppose the quantity of cricket balls (Good A) demanded increases from 500 to 600, when the price of cricket bats falls from ₦100 to ₦90. The calculation would be as follows:

Percentage change in quantity of cricket balls:

$$\frac{600 - 500}{(600 + 500)/2} = \frac{100}{550} = 0.181 \text{ or } 18.1\%$$

Percentage change in price of cricket bats:

$$\frac{90 - 100}{(90 + 100)/2} = \frac{-10}{95} = -10.5 \text{ or } -10.5\%$$

Cross price elasticity of demand:

$$\frac{18.1\%}{-10.5\%} = -1.72\%$$

Not only are they complements (the sign is negative), but the relationship is elastic (1.72% is greater than 1).

This means that quantity of cricket balls demanded is sensitive to the price of another good: cricket bats. The quantity demanded is very dependent on price movements in the other.

4.6 Costs

We saw earlier that an increase in the market price of a good would lead to an increase in supply. This is due in part to more businesses entering the market.

A fall in the market price of a good leads to a decrease in supply as less efficient suppliers would no longer be able to earn a profit and would leave the market.

Suppliers operate in a market in order to earn profits. Profit is calculated as total revenue less total costs. Decisions to enter a market are based on potential profit which is in turn based on cost structure.

Costs relate to the factors of production and can be differentiated by their relation to final output and by the time scale over which they operate.

Factors of production

There is a limit on available economic resources so it is important that they are used efficiently. The resources available are categorised into four factors of production, and different combinations of these are used to produce goods and services in an economy.

The four factors of production are:

- Land: This refers to naturally occurring resources e.g. timber, iron ore etc.;
- Labour: This refers to the human input (physical and mental human effort) into the process;
- Capital: Man-made physical goods used to produce other goods and services; and
- Enterprise: This refers to the organisation of production and the bearing of risk often carried out by the entrepreneur in owner managed firms (sole proprietor) or divided between management and shareholders in companies and corporations.



Example: Factors of production

Factors of production in making a textbook:

Land: raw materials to make paper, string, and other parts

Labour: author writing the words

Capital: machine to compile the book

Enterprise: owner of the company that energised the factors of production to make a textbook

This exercise can be done with almost every other good and service in an economy. For example, a housecleaner:

Land: raw materials to make cleaning products

Labour: cleaner using their skill to clean a house

Capital: the products that they use to clean

Enterprise: combining the 3 factors to create an enterprise.

Cost vocabulary

Fixed costs

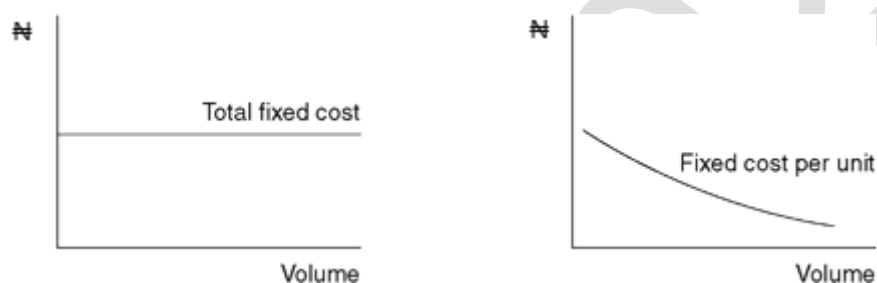
Fixed costs are items of cost that remain the same in total during a time period, no matter how many units are produced, and regardless of the volume or scale of activity. Fixed costs are also called **period costs**, because they are fixed for a given period of time.

Examples of fixed cost items include:

- The rental cost of an office, which is ₦400 000 per month. The rental cost is fixed for a given period: ₦400 000 per month, or ₦4.8 million per year; and
- The salary costs of a worker who is paid ₦50,000 per month. The fixed cost is ₦50,000 per month or ₦600 000 per year.

The average fixed cost per unit can be found by dividing the fixed cost by the number of units. This figure will fall as the number of units produced increases.

Cost behaviour graphs for fixed costs are shown below.



Variable costs

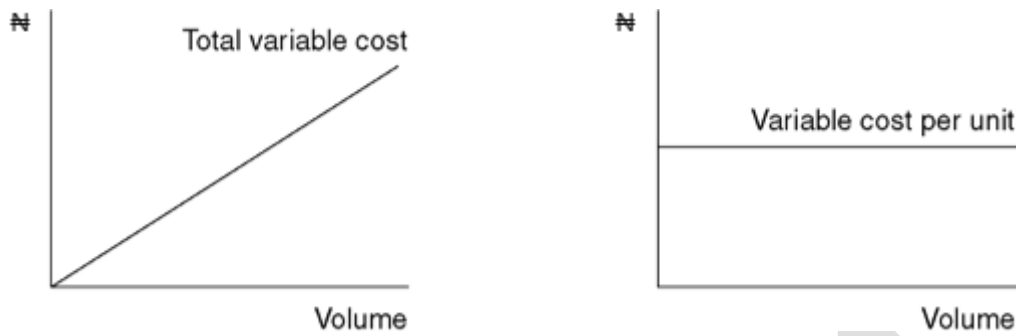
Variable costs are costs that increase, usually by the same amount, for each additional unit of product that is made or each additional unit of service that is provided.

The average variable cost per unit can be found by dividing the total variable cost by the number of units. The variable cost per unit is often the same amount for each additional unit of output or unit of activity (though this is not always the case). This means that total variable costs increase in direct proportion to the total volume of output or activity.

Examples of variable costs include:

- The cost of buying a raw material item might be ₦200 per litre purchased, regardless of purchase quantity. If so, the variable cost is ₦200 per litre: the total cost of buying 1,000 litres would be ₦200 000 and the cost of buying 2,000 litres would be ₦400 000;
- The rate of pay for hourly-paid workers might be ₦200 per hour. If so, 400 hours of labour would cost ₦80,000 and 500 hours would cost ₦100,000; and
- The time needed to produce an item of product is 4 minutes and labour is paid ₦300 per hour. If so, direct labour is a variable cost and the direct labour cost per unit produced is ₦20 ($= ₦300 \times 4/60$).

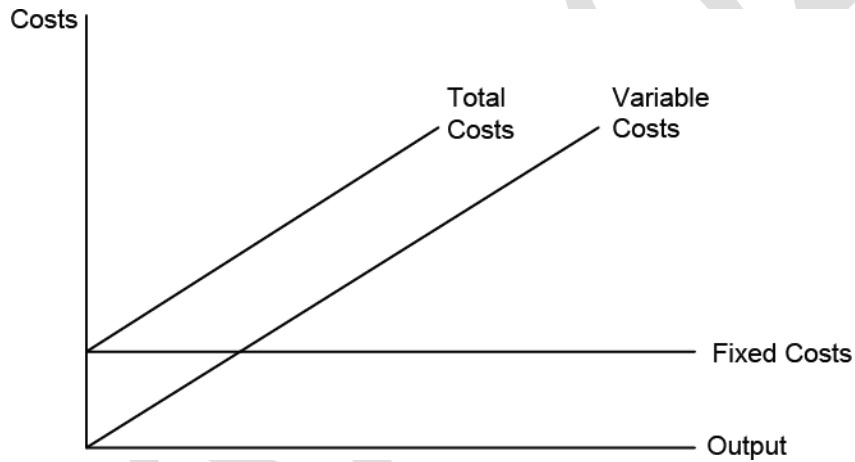
Cost behaviour graphs for variable costs are shown below.



Total costs

Total cost: The total expense to produce each level of output. It is the sum of the fixed costs and the variable costs. This will vary from firm to firm, as each will have different fixed costs, and variable costs.

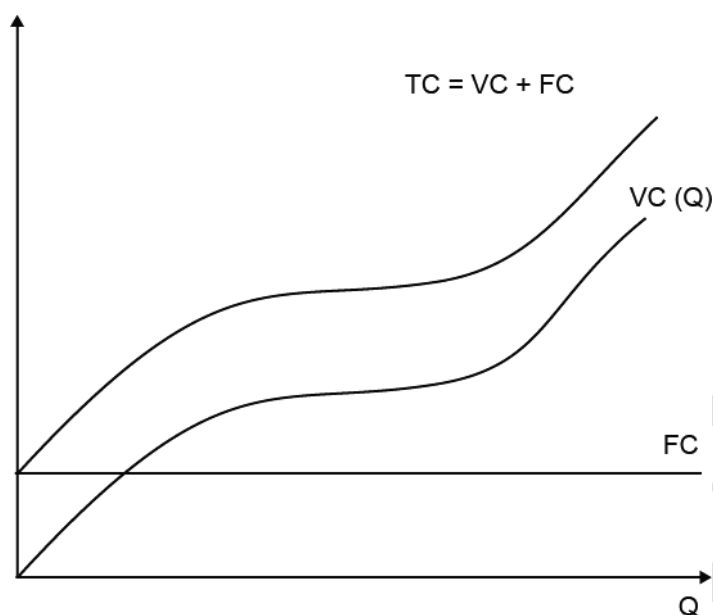
Total cost can be represented in a graphical form:



This shows the cost structure for Firm A, whereby the variable costs remain the same for each incremental increase in output.

The assumption of constant proportion is not present in most firms; however this is the simplest form of displaying the relationship between the three costs.

The illustration below shows the cost curve for a firm where the average variable cost changes at different levels of output.



Marginal cost

Marginal cost is the increase in total costs as a result of making one extra unit of output. If variable cost per unit is constant over the range of production under examination the marginal cost per unit is the variable cost per unit. If the variable cost per unit changes this will not be the case.

Marginal cost is very important to the decisions that a firm will make. A firm can increase its profits from making and selling an extra unit as long as the marginal cost of producing the unit is less than the marginal revenue from selling it. This implies that a firm should continue to produce units until the point where the marginal revenue = the marginal cost. At this point its profit will be maximised.

Quantity	Fixed costs	Variable costs	Total costs	Marginal cost per unit	Average fixed cost per unit	Average variable cost per unit	Average cost per unit
a	b	c	b + c		b/a	c/a	(b + c)/a
1	30	24	54	54	30	24	54
2	30	34	64	10	15	17	32
3	30	40	70	6	10	13.3	23.33
4	30	50	80	10	7.5	12.5	20
5	30	65	95	15	6	13	19
6	30	88	118	23	5	14.7	19.7
7	30	115	145	27	4.3	16.3	20.7
8	30	154	184	39	3.8	19.3	23
9	30	217	247	63	3.3	24.1	27.4
10	30	310	340	93	3	31	34

This can be presented as a graph. Note that the marginal cost curve for a typical firm is U-shaped. Though different in each case, the reason for this general shape is to do with diminishing and increasing returns.

At the low levels of output, there are still efficiencies that can be made (increasing returns) meaning the cost of producing an extra unit will be less than before, because equipment etc. is not being fully utilised.

After a certain point though, this will begin to change, and the cost of producing an extra unit will begin to rise with each incremental increase, as equipment etc. reaches capacity, and inefficiencies start to occur.

Short run cost curves

Short run: That period of time during which it is possible to vary output by varying one factor of production only.

Relationship between the cost curves

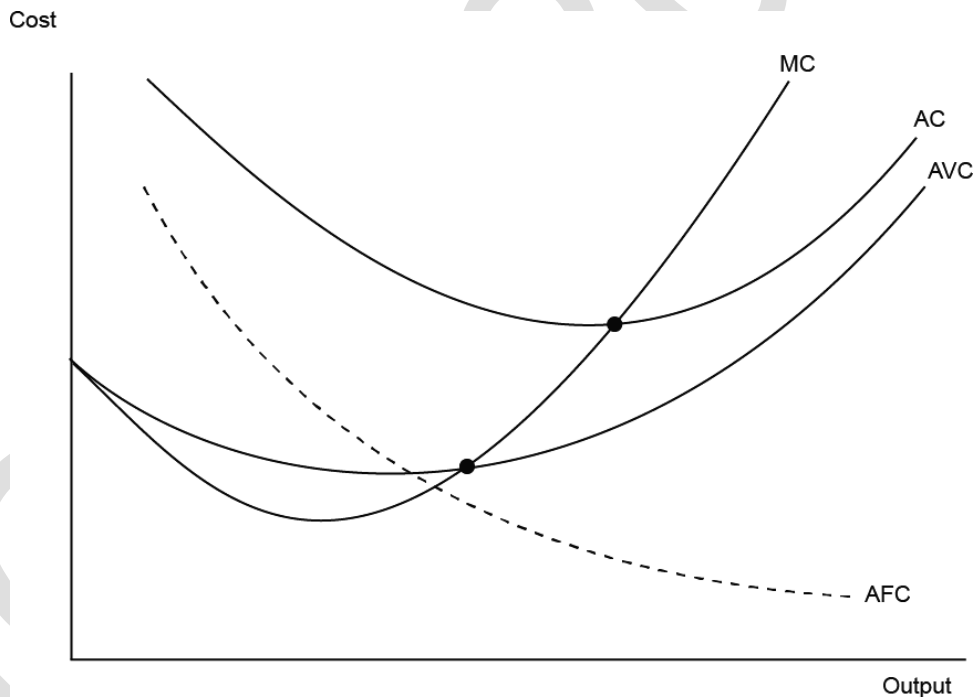
The marginal cost is key to understanding how much a firm will want to produce, and therefore supply to the market. By isolating the cost to produce an additional unit of a good, they can accurately assess the cost of increasing output.

The average variable cost (AVC) curve also begins by decreasing, finds a minimum spot, and then increases afterwards.

The average fixed cost (AFC) curve is always downward sloping, because the fixed costs remain constant, and are then spread out more thinly with each additional unit of output.

The average total cost curve (AC) is the sum of the AVC and AFC curves, so it too is U-shaped.

This can be shown on a cost curve graph below:



There are a number of important points to note from this graph.

The MC, AVC, and AC all start by declining, before reaching a minimum point, and then increasing again.

The AC and AVC are crossed at their minimum points by MC curve. Any average cost curve will continue to decrease if the MC is less than the AC. If the previous incremental cost was less than the average cost per unit, then this will naturally bring the average down. When the MC gets bigger than the AC, each additional unit will add cost which is greater than the average, thereby increasing the average.

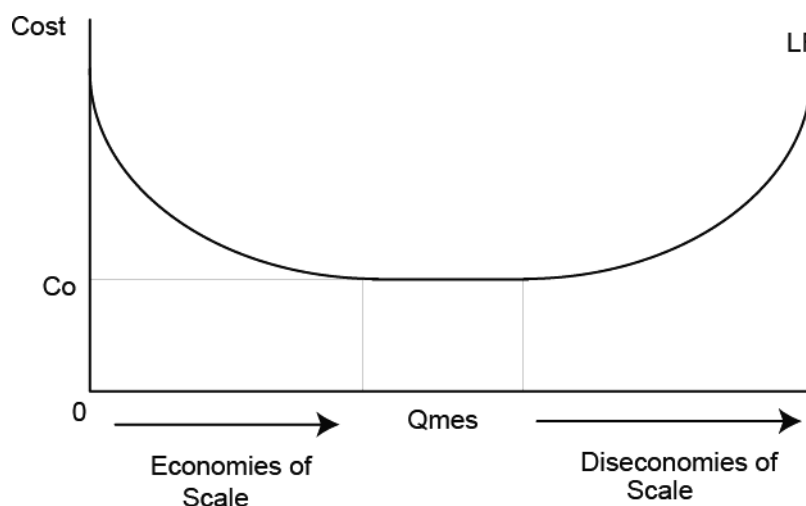
This principle is the same with the AVC curve also, which is why the marginal cost curve crosses it at its minimum point.

The long run average cost curve

Long run: That period of time in which it is possible to vary output by varying all factors of production within the given state of technology.

In the long run, output can be varied by varying all the factors of production within the given state of technology.

The average cost of the product will be determined by the long-run average cost curve of the firm.



As the output of the firm increases the unit cost decline up until output level Q_{mes} .

Q_{mes} is the firm's minimum efficient scale of output and is where unit costs are minimised because economies of scale are maximised.

After a point further growth may cause unit costs to rise due to the inefficiencies generated by diseconomies of scale.

Economies of scale are factors which lead to the overall decrease in unit cost, as output increases. These are usually costs which have similar characteristics to fixed costs, and can be spread out amongst ever greater units, hence reducing the average cost.

Examples of economies of scale include:

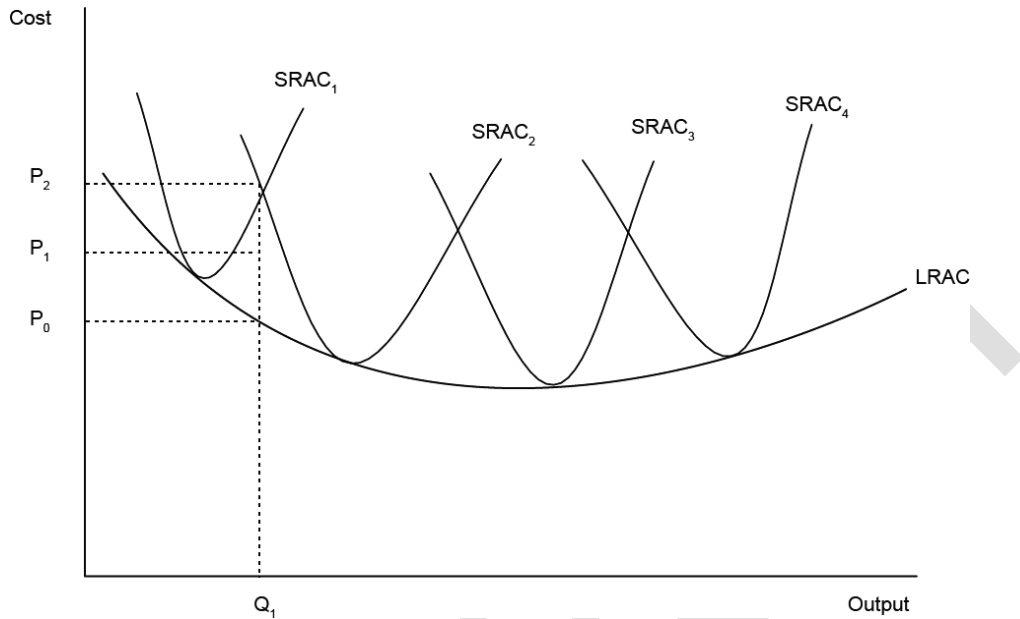
- Technical: generate better efficiency through larger quantities of output
- Managerial: able to employ specialist managers to increase efficiencies
- Trading: able to buy and sell in bulk at more optimal prices
- Financial: able to demand better interest rates with more assets as collateral
- External: firms clustering together – development of specialised labour force etc.

Diseconomies of scale are factors which lead to the overall increase in unit cost, as output increases.

These are often a result of managers/ staff losing control/ motivation as production gets greater. There can also be strains on local infrastructure which come with scale.

Deriving a long run average cost curve

It is possible to construct a long run curve by looking at forecasts of what the average costs would be at various levels of future output, and from there, find the output size that leaves them with the optimal average cost.



If output is to be Q_1 , the lowest cost is achieved on $SRAC_1$. $SRAC_2$ doesn't have the economies of scale at that output to be cheaper than $SRAC_1$.

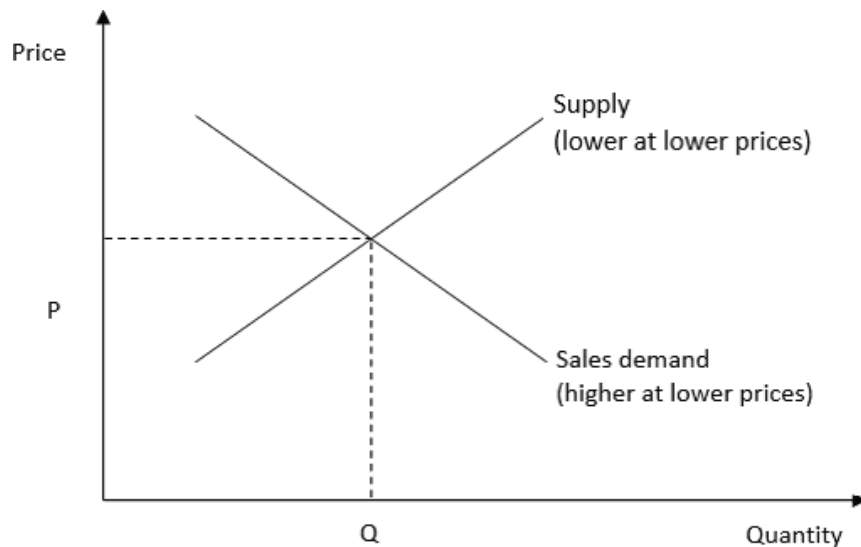
Theoretically, if there was an SRAC curve that was tangential with the LRAC curve at Q_1 , then the cost would be P_0 .

However in this scenario, there are only four SRAC curves, so $SRAC_1$ curve is optimal.

Because the LRAC is a curve where all inputs are flexible, and the SRAC is a curve where only one input is flexible, it is impossible for the SRAC to undercut the LRAC. At points where they meet, this is when resources are deployed in the same way, and so the costs are equal.

4.7 Types of competition

An earlier section explained how the forces of supply and demand interacted to produce a market price for a good at which the quantity demanded was equal to supply. The diagram is repeated below for your convenience.



It is important to realise that the demand curve above represents the demand for the market in its entirety. The demand faced by individual firms depends on the degree of competition in the market.

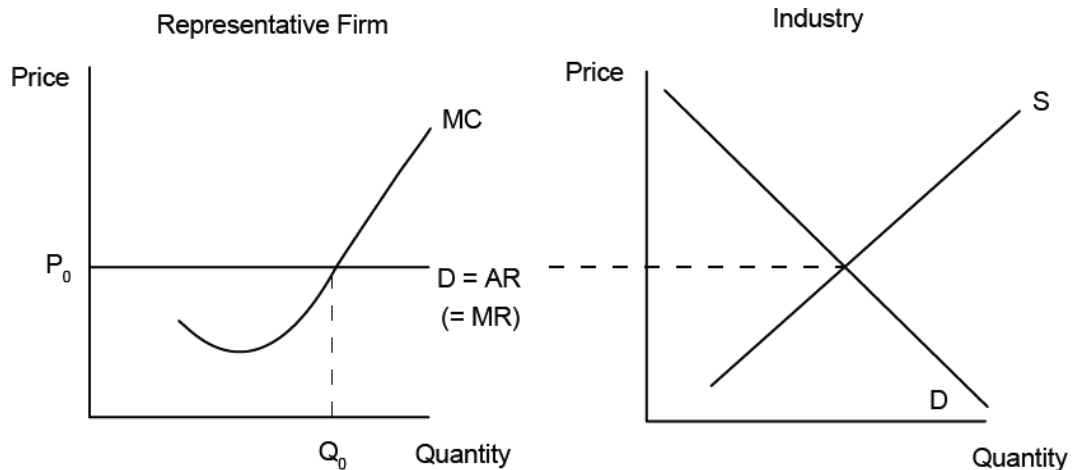
The degree of competition can be represented as a scale with perfect competition at one end and a monopoly at the other.

Perfect competition

A perfectly competitive market has the following characteristics.

- The market consists of a large number of buyers and sellers none of whom can dominate the market.
- The market is for an undifferentiated and homogenous product so that buyers are indifferent as to who they buy it from.
- Buyers and sellers have perfect information about factors affecting price and they all behave rationally.
- There are no barriers to firms entering or leaving the market.

This means that buyers and sellers must take the price determined by the market. The total demand curve is as shown above but the demand curve faced by any one firm is a horizontal straight line representing the market price. A firm can sell any amount of output at this market price. It will choose to sell a quantity where the marginal cost of its goods equals the marginal revenue (which is the price set by the market).



Perfect competition is rare in practice (whether it exists at all is in question) but there are some markets that are close to being perfectly competitive.

Most markets are not perfect but there are varying degrees of imperfection. The following three levels of imperfection are important:

- Monopolies
- Oligopolies
- Monopolistic competition

Monopoly

Monopoly means supply by a single person or firm. It exists only if there are no substitutes for the product and the supplier is able to prevent other firms from supplying the good in question.

In this case the demand curve for the market is the same as the demand curve for the firm (as the firm is the only supplier so all demand is satisfied by the firm).

The monopolist firm can do one of two things:

- It can set the level of price at which it is willing to supply in which case the buyers decide how many units they are willing to buy; or
- It can set the quantity of goods that it wants to sell but in order to do this it must accept the price that the buyers are willing to pay.

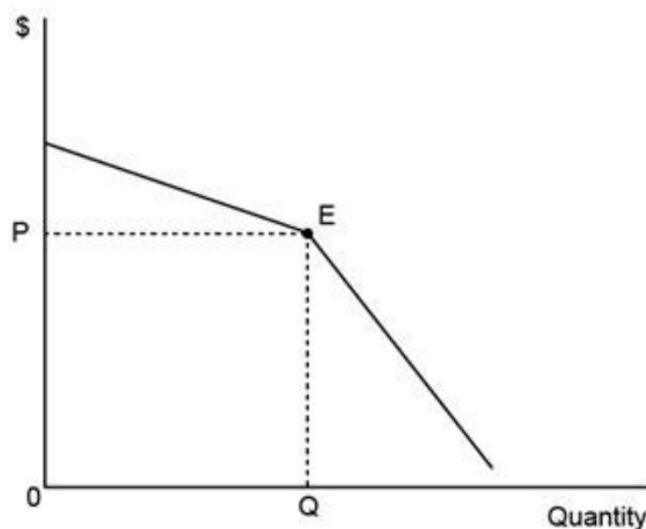
It will choose a price or quantity in such a way as to maximise its profits. This would be where the marginal cost of production equalled the marginal revenue.

Oligopoly

An oligopoly is a market with a small number of suppliers (oligopolists).

Each oligopolist monitors the actions of the other firms. The decisions of one firm therefore influence and are influenced by the decisions of other firms.

Oligopolists face a kinked demand curve as follows.



Example: Oligopoly

There are three fuel suppliers on an island. All three suppliers sell fuel at a price of ₦800 per litre.

If one of the three firms put their price up to ₦1,000 a litre most customers would buy their petrol from one of the other two firms. The firm that has increased the price would experience a large drop in sales volume because of the price increase and this would result in a fall in revenue.

An oligopolist that increases price faces elastic demand because the other firms know that they can increase sales volume (and revenue) by maintaining the old price.

If one of the firms cut the price to ₦600 per litre most customers would want to buy the fuel from that firm.

The other two firms would realise this so they match the price cut.

All three firms would find that the rise in demand for their petrol is proportionately small compared with the fall in price, so their revenues would fall. Demand is inelastic following a price cut.

All three firms face a demand curve that is elastic above ₦800 per litre but inelastic below ₦800 per litre. Therefore there is a kink in the demand curve.

Monopolistic competition

Monopolistic competition is a type of imperfect competition found in many markets. Most economists would agree that this is very common in practice and is a more realistic circumstance than perfect competition.

It applies where many sellers produce similar goods but try to differentiate their products from those of other firms. For example they might do this using advertising or by changing features of the product.

Each producer can set price and quantity without affecting the marketplace as a whole.

Features of monopolistic competition are:

- There are many producers and many consumers;
- Knowledge is widespread, but not perfect;
- Products are differentiated by firms to try to distinguish them from the products of other firms;
- Producers have some control over price because they are the only firm that make their product;
- Barriers to entry and exit do exist, but are low;
- Brand loyalty exists, making demand less sensitive to price; and
- Firms engage in some form of marketing.



Example: Starbucks

Starbucks is a coffee retailer engaged in monopolistic competition. Starbucks is the only company that can sell Starbucks coffee in a Starbucks store so in this sense it has a monopoly. However, there are many places to buy coffee so Starbucks is in competition with these.

All coffee retailers, in essence, provide the same service – they sell cups of coffee. However, Starbucks has differentiated this experience and built brand loyalty through advertising, quality and ambience in its cafes.

A company in monopolistic competition faces a downward sloping demand curve.

5 Social and demographic factors

Section overview

- The nature of social and demographic factors in the environment
- Ageing population and other demographic changes
- Government policy for demographic change

5.1 The nature of social and demographic factors in the environment

Social factors in the environment refer to changes in habits, tastes, values and preferences. In the short term social attitudes and habits are also affected by fashion.

Demography is concerned with a specific aspect of society – the size, spread and distribution of society.

Business organisations need to respond to changes in society, including demographic changes. If they do not, they will continue to offer products and services that are increasingly less relevant to the needs of customers.

The marketing concept in business requires that all successful businesses must keep up to date with and aware of social and demographic change, and respond accordingly.



Example: Demographics in Nigeria

Here are just a few examples of social and demographic change in Nigeria in recent years.

- Nigeria has a population boom. A UN report has predicted that by 2050, Nigeria will have the third largest population of any country in the world (over 300 million people).
- Population growth is exceeding the rate of growth in public infrastructure.
- There remains a culture in Nigeria that favours large families.
- A large number of children are not in school, and only a small proportion of older children are getting into university.
- Unemployment has been high.
- Large numbers of Nigerians have taken the risk of attempting travel to and immigration into Europe.

5.2 Ageing population and other demographic changes

Ageing population

For some Western countries, especially countries of Western Europe, there is an ageing indigenous population. The birth rate is historically low, and the number of new babies per woman of child-bearing age has fallen. Many women are leaving it until much later in life to try to have children.

At the same time, average life expectancy has been increasing. More people are living until an older age than in the past.

As a consequence, there is an ageing population, which means that a larger proportion of the population than in the past will be of an older age – say past normal retirement age.

Governments are aware that the consequence of this demographic change is that in the future, there might be a relatively small working population and a relatively large number of people in retirement. The ‘few’ in work might be expected to support the ‘many’ in retirement, for example by paying taxation to fund state hospital services and many thousands of retired civil servants.

The ageing population of countries such as the UK, Italy and France has been referred to as a ‘demographic time bomb’. The view is that the younger generation might refuse to accept the economic burdens that government might try to impose on it.

Other demographic patterns

Other countries have other demographic problems.

- Some countries suffer from very high rates of mortality, particularly due to disease. In these countries the population on average is very young and there are very few older people.
- Some countries have high rates of child birth but low rates of economic growth. In these countries, large numbers of people might try to migrate to other countries with a wealthier economy.

5.3 Government policy for demographic change

A government might try to develop a policy for social and demographic change. For example, in a country with an ageing population, the government might consider the following measures.

- Permitting immigration of people from other countries, possibly under a controlled immigration scheme, in order to increase the size of the population at working age.
- Increasing the average age at which individuals may retire with entitlement to a state pension.
- Encouraging individuals to work beyond their normal retirement age.
- Providing some form of subsidy or tax-incentive to individuals/couples who have children.

Business organisations are affected by social and demographic change, and by government policy. As a population changes, in age or ethnic origin, the needs and wants of consumers will change. Businesses must respond to those changes.

In addition, the nature of the work force – its age distribution, availability and skills – will also change. Issues such as education and training take on importance for ageing employees as well as young employees, if companies intend to employ them beyond their normal retirement age.

6 Technological factors

Section overview

- The impact of technological change on working methods
- The impact of technological change on products and services
- The impact of technological change on organisation structure and strategy

6.1 The impact of technological change on working methods

Over the years, machines have replaced man for mechanical tasks. Computers have replaced man for many mental tasks and intellectual jobs. The impact of computers on business organisations will be considered in a later chapter. Briefly however:

- Computers have replaced man for many data processing and information analysis tasks;
- Humans have been used for the 'higher level' intellectual tasks and skills tasks that computers have not been able to perform; and
- Computers are taking over from humans even for some high level intellectual and analytical tasks.

6.2 The impact of technological change on products and services

The point should be fairly obvious, but you should also remember that technological change has a huge impact on the nature of products and services that businesses offer to customers.

Companies need to maintain technological developments in the design and manufacture of products, and in the provision of services, in order to remain competitive.



Example: Sony vs. Toshiba

There was competition between manufacturers of televisions, such as Sony and Toshiba, to achieve a technological lead in the development of televisions with the latest 'curved screen OLED' technology.

6.3 The impact of technological change on organisation structure and strategy

Technological change has also had an effect for many businesses on their organisation and strategy. Computerisation, communications technology and other aspects of technological change have led to major developments in business such as:

- Downsizing;
- de-layering; and
- outsourcing.

To some extent, these developments in business organisation are inter-related.

Downsizing

Downsizing means the reduction in size of a business organisation. It does not (necessarily) mean that the business organisation is selling fewer goods or services. It means that its business activities are conducted by a smaller number of people.

Technological change makes downsizing possible, because tasks that were previously performed by humans can now be performed by machine or computer.

De-layering

'De-layering' means removing one or more levels of management in the organisation structure. It could mean removing all layers of middle management entirely, leaving just senior managers and front-line managers and supervisors.

De-layering is made possible by high-quality communications, provided that senior management can delegate sufficient authority to junior managers, and expect junior managers to meet their responsibilities.

When an organisation goes through a de-layering, middle managers are made redundant, and there is consequently some downsizing.

Outsourcing

Outsourcing means arranging for other business organisations to perform some administrative tasks, or management tasks, instead of having to employ individuals to do the task internally, as part of the organisation's own activities.

For example, the following tasks might be outsourced:

- A company might arrange for an external accountancy firm to take over the administration of the payroll, and administer wages and salaries for the company's work force;
- A company might arrange for an external building services company to take over responsibility for cleaning and security in all its buildings;
- A company that produces motor cars might outsource the manufacture of most (or even all) of the component parts, so that its only 'in-house tasks' are product design, assembly, testing and marketing;
- Many companies outsource their IT requirements to specialist IT firms; and
- Some companies outsource most of their office administration tasks, such as record keeping and word processing.

The reason why outsourcing is now popular in many countries is that it can take advantage of specialisations. The conceptual argument in favour of outsourcing is as follows:

- A business succeeds in its competitive markets because it is more successful at doing some things than its competitors. A successful business has some **core competences** that enable it to succeed and do better than rivals;
- A business also has to do other tasks that support its main activities, such as office administration, IT support, building and facilities administration and payroll. It does not have any particular skills in these activities, and there are other companies that can do these tasks just as well, and in some cases much better;

- ❑ When a business performs all these 'non-core' activities itself, this diverts management attention away from the core competences. Management should focus on its strengths, not the routine and ordinary; and
- ❑ It should therefore outsource 'non-core' activities and concentrate on its core activities, to make sure that it maintains or improves its competitive advantage over rivals.

Outsourcing is made much easier by high-quality telecommunications and computer systems, because data and information can flow easily between a business and the other organisations to which it has outsourced activities.

Virtual company - reminder

As you saw in the last chapter a business organisation can outsource almost all its activities, leaving just one or two individuals at the centre managing the business.

A virtual organisation is an organisation that has no physical hub or centre of operations. Instead, it is a network of individuals linked by computer and telecommunications network (such as the internet). The individuals need not be employees of the business: they might be part-time workers or self-employed individuals.

Each individual in the virtual company or virtual organisation might work from home. Data and information is transferred between them, and each performs particular tasks – with no office, no substantial assets and few (if any) full-time employees.

The virtual company has been made possible by developments in information technology.

7 Environmental factors

Section overview

- Impact of business on the physical environment
- Ways in which businesses might limit impact on the environment
- Benefits of economic sustainability to a range of stakeholders

7.1 Impact of business on the physical environment

Environmental issues have become increasingly important to businesses. There has been a growth in awareness of the environmental impact of business organisations. Society at large holds firms responsible for the environmental impacts of their operations.

The precise nature of the environmental impacts of a firm varies from industry to industry but might be grouped into the following areas:

- Use of resources;
- Carbon footprint – the level of CO₂ emissions of a business; and
- Pollution

Use of resources: Non-renewable

Supplies of non-renewable resource are limited. Such resources are being used up.

Extraction of non-renewable resources often has a negative impact on the local natural environment.

Property development can use up land which was previously countryside.

The use of some renewable resources is at such a rate that the systems which generate them cannot keep up with demand. (e.g. over fishing has depleted fish stocks).

Demand for some renewable resources has led to diversion of land from what could have been agricultural use to industrial use. (e.g. growth of crops for biofuels)

Increase of demand for some raw material has led to deforestation of ancient forests to convert the land to use for growing crops that industry needs (e.g. palm oil). This might lead to impact on biodiversity as natural habitats are reduced.

Carbon footprint

Global warming is a major concern. There is wide acceptance in the scientific community that this is a result of human activity through the release of greenhouse gasses (of which CO₂ is the most important). A carbon footprint is the amount of CO₂ generated by an activity or a business. Anything that consumes energy will have a carbon footprint. Businesses use energy in:

- Manufacturing;
- Transport; and
- Heating and lighting.

Pollution

As well as producing CO₂ emissions businesses engage in activities which result in further pollution. This includes obvious things like chemical waste but also one or two that are not so obvious:

- Noise – to the detriment of local residents;
- Heat – many industrial processes have to be cooled and this results in heat being transferred into the local environment; and
- Packaging materials such as polythene bags generate waste that is not biodegradable and hence pollutes the environment.

7.2 Ways in which businesses might limit impact on the environment.

Many large companies are actively committed to reducing their environmental impact. Possible methods include:

- Improved energy efficiency;
- Investment in renewable energies;
- Sourcing goods locally so as to reduce transport costs;
- Investment in IT to make inventory control more effective – this should lead to less waste;
- Investment in more efficient production technologies to reduce waste; and
- Reducing packaging.

7.3 Benefits of economic sustainability to a range of stakeholders

A sustainable business is any organization that participates in environmentally friendly or green activities to ensure that all processes, products, and manufacturing activities adequately address current environmental concerns while maintaining a profit. A sustainable business meets the needs of the present world without compromising the ability of the future generations to meet their own needs.

In general, business is described as green if it:

- Incorporates principles of sustainability into each of its business decisions;
- Supplies environmentally friendly products in place of non-green products;
- Is greener than traditional competition; and
- Has made an enduring commitment to environmental principles in its business operations.

Benefits to stakeholders

A business that takes sustainability seriously will enhance its chances of being able to continue its business at current or enhanced levels. Such a business will be looked on favourably by customers and this might lead to increased sales and profits.

- Shareholders and employees will benefit from the continued success of the business.
- Suppliers benefit through the establishment of long term, ethical trading agreements.

- ❑ Governments benefit as the action of the company will help the government meet its environmental obligations under treaties and provide tax revenue.
- ❑ Society benefits through the provision of continued employment and environmental improvements.

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8 International perspectives

Section overview

- Global competition
- Corporate strategies for international business
- International scale operations, international diversity and globalisation
- Multinational organisations and global organisations

8.1 Global competition

Many business entities have expanded beyond their national markets and operate in foreign markets. As a result, many markets have become international or global, with competitors from different countries competing with each other in all or most countries. The reasons for the internationalisation of markets and competition can be summarised as follows.

- ❑ Business entities succeed by gaining competitive advantage in their markets. One way of achieving competitive advantage is by reducing costs. Costs can be reduced by **economies of scale**. Expanding business operations into the markets of other countries creates a bigger volume of sales, and provides an opportunity for achieving economies of scale and lower unit costs.
- ❑ The **markets in many countries are converging**, and national differences might be fairly small. When customer needs and demands are similar in different countries, an entity should be able to sell a fairly standard product in all of those countries.
- ❑ Foreign currency volatility and **currency risk**. By setting up operations in other countries or currency blocs, an entity can avoid the currency risk of exporting to those countries. By producing and selling its products within the same country or currency bloc, there is no risk from variations in the exchange rate. In contrast, if products are exported from one country to another country with a different currency, the exporter is exposed to the risk of losses from adverse movements in the exchange rate between the two currencies.
- ❑ Porter suggested that some countries obtain a competitive advantage over others in a particular industry. Business entities can use the competitive advantage gained from their own country to compete successfully in other countries.
- ❑ Business entities often need to adopt a global strategy simply to compete against rival entities that are pursuing the same strategy.
- ❑ In some cases, a company might choose to set up new operations within an **economic trading bloc**, to overcome the difficulties of trying to export goods into the bloc due to import control regulations and other regulations. For example, a Japanese or US corporation wanting to sell goods into Europe might set up a subsidiary in the Eurozone, in order to get round the difficulties of exporting from their home country.

8.2 Corporate strategies for international business

Large companies have developed strategies for growing their business operations internationally.

When an entity starts to sell its products in foreign markets for the first time, it will probably think of the foreign market as an extension of its domestic market. It will not change its product design for the foreign markets, and will sell an identical product in all the countries where it operates. The product will be manufactured in the entity's domestic country, and exported to the foreign markets.

However, as an entity becomes more committed to its foreign markets, and as foreign sales increase, the situation changes. The entity will start to recognise differences between the different foreign markets. Customers in each different market will have slightly different needs and preferences. The entity might therefore alter its products to suit the needs of each local market. As a result, total sales will increase. However, profits will fall. This is because the cost of adapting products to local market needs is high.

8.3 International scale operations, international diversity and globalisation

Corporate strategies for international business can be analysed into three different categories:

- International scale operations;
- International diversity; and
- Globalisation.

International scale operations

A company might decide to sell a standard product in many different countries. To do this, it needs to establish operations on an international scale. Production plants might be established in selected countries, each serving a different region of the world. The purpose of selecting a centralised production location in each part of the world is to benefit from economies of scale, by producing the standardised products in large quantities. The products are then distributed to different countries in the region and sold.

International scale operations therefore seek to obtain a cost-minimising balance between production costs and distribution costs.

The operations are usually managed and controlled from a head office in the company's country of origin.

International diversity

A strategy of international diversity is also called multi-domestic strategy. With this type of strategy, the company recognises the differences in customer needs in each different country, and bases its strategy on the view that most or all value-adding activities must be located in the country where the target national market is located. In each country, the product is adapted to suit the unique requirements of the local customers.

It is even possible that the company's products will be sold under different brand names in each country, and the group does not attempt to obtain global recognition for a single global brand name.

Globalisation

A globalisation strategy is similar to an international scale operations strategy, selling a single product under a single global brand name. However, the group operates in every country (or most countries) rather than having centralised regional locations for production.

When it adopts a globalisation strategy, the company will become a global company.

Choosing a suitable international strategy

An entity with international business operations must decide how to develop its business operations and which corporate strategy (or strategies) to adopt. The ideal strategic and marketing solution is to find a balance between:

- ❑ Selling a standardised product, using the same marketing methods, in every foreign market: in this way, the entity will benefit from economies of scale and lower costs; and
- ❑ Adapting its products to the needs of different local markets, in order to achieve higher sales.

Some international companies use a mix of a multi-domestic strategy and an international scale strategy.

8.4 Multinational organisations and global organisations

Companies that operate in different countries and many different national markets are called either multinational companies (MNCs) or global companies. Often, the two terms are used with the same meaning.

However, a difference can be identified between MNCs and global companies according to their differences in corporate strategy.

- ❑ An **international company** is a company with all or most of its production operations in a single country. Most of its senior managers are nationals of the country. The company sells its products in different countries, through local sales agents or local sales offices in each country, or using international sales representatives.
- ❑ A **global company** is a company with operations in a large number of different countries, making a similar range of products or providing a similar range of services. Its senior managers are nationals of a variety of different countries.

When companies expand their business outside their 'home country', they will usually begin as an international company, but may eventually develop into a global company.

Multinational company	Global company
Management make strategic decisions for each foreign market individually.	Management develop worldwide strategies for all their markets.
Products are adapted and designed to the requirements of the local market.	The company produces core products. These are standardised for all markets, with only minimal design changes for individual national markets.
Marketing (for example, advertising) is adapted in each country to suit the local culture.	There is a uniform approach to marketing in all countries, with only small variations.
Countries are selected as a target for production and sales entirely on the basis of their potential for profitability.	Countries are selected for their ability to contribute to the integrated global strategy.
The aim is to optimise the value chain in each country of operation.	The value chain is broken up, and different parts of the value chain are in different countries. The aim is to optimise the value chain globally.
A multinational company often has the culture of the country where its head office is based (for example, the US).	A global company develops a global culture. Its senior managers are likely to come from different countries.

9 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Define the environment of an organisation and discuss how threats and opportunities can arise ('scan' the business environment')
- Explain how political and legal factors affect business
- Explain how economic factors affect business including macroeconomic and microeconomic
- Explain how social and demographic factors affect business
- Explain how technological factors affect business
- Explain how environmental factors affect business
- Discuss international perspectives including globalisation

Financial management

Contents

- 1 Financial management
- 2 Financial objectives
- 3 Stakeholders
- 4 The financial management framework
- 5 The financial markets
- 6 The money markets
- 7 Money market instruments
- 8 The nature of cash management
- 9 Cash budgets and cash flow forecasts
- 10 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

D		The role of finance	
	1	Basics of business finance and financial markets	
		a	Identify the various sources of finance that are available to business organisations.
		b	Explain the characteristics of the different sources of finance, stating their advantages and disadvantages.
		c	Describe the characteristics of financial market.
		d	Explain finance functions and financial management objectives.
		f	Prepare a cash budget using given data.

Exam context

Financial management is about planning and controlling the financial affairs of an organisation to ensure that the organisation achieves its objectives, particularly its financial objectives.

This chapter explains what financial management involves and introduces students to the various components of capital and money markets.

By the end of this chapter students will be able to:

- Define financial management and financial engineering and differentiate between financial management, management accounting and financial accounting;
- Discuss financial objectives in the context of corporate objectives and strategy;
- Explain how different stakeholders may impact on financial management decisions;
- Summarise the financial management framework including sources of finance and financial intermediaries;
- Describe the financial markets including capital markets and money markets;
- Understand the trade-off between risk and return;
- Briefly explain money market terminology and instruments including inter-bank market, repo market, coupon, treasury bills, bills of exchange, certificates of deposit and commercial paper;
- Explain why businesses hold cash and describe the objectives and aspects of good cash management; and
- Describe cash budgets and forecasts and explain how they are constructed.

1 Financial management

Section overview

- The nature of financial management
- Financial management, management accounting and financial accounting
- Financial engineering

1.1 The nature of financial management

Financial management is about planning and controlling the financial affairs of an organisation, to ensure that the organisation achieves its objectives, particularly its financial objectives. This involves decisions about:

- How much finance the business needs for its operations, both its day-to-day operations and for longer-term investment projects;
- Where the finance should be obtained from: long-term finance is raised as equity capital (share capital and profits) or as debt capital, and short-term finance is obtained mainly from trade suppliers and bank overdrafts;
- What should be the balance between long-term and short-term finance, and what should be the balance between equity capital and debt capital (in other words, what should be the capital structure of the organisation?);
- Investing short term cash surpluses;
- Ensuring that the providers of finance are suitably rewarded: the organisation must make sure that it can meet the interest payments on its borrowing, and companies must ensure that shareholders receive an appropriate dividend out of profits; and
- Where appropriate, protecting the organisation against financial risks.

1.2 Financial management, management accounting and financial accounting

Financial management has a strong accounting element, and in large organisations it is usual to find that professional accountants are involved in financial accounting, management accounting and financial management.

Financial accounting is concerned primarily with maintaining a system of accounts (the ledger accounts) and preparing financial statements for shareholders and other external users of financial information, i.e. financial reporting.

Management accountants provide information, mainly financial but also non-financial, to assist management with making decisions about planning and controlling the resources of the organisation. Whereas financial accounting is concerned largely with reporting externally about historical performance, management accounting is concerned with internal reporting to decision-makers within the organisation. Management accounting information might be either historical or forward-looking in nature.

Essentially, however, both financial accounting and management accounting are concerned with the provision and reporting of information.

Financial management is different. As its name suggests, it is concerned mainly with managing the finances of an organisation – raising finance and putting it to efficient and effective use by investing it. Financial managers have a management function as well as an advisory function to senior management.

The relationship between financial accounting, management accounting and financial management

There is often a close relationship between these three areas of finance and accounting.

- ❑ One aspect of financial accounting is the assessment of financial performance and financial position using accounting ratios such as return on capital employed, gearing, profitability ratios and working capital ratios. Users of financial reports can try to use the information in financial statements to make predictions about the future. Ratio analysis is also an element of financial management, because the attitude of shareholders and other investors to a company will depend largely on prospects for its financial performance and the strength of its capital structure.
- ❑ An aspect of financial management is longer-term financial planning, including the setting of financial objectives and targets. Longer-term targets and strategies have to be converted into shorter-term detailed plans. Longer-term financial plans are converted into detailed plans through the budgeting process. Budget preparation is generally regarded as a management accounting function.
- ❑ An aspect of management accounting is strategic management accounting. This is concerned with providing senior management with information to assist with the long-term (strategic) planning and control. This is an area where financial management and management accounting overlap. Capital investment appraisal (DCF analysis) is also regarded as an aspect of both financial management and management accounting.
- ❑ Working capital management is another aspect of operations where financial accounting, management accounting and financial management overlap. Financial management is concerned with the efficient management of inventory, receivables, payables and cash, so that investment in working capital is not excessive but at the same time the entity has enough cash or alternative sources of liquidity at all times to meet its needs. However staff in the financial accounting department might have the day-to-day responsibility for trade receivables, in particular the collection of payments. An aspect of management accounting is to provide information for inventory control, such as information about economic order quantities and reorder levels.

You should therefore find that some aspects of your studies of financial accounting and management accounting will be relevant to the study of financial management.

1.3 Financial engineering

Financial engineering involves the use of mathematical techniques to solve financial problems. Tools and knowledge are drawn from the fields of statistics, economics, computer science and applied mathematics to:

- ❑ Address current financial issues; and
- ❑ Devise new and innovative financial products.

Financial engineering is sometimes called quantitative analysis and is primarily used by investment banks, insurance agencies, hedge funds and commercial banks.

Financial engineering can also be used to refer to strategies adopted by companies to maximise profits or other metrics through:

- ❑ Derivatives that address unusual risks faced by a party in a transaction;
- ❑ Structuring a purchase or sale in a way that better addresses the interests of the buyer or seller; and
- ❑ Using new methods to compute the fair value of new or existing financial instruments.

Continued developments in computing capacity and speed have underpinned recent advancements in the field of financial engineering. However, the discipline can be seen as somewhat controversial as there is an argument that the development of ever increasingly complex derivatives increases an economy's systemic risk (instead of decreasing it). Financial engineering was arguably responsible for triggering the global credit crisis of 2007-2008 through the development of credit-default swaps and mortgage-backed securities.

2 Financial objectives

Section overview

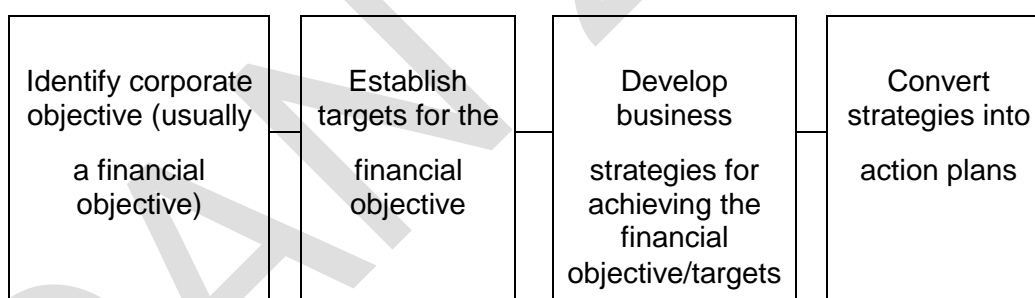
- Financial objectives, corporate objectives and corporate strategy
- Identifying the main financial objective

2.1 Financial objectives, corporate objectives and corporate strategy

A corporate objective is a purpose or aim that a company is trying to achieve. Although there are differing views about what corporate objectives should be, it is generally accepted that the main purpose of a company should be to provide benefits for its owners, the shareholders, in the form of a financial return on their investment.

The main corporate objective might therefore be expressed as a financial objective, such as maximising shareholder wealth or maximising profits. Quantified targets can be established for some financial objectives, such as a target of increasing profits by at least 10% per year for the next ten years.

Plans are formulated for the achievement of the corporate objective. In a large company, longer-term plans are formulated as strategies, from which shorter-term plans are then prepared. Setting the financial objective and financial targets for a company is therefore the initial stage in an extensive process of strategy formulation and implementation. The process can be shown in a simple diagram, as follows.



Business strategies and action plans include financial strategies and plans.

2.2 Identifying the main financial objective

A financial objective can be expressed in a number of different ways, and there are advantages and weaknesses or limitations with each. Three commonly-used financial objectives are to maximise:

- Shareholder wealth;
- Profitability; and
- Growth in earnings per share.

Maximising shareholder wealth

The overall objective of a company might be stated as maximising the wealth of its owners, the shareholders. Shareholder wealth is increased by dividend payments and a higher share price. Corporate strategies are therefore desirable if they result in higher dividends, a higher share price, or both.

However, there are some problems with assuming that the financial objective of a company should be shareholder wealth maximisation.

- ❑ What should be the time period for setting targets for wealth maximisation?
- ❑ How will wealth creation be measured, and how can targets be divided into targets for dividend payments and targets for share price growth?
- ❑ Share prices are often affected by general stock market sentiment, and short-term increases or falls in a share price might be caused by investor attitudes rather than any real success or failing of the company itself.

The objective of maximising shareholder wealth is generally accepted as a sound basis for financial planning, but is not practical in terms of actually setting financial performance targets and measuring actual performance against the target. Other financial objectives might therefore be used instead, in the expectation that if these objectives are achieved, shareholder wealth will be increased by an optimal amount.

Maximising profits

A company might express its main financial objectives in terms of profit maximisation, and targets can be set for profit growth over a strategic planning period. If the underlying objective is to maximise shareholder wealth, targets should be set for growth in profits after tax because these are the profits that are distributable to the company's owners.

Profit growth objectives have the advantage of simplicity. When a company states that its aim is to increase profits by 20% per year for the next three years, the intention is quite clear and easily understood – by managers, investors and others.

The main problem with an objective of maximising profits is to decide the time period over which profit performance should be measured.

- ❑ Short-term profits might be increased only by taking action that will have a harmful effect on profits in the longer term. For example, a company might avoid replacing ageing equipment in order to avoid higher depreciation and interest charges, or might avoid investing in new projects if they will make losses initially – regardless of how profitable they might be in the longer term.
- ❑ It is often necessary to invest now to improve profits over the longer term. Innovation and taking business risks are often essential for long-term success. However, longer-term success is usually only achieved by making some sacrifices in the short term.

In practice, managers often focus on short-term profitability, and give insufficient thought to the longer term:

- ❑ Partly because much of their remuneration might depend on meeting annual performance targets. Annual cash bonuses, for example, might be dependent on making a specified minimum amount of profit for the year.
- ❑ Partly because managers often do not expect to remain in the same job for more than a few years; therefore short-term achievements might mean more to them than longer-term benefits after they have moved on to a different position or job.

Another problem with an objective of profit maximisation is that profits can be increased by raising and investing more capital. When share capital is increased, total profits might increase due to the bigger investment, but the profit per share

might fall. This is why a company's financial objective might be expressed in terms of profit per share or growth in profit per share.

Growth in earnings per share

The most common measure of profit per share is earnings per share or EPS. A financial objective might be to increase the earnings per share each year and possibly to grow EPS by a target amount each year for the next few years. If there is growth in EPS, there will be more profits to pay out in dividends per share, or there will be more retained profits to reinvest with the intention of increasing earnings per share in the future. Growth in EPS should therefore result in growth in shareholder wealth over the long term.

However, there are some problems with using EPS growth as a financial objective. It might be possible to increase EPS through borrowing and debt capital. If a company needs more capital to expand its operations, it can raise the money by borrowing. Tax relief is available on the interest charges, and this reduces the effective cost of borrowing. Shareholders benefit from any growth in profits after interest, allowing for tax relief on the interest, and EPS increases. However, higher financial gearing (the ratio of debt capital to total capital) can expose shareholders to greater financial risk. As a consequence of higher gearing, the share price might fall even when EPS increases.

Financial objectives: conclusion

The main points to note about a company's financial objective are as follows.

- It is generally accepted that the main financial objective of a company should be to maximise (or at least increase) shareholder wealth.
- There are practical difficulties in selecting a suitable measurement for growth in shareholder wealth. Financial targets such as profit maximisation and growth in EPS might be used, but no financial target on its own is ideal.
- Financial performance is therefore assessed in a variety of ways: by the actual or expected increase in the share price, growth in profits, growth in EPS, and so on.

3 Stakeholders

Section overview

- Stakeholders and their objectives
- Conflicts between different stakeholder objectives
- Agency theory
- Measuring the achievement of financial objectives
- Incentive schemes (management reward schemes)

3.1 Stakeholders and their objectives

Although the theoretical objective of a private sector company might be to maximise the wealth of its owners, other individuals and groups have an interest in what a company does and they might be able to influence its corporate objectives. Anyone with an interest in the activities or performance of a company is a 'stakeholder' because they have a stake or interest in what happens.

It is usual to group stakeholders into categories, with each category having its own interests and concerns. The main categories of stakeholder group in a company are usually the following.

- ❑ **Shareholders.** The shareholders themselves are a stakeholder group. Their interest is to obtain a suitable return from their investment and to 'maximise their wealth'. However there might be different types of shareholder in a company: some shareholders are long-term investors who have an interest in longer-term share price growth as well as short-term dividends and gains. Other shareholders might be short-term investors, hoping for a quick capital gain and /or high short-term profits and dividends.
- ❑ **Directors and senior managers.** An organisation is led by its board of directors and senior executive management. These are individuals whose careers, income and personal wealth might depend on the company they work for.
- ❑ **Other employees.** Similarly other employees in a company have a personal interest in what the company does. They receive their salary or wages from the company, and the company might also offer them job security or career prospects. However, unlike directors and senior executives, other employees might have less influence on what the company does, unless they have strong trade union representation or have some other source of 'power' and influence, such as specialist skills that the company needs and relies on.
- ❑ **Lenders.** When a company borrows money, the lender or lenders are stakeholders. Lenders might be banks or investors in the company's bonds. The main concern for lenders is to protect their investment. If the company is heavily in debt, credit risk might be a problem, and lenders might be concerned about the ability of the company to meet its interest and principal repayment obligations. They might also want to ensure that the company does not continue to borrow more money, so that the credit risk does not increase any further.
- ❑ **The government.** The government also has an interest in companies, especially large companies, for a variety of reasons.

- The government regulates commercial and industrial activity; therefore it has an interest in companies as a regulator.
 - Companies are an important source of taxation income for the government - from tax on corporate profits and also from tax on employment income and sales taxes.
 - Companies are also employers, and one of the economic aims of government might be to achieve full employment.
 - Some companies are major suppliers to the government.
- Customers.** Customers have an interest in the actions of companies whose goods or services they buy, and might be able to influence what companies do.
 - Suppliers.** Major suppliers to a company might have some influence over its actions.
 - Society as a whole.** A company might need to consider the concerns of society as a whole, about issues such as business ethics, human rights, the protection of the environment, the preservation of natural resources and avoiding pollution. Companies might need to consider how to protect their 'reputation' in the mind of the public, since a poor reputation might lead to public pressure for new legislation, or a loss in consumer (customer) support for the company's products or services.

Companies might therefore state their objectives in terms of seeking to increase the wealth of their shareholders, but subject to a need to satisfy other stakeholders too - rewarding employees well and being a good employer, acting ethically in business, and showing due concern for social and environmental issues.

The ability of stakeholders to influence what a company does will depend to a large extent on:

- the extent to which their interests can be accommodated and do not conflict with each other
- the power of each group of stakeholders to determine or influence the company's objectives and strategies.

3.2 Conflicts between different stakeholder objectives

Different stakeholders have differing interests in a company which may be incompatible and in conflict with each other. When stakeholders have conflicting interests:

- either a compromise will be found so that the interests of each stakeholder group are satisfied partially but not in full
- or the company will act in the interests of the most powerful stakeholder group, so that the interests of the other stakeholder groups are ignored.

In practice there might be a combination of these two possible outcomes. A company might make small concessions to some stakeholder groups but act mainly in the interests of its most powerful stakeholder group (or groups).

Some examples of conflicting interests of stakeholder groups are as follows.

- ❑ If a company needs to raise more long-term finance, its directors and shareholders might wish to do so by raising more debt capital, because debt capital is usually cheaper than equity finance. (The reason why this is so will be explained in the next chapter.) However, existing lenders might believe that the company should not borrow any more without first increasing its equity capital – by issuing more shares or retaining more profits. The terms of loan agreements (the lending ‘covenants’) might therefore include a specification that the company must not allow its debt level (gearing level) to exceed a specified maximum amount.
- ❑ The government might want to receive tax on a company’s profits, whereas the company will want to minimise its tax liabilities, through ‘efficient’ tax avoidance schemes.
- ❑ A company cannot maximise returns to its shareholders if it also seeks to maintain a contented work force, possibly by paying them high wages and salaries.
- ❑ A company cannot maximise short-term profits if it spends money on environmental protection measures and safe waste disposal measures.

However the most significant conflict of interest between stakeholders in a large company, especially a public company whose shares are traded on a stock market, is generally considered to be the conflict of interests between:

- ❑ the shareholders and
- ❑ the board of directors, especially the executive directors, and the other senior executive managers.

This perceived conflict of interests is fundamental to agency theory and the concepts of good corporate governance that have developed from agency theory.

3.3 Agency theory

Agency theory was developed by Jensen and Meckling (1976) who defined the agency relationship as a form of contract between a company’s owners and its managers, where the owners appoint an agent (the managers) to manage the company on their behalf. As a part of this arrangement, the owners must delegate decision-making authority to the management.

The owners expect the agents to act in the best interests of the owners. Ideally, the ‘contract’ between the owners and the managers should ensure that the managers always act in the best interests of the shareholders. However, it is impossible to arrange the ‘perfect contract’, because decisions by the managers (agents) affect their own personal interests as well as the interests of the owners. Managers will give priority to their personal interests over those of the shareholders.

When this happens, there is a weakness or failing on the governance of the company.

Agency conflicts

Agency conflicts are differences in the interests of a company’s owners and managers. They arise in several ways.

- ❑ **Moral hazard.** A manager has an interest in receiving benefits from his or her position as a manager. These include all the benefits that come from status, such as a company car, use of a company airplane, lunches, attendance at sponsored sporting events, and so on. Jensen and Meckling suggested that a manager’s incentive to obtain these benefits is higher when he has no shares, or only a few shares, in the company. The biggest problem is in large companies.

- ❑ **Effort level.** Managers may work less hard than they would if they were the owners of the company. The effect of this 'lack of effort' could be lower profits and a lower share price. The problem will exist in a large company at middle levels of management as well as at senior management level. The interests of middle managers and the interests of senior managers might well be different, especially if senior management are given pay incentives to achieve higher profits, but the middle managers are not.
- ❑ **Earnings retention.** The remuneration of directors and senior managers is often related to the size of the company, rather than its profits. This gives managers an incentive to grow the company, and increase its sales turnover and assets, rather than to increase the returns to the company's shareholders. Management are more likely to want to re-invest profits in order to make the company bigger, rather than pay out the profits as dividends.
- ❑ **Risk aversion.** Executive directors and senior managers usually earn most of their income from the company they work for. They are therefore interested in the stability of the company, because this will protect their job and their future income. This means that management might be risk-averse, and reluctant to invest in higher-risk projects. In contrast, shareholders might want a company to take bigger risks, if the expected returns are sufficiently high.
- ❑ **Time horizon.** Shareholders are concerned about the long-term financial prospects of their company, because the value of their shares depends on expectations for the long-term future. In contrast, managers might only be interested in the short-term. This is partly because they might receive annual bonuses based on short-term performance, and partly because they might not expect to be with the company for more than a few years. Managers might therefore have an incentive to increase accounting return on capital employed (or return on investment), whereas shareholders have a greater interest in long-term share value.

Agency costs

Agency costs are the costs that the shareholders incur when professional managers run their company.

- ❑ Agency costs do not exist when the owners and the managers are exactly the same individuals.
- ❑ Agency costs start to arise as soon as some of the shareholders are not also directors of the company.
- ❑ Agency costs are potentially very high in large companies, where there are many different shareholders and a large professional management.

There are three aspects to agency costs:

- ❑ They include the **costs of monitoring**. A company establishes systems for monitoring the actions and performance of management, to try to ensure that management are acting in their best interests. An important example of monitoring is the requirement for the directors to present an annual report and audited accounts to the shareholders, setting out the financial performance and financial position of the company. Preparing accounts and having them audited has a cost.
- ❑ Agency costs also include the costs to the shareholder that arise when the managers take decisions that are not in the best interests of the

shareholders (but are in the interests of the managers themselves). For example, agency costs arise when a company's directors decide to acquire a new subsidiary, and pay more for the acquisition than it is worth. The managers would gain personally from the enhanced status of managing a larger group of companies. The cost to the shareholders comes from the fall in share price that would result from paying too much for the acquisition.

- ❑ The third aspect of agency costs is costs that might be incurred to provide incentives to managers to act in the best interests of the shareholders. These are sometimes called **bonding costs**. The main example of bonding costs are the costs of remuneration packages for senior executives. These costs are intended to reduce the size of the agency problem. Directors and other senior managers might be given incentives in the form of free shares in the company, or share options. In addition, directors and senior managers might be paid cash bonuses if the company achieves certain specified financial targets.

Reducing the agency problem

Jensen and Meckling argued that in order to reduce the agency problem, incentives should be provided to management to increase their willingness to take 'value-maximising decisions' – in other words, to take decisions that benefit the shareholders by maximising the value of their shares.

Several methods of reducing the agency problem have been suggested. These include:

- ❑ Devising a remuneration package for executive directors and senior managers that gives them an incentive to act in the best interests of the shareholders.
- ❑ Fama and Jensen (1983) argued that an effective board must consist largely of **independent non-executive directors**. Independent non-executive directors have no executive role in the company and are not full-time employees. They are able to act in the best interests of the shareholders.
- ❑ Independent non-executive directors should also take the decisions where there is (or could be) a conflict of interest between executive directors and the best interests of the company. For example, non-executive directors should be responsible for the remuneration packages for executive directors and other senior managers.

These ideas for reducing the agency problem are contained in codes of corporate governance.

3.4 Measuring the achievement of financial objectives

It has been suggested that the financial objective for a company might be stated as maximisation of shareholder wealth, or possibly in terms of profitability and earnings per share, or growth in profits or EPS.

When a financial objective is established, actual performance should be measured against the objective. In your examination, you might be required to comment on the relative success or failure of a company to achieve its objectives. To do this you might need to calculate one or more suitable performance measurements.

Financial objectives are commonly measured using ratio analysis. Financial ratios can be used to make comparisons:

- ❑ Comparisons over a number of years. By looking at the ratios of a company over a number of years, it might be possible to detect improvements or deterioration in the financial performance or financial position of the entity. Ratios can therefore be used to make comparisons over time, and to identify changes or trends
- ❑ Comparisons with the similar ratios of other, similar companies for the same period.
- ❑ In some cases, perhaps, comparisons with 'industry average' ratios.

Return on capital employed (ROCE)

Profit-making companies should try to make a profit that is large enough in relation to the amount of money or capital invested in the business. The most important profitability ratio is return on capital employed or ROCE.

For a single company:

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{Share capital and reserves} + \text{Long-term debt capital}} \times 100\%$$

The capital employed is the share capital and reserves, plus long-term debt capital such as bank loans, bonds and loan stock.

Where possible, use the average capital employed during the year. This is usually the average of the capital employed at the beginning of the year and end of the year.



Example: ROCE

Sting Company achieved the following results in Year 1.

	1st January Year 1	31st December Year 1
	₦	₦
Share capital of ₦1	200,000	200,000
Share premium	100,000	100,000
Accumulated profits	500,000	600,000
Bank loans	200,000	500,000
	₦	
Profit before taxation	210,000	
Taxation	75,000	
Profit after taxation	135,000	

Interest charges on bank loans were ₦30,000. Dividend payments to shareholders were ₦45,000. Sales during the year were ₦5,800,000.

Required

Calculate the return on capital employed for Year 1.

**Answer**

Capital employed at the beginning of the year = ₦1,000,000.

Capital employed at the end of the year = ₦1,400,000.

Average capital employed = $[\text{₦}1,000,000 + \text{₦}1,400,000]/2 = \text{₦}1,200,000$.

Profit before interest and taxation = ₦210,000 + ₦30,000 = ₦240,000.

ROCE = $\text{₦}240,000/\text{₦}1,200,000 = 0.20$ or 20%.

Return on equity

Return on equity measures the return on investment that the shareholders of the company have made. This ratio normally uses the values in the statement of financial position (balance sheet values) of the shareholders' investment, rather than market values of the shares.

$$\text{ROSC} = \frac{\text{Profit after taxation}}{\text{Share capital and reserves}} \times 100\%$$

The average value of shareholder capital should be used if possible. This is the average of the shareholder capital at the beginning and the end of the year.

Profit after taxation is used as the most suitable measure of return for the shareholders, since this is a measure of earnings (available for payment as dividends or for reinvestment in the business).

**Example: ROE**

Using the figures in the previous example:

Shareholders' capital at the beginning of the year = ₦200,000 + ₦100,000 + ₦500,000 = ₦800,000.

Shareholders' capital at the end of the year = ₦200,000 + ₦100,000 + ₦600,000 = ₦900,000.

Average shareholders' capital employed = $[\text{₦}800,000 + \text{₦}900,000]/2 = \text{₦}850,000$.

Return on equity = $135,000/850,000 \times 100\% = 15.88\%$.

Note that the return on equity is not directly comparable with ROCE because ROCE is a before-tax measure of return whereas return on equity is measured after tax.

Earnings per share and dividend per share

The earnings per share (EPS) is a measure of the profit after taxation (and preference share dividend, if any) per equity share, during the course of a financial year. The EPS might be:

- a historical EPS, as reported in the company's financial statements, or
- a forward-looking EPS, which is the EPS that the company will expect to achieve in the future, usually in the next financial year.

Dividend per share may be important for shareholders who are seeking income from shares rather than capital growth. The company may have a dividend policy which aims for steady growth of dividend per share.



Example: EPS and DPS

Using the figures in the previous example:

EPS = profit after tax / Number of ordinary shares = ₦135,000 / 200,000 = 67.5k per share

Dividend per share = ₦45,000 / 200,000 = 22.5k per share

Changes in share price and dividend

Financial performance can also be measured by the return provided to shareholders over a period of time such as a financial year. The total return consists of dividend payments plus the increase in the share price during the period (or minus the fall in the share price).

This total return, often called the **Total Shareholder Return** or **TSR**, can be expressed as a percentage of the value of the shares at the beginning of the period.



Example: TSR

At 1 January the market value of a company's shares was ₦8.40 per share.

During the year dividends of 45 kobo per share were paid and at 31 December the share price was ₦9.00.

The share price has risen by ₦0.60; therefore TSR = $\frac{₦(0.60 + 0.45)}{₦8.40} = 0.125$ or 12.5%.

3.5 Incentive schemes (management reward schemes)

This chapter has so far made the point that the main objective of a company should be a financial objective, but there are different ways of stating this objective and in measuring the extent to which the objective has been achieved.

There are different stakeholder groups with an interest in a company, and these are likely to have conflicting interests. The main conflict of interests is the agency problem and the different interests of shareholders and senior executive managers and directors.

This raises the question: Can the agency problem be reduced and can managers be persuaded to focus on returns to shareholders as the main objective of the company? Managers may be encouraged to work in the best interests of the company if there are remuneration incentive schemes (reward schemes) linked to profits, earnings, share price or Total Shareholder Return.

Most, if not all, large stock market companies have remuneration schemes for their executive directors and other senior managers, and the purpose of such schemes is to make the personal interests of the directors and managers similar to those of the shareholders. By achieving a financial performance that is in the interests of the shareholders, directors and managers will also obtain personal benefits for themselves.

Structure of a remuneration package for senior executives

The structure of a remuneration package for executive directors or senior managers can vary, but it is usual for a remuneration package to have at least three elements.

- ❑ A **basic salary** (with pension entitlements). Basic salaries need to be high enough to attract and retain individuals with the required skills and talent.
- ❑ Annual performance incentives, where the reward is based on achieving or exceeding specified annual performance targets. The performance target might be stated as profit or earnings growth, EPS growth, achieving a profit target or achieving a target for TSR. Some managers might also have a non-financial performance target. Some managers might have several annual performance targets, and there is a reward for achieving each separate target. **Annual rewards** are usually in the form of a **cash bonus**.
- ❑ **Long-term performance incentives**, which are linked in some way to share price growth or TSR over a longer period of time (in practice typically three years). Long-term incentives are usually provided in the form of **share awards** or **share options** in the company. The purpose of these awards is to give the manager a personal incentive in trying to increase the value of the company's shares. As a holder of shares or share options, the manager will benefit financially from a rising share price.

Share awards

With a share award scheme, the company purchases a quantity of its own shares and awards these to its executive directors and other senior managers on condition that certain 'long-term' financial targets are achieved, typically over a three-year period.

Share options

A company might award share options to its executives. A share option gives its holder the right to purchase new shares in the company on or after a specified date in the future, typically from three years after the options have been awarded. The right to buy new shares in the company is at a fixed price (an 'exercise price') that is specified when the share options are awarded. Typically the exercise price is the market price of the shares at the time the options are awarded. The holder of a share option gains from any increase in the share price above the exercise price, and so has a direct personal interest in a rising share price.

For example, a company might award share options to its chief executive officer. If the market price of the shares at the date of the award is, say, ₦7.00, the CEO might be given 500,000 share options at ₦7 per share, exercisable from three years after the date of the option award. If the share price three years later is, say, ₦10, the CEO will be able to buy 500,000 new shares at ₦7 and sell them immediately at ₦10, to make a personal financial gain of ₦1,500,000.

4 The financial management framework

Section overview

- Businesses and sources of finance
- Financial intermediaries

4.1 Businesses and sources of finance

Businesses raise new finance to invest. Long-term finance is needed to invest in long-term assets and working capital. Short-term finance might be needed to help with cash flow problems, and to ensure that the entity has enough funds to pay its suppliers and liabilities on time. Finance has a cost, because the providers of finance to a company expect a return on their investment.

Financial management involves deciding how to raise additional finance, and for how long, and ensuring that the providers of finance receive the returns to which they are either entitled (in the case of lenders) or which they expect (in the case of shareholders). Financial managers therefore need to have an understanding of the financial markets.

The main sources of new finance for companies include:

- Banks which might provide short-term lending facilities such as an overdraft or longer-term loan;
- The capital markets; and
- The money markets.

4.2 Financial intermediaries

Borrowers of finance include companies, governments and individuals that need to raise money. Providers of finance are individuals, companies and other organisations with surplus funds to invest. Although it is possible for borrowers to obtain funding directly from an investor, it is usual for borrowers and investors/lenders to be brought together by financial intermediaries in the financial markets.

A financial intermediary is a person or organisation that operates between savers (investors) and borrowers. Their role is to re-direct the funds of savers and investors to the individuals and organisations that need to obtain finance.

Without financial intermediaries, it would be difficult for businesses to find individuals willing to provide all the money they need, for the length of time that they need it and at a cost they are willing to pay.

Banks as financial intermediaries

Banks are financial intermediaries. They take deposits from customers, and lend this money to other customers in the form of bank loans and bank overdrafts. If a company needs to borrow, it can go to a bank (the intermediary), instead of having to find an individual or an organisation with spare funds for lending.

Banks are important financial intermediaries because:

- They are a major source of debt finance for many companies and individuals; and
- They also create new credit.

The role of banks in credit creation is unique. Suppose that banks receive new customer deposits of ₦1 million. The banks can re-lend some of this money, but will hold some in the form of cash or near-cash investments, to cover the possibility that some of the deposits will be withdrawn. When banks lend money, this money becomes new customer bank deposits. In other words, by lending money, banks create more bank deposits, which can be lent. The new money that is lent becomes more new bank deposits, which can also be lent.

In performing an intermediary role, banks perform several functions.

- ❑ They are able to accept small deposits from customers and lend in much larger amounts to borrowers. Without banks, loans in large amounts would be difficult to obtain.
- ❑ Banks provide **maturity transformation**. Many bank deposits are short-term in nature and deposits can be withdrawn on demand or by giving only short notice. On the other hand, many borrowers want loans for several years – far longer than most customers are willing to keep deposits or savings accounts. Banks are able to accept short-term deposits and lend to borrowers over longer terms. In other words, short-term deposits are transformed by banks into longer-term loans.
- ❑ Banks provide **risk transformation** for savers. If an individual lent money directly to a borrower, the individual would be faced with the risk of default by the borrower. However, if an individual deposits money with a bank and the bank re-lends the money to a borrower, the bank would be exposed to the credit risk from the borrower. The individual's credit risk would be limited to the risk of insolvency of the bank. Generally, this risk is much lower.

Banks are an important source of finance for all types of business and all sizes of business. In the case of small businesses, bank loans and overdrafts (and possibly lease finance) are the only readily-available sources of borrowed capital.

Other financial intermediaries

The term 'financial intermediary' can be used to describe any person or organisation that brings together investors and individuals or organisations seeking to raise funds. In this sense, financial intermediaries include:

- ❑ Some investment banks and commercial banks, that deal in the capital markets with investors (buying and selling shares or bonds in the 'secondary' markets);
- ❑ Stock markets, which provide a market place for trading in shares.

5 The financial markets

Section overview

- Domestic and international equity and bond markets: the capital markets
- The money markets
- The trade-off between risk and return

The financial markets bring together organisations and individuals wishing to obtain finance as well as organisations and individuals wishing to invest.

In addition to the bank lending markets, the financial markets can be classified as capital markets or money markets. The capital markets can be classified into:

- Equity markets; and
- Bond markets.

5.1 Domestic and international equity and bond markets: the capital markets

Capital markets are financial markets for primary issues and secondary market trading in long-term investments: equities and bonds. The capital markets are both national ('domestic') and international.

Many countries have at least one stock market. Although some bonds might be traded on stock markets, the main purpose of stock markets is to trade in shares of companies.

There is a **primary market** and a **secondary market** for shares.

- The primary market is used by companies to sell shares to investors for the first time, for example by issuing new shares to raise cash. The primary capital markets are therefore a source of new long-term capital for companies, governments and other organisations.
- The secondary market is used by investors to sell shares that they own, or to buy shares that are already in issue.

A successful primary market relies on a large and liquid secondary market, because when investors buy shares in the primary market, they want to know that they can sell their investment at any time at a fair market price.

Functions of a stock market

A stock market is a market place for buying and selling shares in companies that apply to have their shares traded on the exchange and whose application is accepted. It acts as both a primary market and a secondary market for shares.

In the UK, companies must obtain a listing for their shares from the financial services regulator, and also apply to have their shares traded on the stock exchange. The major stock exchanges trade shares of domestic companies (companies registered in the same country) but also the shares of some international companies. For example, many UK companies have their shares traded both in the UK (on the London Stock Exchange) and in the US (for example, on the New York Stock Exchange).

The **international stock markets** therefore consist mainly of national stock exchanges that also trade shares of some foreign companies. However, the New York Stock Exchange owns Euronext which in turn owns the national stock exchanges of France, Belgium and the Netherlands.

The main functions of a stock exchange are to:

- provide a system in which shares can be traded in a regulated manner
- enforce rules of business conduct on market participants, to ensure fair dealing
- ensure that there is an efficient system for providing new financial information about companies to investors in the market
- provide a system for recording information about the prices at which shares are bought and sold, and providing share price information to participants in the market.

The bond markets

Bond markets can be classified as **domestic** or **international**.

Bonds are debt instruments issued by governments, government agencies, international organisations and companies. Most bonds are issued for a fixed period of time (maturity) after which they are redeemed by the issuer, usually at their face value. During the time they are in issue, the issuer pays interest to the bondholders, usually once, twice or quarterly in each year at a fixed rate of interest. For example, a government might issue ₦100 million of 6% Treasury Stock with a maturity of 15 years. It would pay interest of ₦6 million in each year to the investors in the bonds (the bondholders) and redeem the bonds at the end of 15 years for ₦100 million. Investors can trade the bonds in a secondary bond market, and so invest or disinvest at any time of their choice.

In the US, the largest bond market is for US government bonds (Treasuries), but there is also a large and active market for corporate bonds, which are bonds issued by companies. In the UK, there is a large bond market for UK government bonds (gilts) but only a very small domestic market for corporate bonds.

International bond markets (also called 'Eurobond markets') are used by large companies, governments and international organisations to issue bonds, usually in a major currency (US dollars or euros). The markets are organised by international investment banks. These banks advise issuers and organise the selling of the bonds to investors.

International bonds are also traded in a secondary market, although much of the trading is arranged by telephone and e-mail. There is also an electronic trading platform for trading bonds electronically.

The bond markets are not accessible to small companies. The international bond markets are used by governments and very large companies to issue bonds denominated mainly in either US dollars or euros (although bonds in other currencies such as Japanese yen, Swiss francs or British pounds might occasionally be issued). Smaller non-US companies are able to borrow in the US corporate bond market, by issuing bonds denominated in dollars. However, foreign companies need to be fairly large and well-established to persuade US investors to buy their bonds.



Example: Nigerian bond market

The Nigerian Stock Exchange (NSE) hosts and lists numerous bonds on its platform, including:

- Federal government bonds – the most liquid and capitalized bonds on the NSE. These bonds are issued in the primary market at monthly auctions by the Debt Management Office (DMO) then subsequently listed on the exchange for trading.

Federal government bonds are backed by the Federal Government of Nigeria (FGN) and accrue bi-annual, tax-free coupons.

- FGN savings bonds – a new partnership between the DMO and NSE which gives retail investors access to the development of Nigeria through participation in 2- and 3-year savings bonds.

FGN bonds are backed by the FGN and accrue quarterly, tax-free coupons.

- State/local government bonds – these bonds are regarded as sub-national and are issued by state or local governments, usually to raise capital to fund local projects.

State/local government bonds are backed by the local state or government and pay coupons twice a year.

- Supranational bonds – these bonds are issued by supranational entities formed through the partnership of two or more sovereign nations. Supranational bonds can be issued in the local domestic currency or issued as Eurobonds. They are sold on the local markets of the member countries or in the Eurobond market.

- Corporate bonds – these are issued (and backed) by private and/or public companies. They typically attract a higher interest rate or yield than government bonds due to their higher inherent risk.

- Eurobonds – these are bonds issued by sovereigns, corporates and supranational institutions outside the country in which the underlying currency is denominated (typically in USD).

5.2 The money markets

Money markets are for trading in financial instruments with a much shorter maturity. As a general guide, the maturity of instruments in the money markets is not usually longer than one year, but the maturity of many transactions and instruments is less than three months, even 'overnight'.

Examples of money market transactions and instruments are as follows:

- the interbank market
- Treasury bills
- Certificates of Deposit (CDs)
- the repo market.

Interbank market

The interbank market describes large-scale short-term lending and borrowing between banks. Large-scale lending is known as 'wholesale lending'. Banks with a short-term funding deficit will borrow from banks with a short-term surplus.

Interest rates in the interbank market are significant, because when most large companies borrow from banks, they usually pay a floating rate of interest (a variable interest rate) that is linked to the benchmark interest rate in the money market.

In the UK, the benchmark interbank rate is called the London Inter-bank Offered Rate or LIBOR, and there is a LIBOR rate for different maturities of lending, such as seven-day LIBOR, one-month LIBOR, three month LIBOR, six-month LIBOR and so on. A company might arrange to borrow from its bank at, say, the three-month LIBOR rate plus 1%, with interest payable every three months.

Interbank lending can be in a variety of currencies but predominantly US dollars and euros.

A similar system operates in Nigeria where the benchmark is called the Nigeria Inter-bank Offered Rate or NIBOR.

Treasury bills

There is a market for Treasury bills and other bills of exchange, particularly bills of exchange payable by banks (bank bills). A bill of exchange is a financial instrument acknowledging a short-term debt. The buyer of a bill or holder of a bill can hold the bill until maturity, when it should be redeemed. Alternatively, the bill holder can sell the bill in a secondary market before maturity. Bills are redeemable at face value (at 'par') and do not pay interest; therefore their market value is always below their redemption value/face value. The bills are traded at a discount, and the market for bills is known as the **discount market**.

Certificates of Deposit (CDs)

There is also a money market for Certificates of Deposit (CDs). A CD is a financial instrument issued by a bank, acknowledging that the bank is holding a short-term bank deposit on which interest is being earned. At the end of the deposit period, the holder of the CD is entitled to take the deposit with interest. A company placing a deposit with a bank for a fixed short term, say six months, can ask the bank to provide it with a CD; if the company subsequently needs the cash before the end of the deposit period, it can sell the CD in the secondary market. The advantage of a CD for the bank is that it can hold onto the deposit for the full period to maturity, even if the original depositor needs cash earlier.

Repo market

The repo market is a market for the sale and repurchase of short-term financial instruments, in particular Treasury bills, government bonds with a very short time remaining to maturity and some bank bills. A repo transaction is the simultaneous agreement to sell a quantity of financial instruments and to buy them back again at a later date, say 14 days later, at a higher price. The difference between the sale and the repurchase price represents, in effect, interest on a cash loan secured by the financial instruments in the transaction. This is the money market used by central banks to manage the interest rate.

5.3 The trade-off between risk and return

When investors put money into financial investments, they expect to receive a return on their investment. In most cases, they also expect to accept some investment risk. Investment risk is the risk that returns will not be as high as expected.

For example:

- an investment might fall in value, as well as rise in value; for example, shares can go up or down in price
- the investment will lose all its value, for example if a company goes into liquidation, there is a risk that shareholders will lose their entire investment
- borrowers will not repay what they owe in full or on time. For example, if a company goes into liquidation, its bondholders will not be repaid in full, although there might be some receipts from the sell-off of the collapsed company's assets.
- Investors in bonds rely on the creditworthiness of the bond issuer. Some bond issuers are more creditworthy than others, and so the investment is less risky.

In the case of equities, investors buy shares hoping for some dividends out of the profits each year, and for some increase over time in the share price. Equity returns are therefore a combination of dividends and capital gain. However, unprofitable companies might pay no dividends, and share prices might fall. Equity investors can therefore face a substantial risk of negative returns.

As a general rule, investors will demand a higher return for putting their money into higher-risk investments. Each investor has his own preference for risk and returns, and will build an investment portfolio that appears to provide a suitable balance or 'trade-off' between risk and return.

A guide to the risk in capital instruments is as follows:

- | | | |
|--------------|----------|---|
| Highest risk | Equities | <ul style="list-style-type: none"> <input type="checkbox"/> Risk of lower dividends and a falling share price. ■ If the company goes into liquidation, equity shareholders are the last in line for payment from the sale of the company's assets. ■ Shareholders are not entitled to any dividend unless there are distributed profits available after paying all interest obligations and any dividend payment obligations to preference shareholders. |
|--------------|----------|---|

High risk	Junk bonds	<ul style="list-style-type: none"> ■ Bonds issued by companies that are considered a high credit risk. Junk bonds have a 'sub-investment grade' credit rating. A high interest yield is required to compensate investors for the high risk of default.
	Corporate bonds with an investment grade rating	<ul style="list-style-type: none"> ■ Bonds issued by companies with a higher credit rating are 'investment grade rating'. Top-rated bonds are 'triple-A rated' (credit rating AAA). ■ The better the credit rating, the lower the credit risk and the lower the yield paid to bondholders.
Low risk	Government bonds	<ul style="list-style-type: none"> ■ Bonds issued by a government in their own currency, such as gilts issued by the UK government or Treasuries issued by the US government, are considered risk-free. Investors consider the risk of default by the issuer to be zero. ■ The interest yield on domestic government bonds of a government in a stable economy is therefore considered 'risk free'. In financial management, we refer to this interest yield as the 'risk-free rate of return'.

The same principle applies to interest rates on bank loans. Banks will charge a higher rate of interest on loans where they consider the credit risk to be higher. Therefore:

- the interest rate on secured loans will be lower than the rate for unsecured loans to the same borrower
- the interest rate on a subordinated loan will be higher than the rate on a senior loan to the same borrower. (A subordinated loan ranks below a senior loan in the right to payment of interest, and the right to repayment out of selling the borrower's assets in the event of the borrower's default and liquidation).

Financial managers should be interested in risk and return in financial investments, and the risks and returns from the financial markets (for example, the equity markets) as a whole. However, financial managers do not concern themselves with the investment decisions of investors, and how individual investors make the trade-off between risk and return in their personal investment portfolio.

Separating the risk and return characteristics of market investments from the individual investment decisions of investors (and their individual preferences for risk and return) is known as the **Separation Theorem**.

6 The money markets

Section overview

- Definition of the money markets
- Purpose of the money markets
- The inter-bank market
- The repo market
- Comparison of the repo market and inter-bank market

6.1 Definition of the money markets

The money markets are wholesale markets for dealing in short-term lending and borrowing and for trading short-dated financial instruments.

- 'Wholesale' markets are markets for large-value transactions.
- Short-dated financial instruments are financial instruments that have one year or less to maturity when they are issued. They include Treasury bills, bills of exchange, commercial paper and certificates of deposit (CDs). The repo market, which is one of the money markets, also deals in short-dated bonds (bonds with a short time remaining to maturity) as well as other money market securities.

The main money markets are:

- the inter-bank market and
- the repo market.

There are international money markets for all the main currencies. For example, London is a major money market centre which operates large money markets in US dollars, euros, yen, Swiss francs and Canadian dollars as well as sterling.

6.2 Purpose of the money markets

The main purpose of the money markets is to provide:

- short-term liquidity to entities needing money, and
- short-term investment opportunities for entities with surplus liquidity.

Banks are the most active participants in the money markets, but some large companies also have direct access to the markets. Smaller companies and individuals might be offered an opportunity by their bank to borrow or lend at money market interest rates, and their access to the money markets is made through the bank. This means that companies are able to borrow or deposit money short-term in the money markets through their bank. When they participate through their bank, they can borrow or lend much smaller amounts of money than the normal size of money market transaction.

Money markets also provide ready access to short-term borrowing and lending opportunities in foreign currency. This is important for companies involved in international trade that need short-term finance for transactions involving a foreign currency.

6.3 The inter-bank market

The inter-bank market is a market for borrowing and lending large amounts of money for a short-term, often 'overnight' (for one day) but possibly up to one year. As the name of the market indicates, it is mainly a market for borrowing or lending between banks, but as explained earlier, companies are able to participate directly or through their bank. (When they participate through their bank, they can borrow or lend much smaller quantities of money.)

Interest rates in the inter-bank market vary according to:

- ❑ the duration of the loan, and
- ❑ the credit rating or credit status of the borrowing bank.

Banks with a very high credit rating are able to borrow at lower rates than banks with a lower credit rating.

The interest rates charged to top-quality banks are monitored. In London for example, a number of banks report their borrowing rates to the British Bankers Association (BBA) each day, and the BBA uses these rates to determine the average borrowing rates for top-rated banks. In Nigeria this role is performed by the central bank of Nigeria.

LIBOR

The BBA publishes these rates as the BBA London Inter-Bank Offered Rate or LIBOR. LIBOR (also written as Libor) is an important rate in the London markets, because it provides a guideline on interest rates to banks and it is also used as a benchmark interest rate in some derivatives markets.

The financial press publishes LIBOR rates, which might be presented as follows:

Market interest rates

18th July	Overnight	Month	Three months	Six months	One year
US\$ Libor	5.30375	5.32000	5.36000	5.40906	5.50594
Euro Libor	4.09063	4.11463	4.14250	4.28488	4.52538
£ Libor	5.60625	5.67125	5.84875	6.00250	6.26000
Swiss Fr Libor	2.39000	2.42000	2.48833	2.65083	2.91250
Yen Libor	0.61250	0.64250	0.74563	0.84938	0.99750
Canada Libor	4.34833	4.32167	4.46000	4.64000	4.89833

LIBOR can be regarded as a risk-free money market rate. The money market yield curve is normally upward-sloping, but this is not always the case, and a yield curve may be downward sloping along all or a part of its length.

Only a few LIBOR rates are published in the financial press, and it is possible to borrow or lend for any money market period.

Money market rates are shown as annual rates of interest. The actual amount of interest payable on a money market loan, or receivable on a money market deposit, depends on the term of the loan or deposit as well as the interest rate.

There are specific rules for the calculation of money market interest, but for the purpose of your examination, you can assume that the interest payable or receivable is the annual interest rate multiplied by the number of months of the loan or deposit and divided by 12. Here are some examples.

- ❑ For a three-month loan of \$1,000,000 when three-month LIBOR is 5.36%, the interest rate is $(5.36\% \times 3/12)$ 1.34% and the interest payable is \$13,400.
- ❑ For a six-month deposit of €1,000,000 when six month LIBOR is 4.28488%, the interest rate is 2.14244% and interest receivable will be €21,424.40.

Only top-rated banks are able to borrow at LIBOR. Other banks and companies borrow at a 'spread' above LIBOR or earn interest on deposits at a rate below LIBOR. For example a company might be able to borrow at LIBOR plus 0.5% (plus 50 basis points), and if one-month LIBOR is 6.125%, it is able to borrow for one month at 6.625%.

NIBOR

The Nigerian interbank rate is published in Nigeria as the Nigeria Inter-Bank Offered Rate or NIBOR. NIBOR (also written as Nibor) is an important rate in the Nigerian markets because it provides a guideline on interest rates to banks and it is also used as a benchmark interest rate in some derivatives markets.

Note on base rates

Not all companies borrow from their bank at a rate of interest based on LIBOR or NIBOR. Many companies, especially smaller companies, might pay a rate of interest on an overdraft or variable rate loan at an interest rate linked to the bank's base rate. For example a company might borrow at base rate plus 2%. A base rate is an 'administered rate' which means that it is set by the lending bank and is not directly related to market rates of interest.

Changes in money market interest rates

Money market interest rates can change rapidly, in response to market conditions and prospects for the economy. However, in the United States, the European Union, the UK and Nigeria, the biggest influences on LIBOR and NIBOR rates are the central banks.

A central bank is able to raise or lower the money market interest rate for its dealings with commercial banks, and it uses interest rates to try to influence the state of the economy (and in particular the rate of inflation). If the central bank in the UK raises its interest rate by 0.25% for example, banks will immediately increase their LIBOR rates by the same amount. The same applies in Nigeria.

6.4 The repo market

A repo is a sale and repurchase transaction. In a repo transaction, one party sells a quantity of short-dated bonds or money market securities to the other party and at the same time undertakes to buy them back at a specified future date at a higher price.

For example Bank A might arrange a repo transaction with Bank B, in which Bank A sells a quantity of short-dated government bonds and money market instruments to Bank B for ₦20 million and agrees to buy them back after 14 days for ₦20.046 million.

In effect a repo transaction is a short-term secured loan. In this example, Bank B is effectively lending ₦20 million to Bank A for 14 days and takes government bonds and money market instruments as security for the loan. When the repurchase takes place after 14 days, Bank B receives ₦46,000 more than it lent, which is the interest on the loan.

Importance of the repo market

The repo market is important in the USA, European Union and UK for two reasons.

- ❑ The central bank uses the repo market to provide liquidity to commercial banks, and sets the interest rate (repo rate) for these transactions. The 14-day 'gilt repo' rate is in effect the marginal cost of borrowing for banks that cannot obtain liquidity anywhere else. This rate is used by the central bank to influence other money market interest rates, as explained above.
- ❑ Commercial banks use the repo market for secured borrowing and lending between themselves. It is an alternative to the inter-bank market, where borrowing and lending is unsecured.

6.5 Comparison of the repo market and inter-bank market

Interest rates in the inter-bank market are slightly higher than interest rates in the repo market. This is because repo transactions are a form of secured lending whereas inter-bank loans are unsecured.

A bank with a large quantity of short-dated government bonds or money market securities will therefore prefer to borrow in the repo market than in the inter-bank market, because borrowing costs are less. However, banks might not hold large quantities of short-dated government bonds or money market securities. If these banks need to borrow, they will use the inter-bank market.

For the purpose of your examination, the inter-bank market and inter-bank market interest rate (LIBOR) are more significant than the repo rate, because the inter-bank rate is more relevant for obtaining short-term liquidity and for hedging both interest rate risk and foreign exchange risk.

7 Money market instruments

Section overview

- Coupon-bearing and discount instruments
- Treasury bills
- Bills of exchange
- Certificates of deposit (CDs)
- Commercial paper (CP)

The largest money market is the inter-bank market for loans and deposits. There are also markets for dealing in other money market 'instruments' or securities. These include:

- Treasury bills;
- Bills of exchange (including bankers' acceptances or BAs);
- Certificates of deposit (CDs); and
- Commercial paper (CP).

7.1 Coupon-bearing and discount instruments

There are two broad categories of money market instrument, coupon-bearing and discount instruments.

- Coupon-bearing instruments are instruments or securities on which interest is payable at a stated interest rate (or 'coupon') on a fixed amount of principal. When the instrument or security reaches its maturity date, its holder receives the initial principal plus interest in settlement. Examples of coupon-bearing instruments are certificates of deposit.
- Discount instruments are instruments or securities where the borrower undertakes to pay a fixed amount of principal at maturity, and the instrument is issued at a discount to its 'face value'. The difference between the discounted issue price and the eventual redemption price (face value) represents interest on the borrowing. Examples of discount instruments are Treasury bills, bills of exchange and commercial paper.

7.2 Treasury bills

Treasury bills are short-dated securities issued by a government, when money is needed to meet a short-term financing requirement. Treasury bills are normally issued for 91 days (three months).

They are discount instruments. The government might issue 91-day Treasury bills with a face value of ₦100 million at a price of, say, 98.75. It would raise ₦98.75 million from the issue and at the end of the 91 days it would pay ₦100 million to the holders of the bills. Interest for the three-month period would be ₦1.25 million on the ₦98.75 million raised, which is an interest rate of about 3% (annual).

There is an active market in Treasury bills. Buyers of Treasury bills can re-sell them before they mature to other investors or banks. Treasury bills should be risk-free, because they are promises to pay by the government. A company with a short-term cash surplus might therefore decide to invest in Treasury bills, which can be re-sold at any time or held until the bills eventually mature.

7.3 Bills of exchange

A bill of exchange is a form of promise to pay a stated amount of money at a date in the future (usually in several months' time). A bill has a drawer and a drawee.

- ❑ The bill is issued by the borrower, and is 'drawn on' the drawee. When the bill is drawn, it is a form of 'You Owe Me'. With the bill the drawer is stating that the drawee owes a specified amount of money.
- ❑ The bill is then 'accepted' by the drawee, who signs the bill to indicate acceptance. An accepted bill becomes an undertaking by the drawee to pay the specified amount of money at the specified date.

A bill of exchange that is drawn on and accepted by a bank is called a bank bill.

There is an active market in bank bills, especially bills that have been accepted by banks with high credit ratings. This means that the drawer of a bill is able to obtain short-term finance by selling the accepted bill in the money markets.

Bank bills might be used as a source of short-term finance by companies in two ways.

- ❑ As a method of financing foreign trade transactions.
- ❑ As a method of raising short-term finance by means of bankers' acceptances (BAs), as an alternative to bank borrowing or issuing commercial paper.

Bankers' acceptances (BAs)

A company that intends to borrow amounts of money for a short-term over a period of time in the future might arrange a BA programme with a bank. Under the terms of the agreement, the bank undertakes to accept bills of exchange that are drawn on it by the company, up to a maximum amount. When the company needs short-term funding, it draws a bill on the bank. The bank accepts it and then sells it in the money market on behalf of the company at a discount.

The company therefore receives the money 'now'. The company must also pay the bank the face value of the bill when it reaches maturity, to enable the bank to settle the bill. The bill is therefore a form of short-term finance, and the interest cost is the difference between the discounted value of the bill when it is sold and the face value of the bill that must be paid in settlement.

An advantage of BAs for a company is that if the programme is arranged with a top-quality bank, the discount rate (interest rate) on the accepted bills might be fairly low – lower than on other forms of money market borrowing.



Example: Bas

A company has arranged a bankers' acceptances programme with its bank. Under the terms of the arrangement, which lasts for one year, the company is able to draw bills on the bank up to a total value in issue at any time of ₦25 million.

The company might draw a bill on the bank for ₦1,000,000 with a settlement date in three months' time. The bank accepts the bill and sells it for the company in the bills market. The company might receive, say, ₦985,222, so that the discount on the bill is ₦14,778.

The discount means that the rate of interest for the three months is about:

$$(\text{₦}14,778/\text{₦}985,222) \times 12/3 = 6.0\%$$

After three months when the bill reaches maturity, the bank pays the bill and the company pays ₦1,000,000 to the bank.

7.4 Certificates of deposit (CDs)

A certificate of deposit is a certificate issued by a bank stating that the bank is holding a specified quantity of money as a term deposit, on which interest is being earned at a specified rate. The deposit cannot be removed from the bank until the end of the stated term, but it can be sold in a money market for CDs.

For example, an investor might place a deposit of ₦20 million with a bank for a fixed term of six months, and receive interest at 5.5% on the deposit. It might be agreed that the bank should issue a certificate of deposit that the depositor holds. However, if the depositor needs access to money before the end of the six months, it can sell the CD on to another investor or a bank and receive immediate cash.

7.5 Commercial paper (CP)

Large creditworthy companies have several ways of raising short-term finance, and might select the least-cost financing method. This might be borrowing at money market rates from a bank, arranging a BA programme or issuing commercial paper. The cheapest rate of financing might vary according to conditions in each of the money markets.

Commercial paper (CP) is an unsecured promissory note. A promissory note is a promise by the issuer of the note to pay a specific amount of money on a specified date. When a company issues CP it promises to pay the face value of the paper at a specified date in the future.

Non-financial companies issue CP through a bank, as part of a commercial paper programme. The bank issues the CP on behalf of the company and sells it to investors. All CP is negotiable, which means that it can be sold in the money market. In practice, however, investors buying CP normally hold it to maturity when they are paid the face value of the paper they have bought.

The company issuing the CP therefore receives immediate cash (at a discount to the face value of the paper) and makes a payment when the paper reaches maturity.

Only companies with a good credit rating are able to issue CP, and commercial paper is normally given a credit rating by one or more of the major credit rating agencies (Moody's, Standard & Poor's and Fitch). The interest rate payable on CP varies with the term to maturity of the paper when it is issued, the credit rating for the paper and conditions in the market at the time of the issue.



Example: Commercial paper

A large company has arranged a commercial paper programme with a bank. The programme will last for two years. During that time the company may issue CP up to a total value of ₦300 million in issue at any time.

Initially, the company might issue ₦50 million of CP with a maturity date in three months' time. The bank sells the paper to a number of investors, who buy the paper at a discount and will receive payment of the full face value after three months.

Investors buying the CP are able to re-sell it if they wish to do so at any time before maturity, through a bank that deals in the CP market.

The company can issue more CP at any time, up to the specified limit.

8 The nature of cash management

Section overview

- Reasons for holding cash
- Objective of good cash management
- Aspects of cash management

Cash and liquidity is critical for a business because if a company is unable to pay what it owes at the required time a creditor might take legal action to recover the unpaid amount. Even if such extreme action is not taken, but a company is slow in paying invoices, creditors will be reluctant to provide additional credit.

It is therefore essential for a business to ensure that its cash flows are well managed and that it has sufficient liquidity.

8.1 Reasons for holding cash

There are several reasons why a business entity might choose to hold cash.

- To **settle transactions**. Cash is needed to pay expenses, and to settle debts.
- As a **precaution** against unexpected requirements for cash. A business might hold some additional cash in the event that there is a need to make an unexpected and unforeseen payment.
- For **speculative reasons**. A company might hold some cash that can be used if a business opportunity arises. Some investment opportunities, such as the opportunity to purchase a rival business, might require some element of cash. Holding a 'war chest' of cash might therefore be a strategic measure taken by a company, to take opportunities for developing the business whenever an attractive opportunity arises.

However, cash does not earn a high return. Cash in a normal business bank account earns no interest at all. Holding cash therefore provides a company with liquidity (an ability to pay), but reduces profitability (the lost income resulting from holding cash rather than investing it in business development).

8.2 Objective of good cash management

The objective of good cash management is to hold sufficient cash to meet liabilities as they fall due, whilst making sure that not too much cash is held. Money held as cash is not being invested in the wealth-creating assets of the organisation – thereby affecting profitability.

If a business entity wants to maintain sufficient liquidity, but does not want to hold too much cash, it might consider investing cash that is surplus to short-term requirements. Surplus cash can be invested in short-term financial instruments or even savings accounts, and so can earn some interest (although possibly not much) until it is needed. When the cash is eventually needed, the investments can be sold, or cash can be withdrawn from the savings accounts.

8.3 Aspects of cash management

You might be required to consider any of the following three aspects of cash management.

- Forecasting cash flow requirements and operational cash flows. This is done by means of cash budgeting or cash flow forecasting. In your examination it is more likely that you will be required to prepare a cash flow forecast rather than a detailed cash budget.
- Deciding how to invest surplus cash in short-term investments.
- Deciding how much cash to keep and how much to invest in short-term investments. In addition, if money is invested in short-term investments, deciding how many investments to sell in exchange for cash when some cash is eventually needed for operational requirements.

9 Cash budgets and cash flow forecasts

Section overview

- Cash budgets
- Preparing a cash budget
- Cash flow forecasts
- Cash flow statement approach
- Revenue and cost estimation approach

9.1 Cash budgets

A cash budget is a detailed plan of cash receipts and cash payments during a planning period. The planning period is sub-divided into shorter periods, and the cash receipts and payments are forecast/planned for each of the sub-divisions of time.

For an annual master budget, the cash budget might be prepared on a monthly basis, or possibly a quarterly basis. Some business entities prepare new cash budgets regularly, possibly forecasting daily cash flows for the next week, or weekly cash flows for the next month.

The main uses of a cash budget are as follows:

- To forecast how much cash receipts and payments are expected to be over the planning period.
- To learn whether there will be a shortage of cash at any time during the period, or possibly a cash surplus.
- If there is a forecast shortage of cash, to consider measures in advance for dealing with the problem - for example by planning to defer some purchases of non-current assets, or approaching the bank for a larger bank overdraft facility.
- To monitor actual cash flows during the planning period, by comparing actual cash flows with the budget.

9.2 Preparing a cash budget

A cash budget can be prepared by producing a table for the cash receipts and cash payments, containing each item of cash receipt and each item of cash payment. The cash receipts and then the cash payments should be listed in rows of the table, and each column of the table represents a time period, such as one month.

A typical format for a monthly cash budget is shown below.

	January	February	March
Cash receipts	₦	₦	₦
Cash sales	5,000	6,000	5,000
Cash from credit sales			
Credit sales the previous month (month M - 1)	22,000	20,000	24,000
Credit sales in two months ago (month M - 2)	50,000	44,000	40,000
Credit sales in three months ago (month M - 3)			
Other cash receipts	4,000	2,000	2,000
Total cash receipts	<u>81,000</u>	<u>72,000</u>	<u>71,000</u>
Cash payments			
Payments for purchases in current month	6,000	6,600	6,200
Payments for purchases in previous month	8,400	9,000	9,900
Payments of rent	-	30,000	-
Payments of wages and salaries	23,000	23,000	23,000
Dividend payments	-	-	40,000
Payments for non-current assets		70,000	10,000
Other payments	3,000	3,000	3,000
Total cash payments	<u>40,400</u>	<u>141,600</u>	<u>92,100</u>
Receipts minus payments (net cash flow)	40,600	(69,600)	(21,100)
Cash balance at the beginning of the month	<u>45,000</u>	<u>85,600</u>	<u>16,000</u>
Cash balance at the end of the month	<u>85,600</u>	<u>16,000</u>	<u>(5,100)</u>

9.3 Cash flow forecasts

Cash flow forecasts, like cash budgets, are used to predict future cash requirements, or future cash surpluses. However, unlike cash budgets:

- they are prepared throughout the financial year, and are not a part of a formal budget plan.
- they are often prepared in much less detail than a cash budget.

The main objectives of cash flow forecasting, like the purposes of a cash budget, are to:

- make sure that the entity is still expected to have sufficient cash to meet its payment commitments as they fall due;
- identify periods when there will be a shortfall in cash resources, so that financing can be arranged;
- identify whether there will be a surplus of cash, so that the surplus can be invested;
- assess whether operating activities are generating the cash that is expected from them.

The main focus of cash flow forecasting is likely to be operating cash flows, although some investing and financing cash flows might also be significant.

Techniques for preparing a cash flow forecast

There are no rules about how to prepare a cash flow forecast. A forecast need not be in the same amount of detail as a cash budget. However there are two basic approaches that might be used:

- producing a cash flow forecast similar to a statement of cash flows prepared using the indirect method
- forecasting cash flows by estimating revenues and costs to arrive at an estimate of earnings before interest, tax and depreciation (EBITDA).

9.4 Cash flow statement approach

One way of preparing a cash flow forecast for a period of time is to produce a statement similar to a statement of cash flows in financial reporting. The general structure of the forecast will therefore be as follows:

Cash flow forecast

	₦	₦
Expected trading profit in the period		34,000
Adjustments for non-cash items:		
Depreciation		<u>22,000</u>
		56,000
Adjustments for working capital		
Increase in inventory	(15,000)	
Increase in trade receivables	(18,000)	
Increase in trade payables	10,000	
		<u>(23,000)</u>
Operational cash flows		33,000
Interest payments		(10,000)
Tax payments (on profits)		<u>(7,000)</u>
Cash flows from operating activities		16,000
Cash flows from investing activities		
Sale of non-current asset	4,000	
Purchase of non-current asset	<u>(25,000)</u>	
		(21,000)
Cash flows from financing activities		
Repayment of loan	(12,000)	
Payment of dividend	<u>(15,000)</u>	<u>(27,000)</u>
Net change in cash position		(32,000)
Cash at beginning of forecast period		<u>40,000</u>
Cash at end of forecast period		<u>8,000</u>

Trading profit (profit before interest and tax)

The expected trading profit might be estimated by projecting the current year's trading profit (profit before interest and tax). For example, if trading profits have been increasing by about 5% per year and were ₦300,000 in the year just ended, it might be assumed for the purpose of the cash forecast that trading profit will be ₦315,000 next year.

Depreciation (and amortisation)

Depreciation is not a cash flow; therefore it must be added back to profit in order to calculate cash flows. Detailed information might be available about non-current assets to enable an accurate estimate of future depreciation charges (and amortisation charges, if there are any intangible assets). Alternatively, it might be assumed that the depreciation charge in the next year will be about the same as in the current year.

An assumption has to be made about depreciation charges, and alternative assumptions might be more appropriate. If you have to make an estimate of depreciation for the purpose of cash flow forecasting in your examination, you should make the most reasonable assumption available on the basis of the information provided in the question.

Changes in inventory, trade receivables and trade payables

The figure for profit must also be adjusted for changes in working capital in order to estimate cash flows from operational activities. The most appropriate assumptions about working capital changes might be one of the following:

- that there will be no changes in working capital
- that inventory, trade receivables and trade payables will increase by the same percentage amount as the growth in sales. For example, if sales are expected to increase by 5%, it might be reasonable to assume that inventory, trade receivables and trade payables will also increase by 5% above their amount at the beginning of the year.

Interest payments and tax payments

Assumptions might be needed about interest and tax payments in the cash flow forecast.

- It might be assumed that interest payments will be the same as interest costs in the current year's income statement, on the assumption that the company's total borrowings will not change significantly and interest rates will remain stable.
- It might be assumed that tax payments will be a percentage of the figure for trading profit.
- However, other assumptions might be more appropriate, given the information provided in an examination question.

Investing cash flows

Investing cash flows might be included in a cash flow forecast if:

- it is expected that additional non-current assets will be purchased in the period
- it is expected that some non-current assets will be sold/disposed of
- it is assumed that some essential replacement of ageing and worn-out non-current assets will be necessary. For example it might be assumed that purchases of replacement non-current assets will be necessary, and the amount of replacements required will be equal approximately to the annual depreciation charge for those assets.

Financing cash flows

It might also be appropriate to include some financing cash flows in the cash flow forecast, where these are expected. In particular, if the company intends to pay an equity dividend, this should be included in the forecast as a cash outflow.

9.5 Revenue and cost estimation approach

Another approach to preparing a cash flow statement is to estimate earnings before interest, tax, depreciation and amortisation (EBITDA) using estimates of revenues and costs.

Cash flow forecast

	₦
Sales revenue forecast	300,000
Cost of sales (% of sales revenue)	(180,000)
Gross profit	120,000
Other expenses (possibly fixed, possibly a % of sales revenue)	(90,000)
Net profit	30,000
Add	
Depreciation and amortisation	26,000
EBITDA	56,000

The figure for EBITDA is equivalent to the figure in the cash flow statement for operational cash flows before working capital adjustments. Adjustments can be made to EBITDA for working capital changes, interest and tax payments, investing cash flows and financing cash flows, in order to arrive at an estimate of the net cash flow surplus or deficit for the period.

Sales revenue forecast

The sales revenue forecast should be based on sales revenue in the previous year with an adjustment for volume growth (and possibly an increase in unit sales prices).

Cost of sales and gross profit

If the ratio of cost of sales: sales and the gross profit margin percentage have been fairly stable in recent years, it might be assumed that these ratios will apply in the future. For example, if sales revenue in the previous year was ₦10 million, gross profit has been 60% of sales for the past few years and sales revenue should increase by 5% next year with volume growth the estimate of gross profit for next year will be ₦10 million \times 1.05 \times 60% = ₦6.3 million.

Other expenses

The estimate for other expenses should be based on reasonable assumptions. For example it might be assumed that these are fixed costs and so will be unchanged next year. Alternatively, it might be assumed that these costs will be the same percentage amount of sales revenue as in previous years.

Other adjustments might be necessary, to allow for known changes in cost (for example, if an exceptionally large increase in raw material costs is forecast, this will affect the gross profit margin. Other costs might be affected by an expectation of an unusually large increase in administrative labour costs, and so on.

Depreciation and amortisation

If the estimates of cost of sales and other expenses include depreciation costs and amortisation costs, these must be added back in order to obtain an estimate of EBITDA.

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10 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Define financial management and financial engineering and differentiate between financial management, management accounting and financial accounting
- Discuss financial objectives in the context of corporate objectives and strategy
- Explain how different stakeholders may impact on financial management decisions
- Summarise the financial management framework including sources of finance and financial intermediaries
- Describe the financial markets including capital markets and money markets
- Understand the trade-off between risk and return
- Briefly explain money market terminology and instruments including inter-bank market, repo market, coupon, treasury bills, bills of exchange, certificates of deposit and commercial paper
- Explain why businesses hold cash and describe the objectives and aspects of good cash management
- Describe cash budgets and forecasts and explain how they are constructed

Sources of finance

Contents

- 1 Sources of long-term and short-term finance
- 2 Raising new equity externally
- 3 Using debt capital
- 4 Convertible bonds and bonds with warrants attached
- 5 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

D		The role of finance	
	1	Basics of business finance and financial markets	
		a	Identify the various sources of finance that are available to business organisations
		b	Explain the characteristics of the different sources of finance, stating their advantages and disadvantages
		c	Describe the characteristics of financial markets
		e	Explain the following concepts:
		i	Covenants;
		ii	Warranties; and Gurantees
		iii	Guarantees. Indeminities

Exam context

Having been introduced to the fundamentals of financial management in the last chapter we now focus specifically on equity and debt financing. You will learn relevant terminology and the advantages and disadvantages of each of the various funding options.

By the end of this chapter students will be able to:

- Summarise the various sources of long-term and short-term finance;
- Explain the mechanisms for raising new equity externally including public offer, placing, introduction and rights issue;
- Explain how a rights issue works and what is meant by underwriting;
- Summarise the nature of debt finance and differentiate between long-, medium- and short-term debt finance;
- Describe different components of debt financing including interest, tax relief, access to the bond markets, risk and finance leases; and
- Explain how convertible bonds and bonds with warrants attached operate.

1 Sources of long-term and short-term finance

Section overview

- Sources of finance and financial management
- Sources of short-term funds
- Sources of long-term funds
- Introduction to equity finance
- Internal sources of finance and dividend policy

1.1 Sources of finance and financial management

An important aspect of financial management is the choice of methods of financing 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
- adequate working capital
- a suitable balance between equity and debt capital in the long-term capital structure.

1.2 Sources of short-term funds

Sources of short-term funding are used to finance some current assets. (In some cases, companies operate with current liabilities in excess of current assets, but this is unusual.)

The usual sources of short-term finance are:

- bank overdraft
- short-term bank loans
- suppliers (trade payables).

The main points to note about these sources of finance are as follows.

Bank overdraft

A company might arrange a bank overdraft to finance its need for cash to meet payment obligations. An overdraft facility is negotiated with a bank, which sets a limit to the amount of overdraft that is allowed. From the point of view of the bank, the company should be expected to use its overdraft facility as follows:

- The overdraft should be used to finance short-term cash deficits from operational activities. The company's bank balance ought to fluctuate regularly between deficit (overdraft) and surplus. There should not be a 'permanent' element to the overdraft, and an overdraft should not be seen as a long-term source of funding.
- An overdraft facility is for operational requirements and paying for running costs. An overdraft should not be used to finance the purchase of long-term (non-current) assets.
- The bank normally has the right to call in an overdraft at any time, and might do so if it believes the company is not managing its finances and cash flows well.

Short-term 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.

Trade payables

A company 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, a company should honour its credit arrangements and pay its suppliers on time at the end of the agreed credit period. It is inappropriate for a company to increase the amount of its trade payables by taking excess credit and making payments late.

Debt factoring

Companies that use debt factors to collect their trade receivables might obtain financing for most of their trade receivables from the factor. One of the services offered by a factor is to provide finance for up to 70% or 80% of the value of outstanding trade receivables that the factor has undertaken to collect.

Operating leases

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.)

Companies that obtain the use of non-current assets with operating lease agreements avoid the need to purchase the assets and to finance these purchases with capital.

Operating leases might be used extensively by small and medium-sized business enterprises which find it difficult to obtain finance to pay for non-current asset purchases.

1.3 Sources of long-term funds

Long-term funding is required for a company's long-term assets and also to finance working capital. The main sources of long-term capital are:

- Equity finance;
- Debt finance; and
- Lease finance (finance leases).

For some companies, long-term finance might be provided in the form of venture capital.

1.4 Introduction to equity finance

Equity finance is finance provided by the owners of a company – its ordinary shareholders, also called equity shareholders. (Some forms of irredeemable preference share might be regarded as equity finance, but in practice irredeemable preference shares are rare in public companies.)

New equity finance can be raised by issuing new shares for cash, or issuing new shares to acquire a subsidiary in a takeover. Methods of issuing new shares are described in the next section of this chapter.

For most companies, however, the main source of new equity finance is internal, from retained profits.

1.5 Internal sources of finance and dividend policy

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.
- ❑ 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.
- ❑ Earnings are either retained or paid out to shareholders as dividends. By retaining earnings, a company is therefore withholding dividends from its shareholders. A company might have a dividend policy, and its shareholders might have expectations about what future dividends ought to be. Earnings retention is therefore restricted by the constraints of dividend policy.

Long-term finance and working capital management

Improvements in working capital efficiency can also release cash. Efficient inventory management, collection of trade receivables and payment of trade payables can reduce the requirement for working capital. A reduction in working capital generates a one-off additional source of cash funding that can be used for investment.

2 Raising new equity externally

Section overview

- Private companies and public companies: issuing new shares
- Methods of issuing new shares for cash
- Public offer
- Placing
- Stock market introduction
- Rights issue
- Underwriting of new share issues
- Share repurchases

2.1 Private companies and public companies: issuing new shares

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.

Private companies and issuing shares for cash

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.

Other investors usually avoid investing in the equity of private companies because the shares are not traded on a stock exchange, and consequently they might be:

- Difficult to value; and
- Difficult to sell when the shareholder wants to cash in the investment.

Small companies and most medium-sized companies are private companies, and most are unable to raise significant amounts of new equity capital by issuing shares. They rely on retained earnings for new equity capital, but given their small size, profits are relatively small and this restricts the amount of retained profits they can reinvest in the business.

Public companies and new share issues

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. The existence of a secondary market and stock market trading in shares means that:

- The shares of a company have a recognisable value (their current stock market price); and

- Shareholders can sell their shareholdings in the market whenever they want to cash in their shareholding.

However, before their shares can be traded on a stock exchange, a public company must:

- Satisfy the regulatory authorities that the company and its shares comply with the appropriate regulatory requirements, and appropriate information about the company and its shares will be made available to investors; and
- Obtain acceptance by the appropriate stock exchange for trading in the shares.

In the UK for example, there is a main stock market operated by the London Stock Exchange, and a secondary market for shares in smaller companies, the Alternative Investments Market or AIM. (Companies wanting to have their shares accepted for trading on AIM must meet certain regulatory requirements, but these are not as onerous as the requirements for companies on the main market.)

In Nigeria, the Securities and Exchange Commission is the regulatory authority for the regulation of stock market operations whilst the Nigerian Stock Exchange is the stock market. The Nigerian Stock Exchange has a second-tier stock market that provides a secondary market for trading in the shares of smaller companies. The conditions for listing on this market are less stringent than those of the main market.

Electronic trading platforms for secondary market trading in shares have been developed and are capturing a substantial proportion of the total volume of secondary market trading in shares of the major companies in the USA, the European Community and Nigeria.

Regulatory requirements

In the UK for example, to obtain acceptance to trades shares on the main London Stock Exchange, companies must:

- apply to the regulatory authorities for the shares to be accepted onto the Official List (and companies whose shares are traded on the main market are therefore called '**listed companies**'); and
- apply to the London Stock Exchange for acceptance of the shares onto the market for trading.

Requirements in other countries with major stock markets are similar. However, since the regulations differ between countries, it should be sufficient for the purpose of your examination to be aware that a public company must comply with certain regulations and minimum standards in order to have access to one or more stock markets.

2.2 Methods of issuing new shares for cash

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

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

2.3 Public offer

A public offer is an offer of new shares to the general investing public. Because of the high costs involved with a public issue, these are normally large share issues that raise a substantial amount of money from investors.

In many countries, including the UK, USA and Nigeria, a company whose shares are already traded on the stock market cannot make a public offer of new shares without shareholder permission (which is unlikely to be obtained, because existing shareholders would suffer a dilution in their shareholding in the company and would own a smaller proportion of the company).

Instead, companies whose shares are already traded on the stock market will use a rights issue or a placing when it wishes to issue new shares for cash.

A public offer might be used to bring the shares of a company to the stock market for the first time. The term for this type of share issue is an **Initial Public Offering** or **IPO**. The company comes to the stock market for the first time in a 'stock market flotation'. The terms 'prospectus issue' and 'offer for sale' are also used to describe a public offer.

The shares that are offered to investors in an IPO might be a combination of:

- New shares (issued to raise cash for the company); and
- Shares already in issue that the current owners are now selling.

Only the new shares issued by the company in the IPO will provide new equity capital for the company.



Example: Public offer

Stabba is a company that is being converted from private to public company status and is planning a stock market flotation with a public offer of shares.

In the flotation, the company wants to raise ~~N~~800 million in cash for investment in its businesses. Issue costs will be 5% of the total amount of capital raised. The company's investment bank advisers have suggested that a share price of ~~N~~8 to ~~N~~9 per share should be sustainable after the flotation, and a suitable issue price per share would therefore be ~~N~~8.

Required

How many new shares should be issued and sold in the public offer?



Answer

Cash required after issue costs (= 95% of cash raised): ~~N~~800 million

Capital required before issue costs deducted: ~~N~~800 million/0.95 = ~~N~~842.1 million

Number of shares to issue to raise ~~N~~842.1 million = ~~N~~842.1m/~~N~~8 = 105,262,500.

Offer for sale by tender

In a normal public offer, the issue price for the new shares is a fixed price and the new shares are offered at that price. With an offer for sale by tender, investors are invited to apply to purchase any amount of shares at a price of their own choosing. The actual issue price for the new shares is the minimum price tendered by investors that will be sufficient for all the shares in the issue to be sold. Offers for sale by tender are now very uncommon.

2.4 Placing

A placing involves the sale of a relatively small number of new shares, usually to selected investment institutions. A placing raises cash for the company when the company does not need a large amount of new capital. A placing might be made by companies whose shares are already traded on the stock exchange, but which now wish to issue a fairly small amount of new shares.

The prior approval of existing shareholders for a placing should be obtained.

2.5 Stock market introduction

In a stock market introduction, a company brings its existing shares to the stock market for the first time, without issuing new shares and without raising any cash. The company simply obtains stock market status, so that its existing shares can be traded on the stock market.

The rules of the stock exchange might require that a minimum percentage of the shares of the company should be held by the general investing public. If so, a stock exchange introduction is only possible for a company that has already issued shares to the public, but without having them traded on the stock market.

A stock market introduction is rare, but might be used by a well-established company (formerly a private company) whose shares are now held by a wide number of individuals and institutions.

When a company makes a stock market introduction, it is able at some time in the future to issue new shares for cash, should it wish to do so, through a placing or a rights issue.

2.6 Rights issue

A rights issue is a large issue of new shares to raise cash, by a company whose shares are already traded on the stock market.

Company law about rights issues varies between countries. Any company (public or private) wishing to issue new shares to obtain cash must issue them in the form of a rights issue, unless the shareholders agree in advance to waive their 'rights'. Large new share issues by existing stock market companies will therefore always take the form of a rights issue.

A rights issue involves offering the new shares to existing shareholders in proportion to their existing shareholding. For example, if a company has 8 million shares in issue already, and now wants to issue 2 million new shares to raise cash, a rights issue would involve offering the existing shareholders one new share for every four shares that they currently hold (2 million: 8 million = a 1 for 4 rights issue).

2.7 Underwriting of new share issues

Large new issues of shares for cash are usually underwritten. When an issue is underwritten, a group of investment institutions (the underwriters) agree to buy up to a maximum stated quantity of the new shares at the issue price, if the shares are not purchased by other investors in the share issue. Each underwriter agrees to buy up to a maximum quantity of the new shares, in return for an underwriting commission (an agreed percentage of the issue value of the shares they underwrite).

The advantage of underwriting is that it ensures that there will be no unsold shares in the issue, and the company can be certain of raising the expected amount of cash.

The main disadvantage of underwriting is the cost (the underwriting commission payable by the company to the underwriters).

If a company does not want to pay to underwrite a rights issue, it might offer the new shares at a very low price compared to the market price of the existing shares. The very low price should, in theory, attract investors and ensure a successful share issue. This type of low-priced share issue is called a **deep-discounted** issue.

Both public offers and rights issues are commonly underwritten.

2.8 Share repurchases

Instead of increasing their equity capital by issuing new shares, a company might repurchase some of its equity shares and cancel them. The shares might be repurchased in the stock market, or bought back directly from some shareholders. The effect of repurchasing shares and cancelling them is to reduce the company's equity capital, with a corresponding fall in cash.

For example, suppose that a company has 200 million shares of ₦1 each (par value) in issue and the shares have a market price of ₦3. It might repurchase 5 million shares at this market price and cancel them. The cost of ₦15 million would result in a reduction in share capital and reserves of ₦15 million, and a reduction in cash of ₦15 million. It would be left with 195 million shares in issue.

There two main reasons why a company might repurchase and cancel shares.

- ❑ It has more cash than it needs and the surplus cash is earning a low return. There is no foreseeable requirement for the surplus cash. Buying back and cancelling some shares will therefore increase the earnings per share for the remaining shares, and so might result in a higher share price for the remaining shares. In this situation, the company is overcapitalised and share repurchases can bring its total capital down to a more suitable level.
- ❑ Debt capital is readily-available and is cheaper than equity. A company might therefore repurchase some of its shares and cancel them, and replace the cancelled equity with debt capital, by issuing new corporate bonds or by borrowing from a bank. The result will be a capital structure with higher financial gearing.

In the mid 2000s, when debt capital was cheap and readily-available, a considerable number of companies in the USA and UK increased their gearing by repurchasing shares and raising more debt capital.

3 Using debt capital

Section overview

- The nature of debt finance
- Long-term, medium-term and short-term debt finance
- Interest payments
- Tax relief on interest
- Security for borrowing
- Straight debt
- Access to the bond markets for companies
- Debt finance and risk for the borrower
- Advantages and disadvantages of debt finance to the investor
- Finance leases

3.1 The nature of debt finance

The term 'debt finance' is used to describe finance where:

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

For companies, the most common forms of debt finance are:

- Borrowing from banks; and
- Issuing debt securities.

Debt finance might be **secured** against assets of the borrower. When a debt is secured, the lender has the right to seek repayment of the outstanding debt out of the secured asset or assets, in the event that the borrower fails to make payments of interest and repayments of capital on schedule. The secured assets provide a second source of repayment if the first source fails.

When a debt is **unsecured**, the lender does not have this second source of repayment in an event of default by the borrower.

For both secured and unsecured debt, the borrower is usually required to give certain undertakings or '**covenants**' to the lender, including an undertaking to make interest payments in full and on time. The borrower will be in default for any breach of covenant, and the lenders will then have the right to take legal action against the borrower to recover the debt.

3.2 Long-term, medium-term and short-term debt finance

Debt finance can be long-term, medium-term or short-term finance. For companies:

- Long-term finance is usually obtained by issuing bonds. Bonds might also be called loan stock or debentures.

- ❑ Medium-term debt finance (with a maturity of up to about five or seven years) is usually in the form of bank loans, but a company might also issue bonds with a maturity of just a few years. Medium-dated bonds are often called 'notes'.
- ❑ Short-term debt finance is usually in the form of a bank overdraft or similar bank facility. Large companies might be able to obtain short-term debt finance in other ways, such as:
 - by issuing short-term debt securities in the money markets as commercial paper, within a commercial paper programme
 - by arranging a 'bills acceptances' programme with a bank

Irredeemable debt

Debt capital might be irredeemable or 'permanent'. However, irredeemable debt is not common, and virtually all debt is redeemable (or possibly convertible, see below).

Committed and uncommitted funds

Most debt finance is committed, which means that the lender has undertaken to provide the finance until the agreed maturity of the debt. The borrower does not have the risk that the lender will demand immediate repayment of the debt, without notice before the agreed maturity date.

Some lending is uncommitted, which means that the lender is not obliged to lend the money, and having lent the money can demand immediate repayment at any time. A bank overdraft facility is normally uncommitted lending by the bank, and the bank has the right to demand immediate repayment at any time. A bank overdraft can therefore be a fairly risky type of borrowing for a company.

3.3 Interest payments

The frequency of interest payments varies according to the type of debt.

- ❑ For a bank loan or a bond, the interest payable is calculated on the full amount of the debt.
- ❑ For a bank overdraft (or a revolving credit with a bank), interest is charged only on the current overdraft balance.

For example, if a company has a loan of ₦100,000, it will pay interest on the full amount of the loan. However, if it has a bank overdraft facility of ₦100,000, it will pay interest only on the overdraft balance, typically with interest charged on a daily basis.

The interest rate on most medium-term bank loans is a **floating rate** or **variable rate**. This means that the rate of interest is adjusted for each successive payment period, according to any changes that have occurred in the interest rate since the beginning of the previous interest period. Lending to companies is at either a margin above the bank's base rate or a margin above another reference rate of interest, such as the London Inter-Bank Offered Rate (LIBOR) or Nigeria Inter-Bank Offered rate (NIBOR).

For example, the interest rate on a bank loan might be payable every six months at six-month NIBOR plus 1%. At the beginning of each six-monthly interest period, the interest for the period will be fixed at whatever the current six-month NIBOR rate happens to be, plus 1%.

The interest rate on most bonds and notes is at a **fixed coupon rate**. The interest payable in each interest period is a fixed amount, calculated as the fixed coupon percentage of the nominal value of the bonds. For example, if a company issues 6% bonds with interest payable every six months, the company will pay ₦3 for every ₦100 nominal value of bonds every six months.

3.4 Tax relief on interest

Interest costs are an allowable expense for tax purposes. This can make debt finance an attractive 'cheap' source of finance.



Example:

A company borrows ₦10 million at an interest cost of 5% per year. The rate of taxation is 30%.

The company will pay ₦500,000 each year in interest. Its tax payments to the government will be reduced by ₦150,000 (30% × ₦500,000). The net cost of interest is therefore ₦350,000, and the after-tax cost of debt is 3.5% (₦350,000/₦10 million, or 5% × (100 – 30)).

In comparison, dividends on shares are not an allowable cost for tax purposes. Dividends are paid out of after-tax profits.

3.5 Security for borrowing

For many loan agreements, the borrower is required to provide undertakings or guarantees of some kind.

- ❑ Covenants. Covenants are promises or undertakings in a written agreement such as a loan agreement. For example, a borrower will undertake to make interest payments and capital repayments to the lender. A borrower who fails in these undertakings is in breach of the covenants and so in breach of the loan agreement, giving the lender the right to take legal action for the recovery of the loan.
- ❑ Guarantees and warranties. A guarantee is a legally-binding promise, given in writing. The person giving the guarantee is making a legally-binding promise. For example, when a bank lends money to a borrower, a third party (a guarantor) may give a guarantee to the lender that in the event of default by the borrower, the guarantor will pay the money that the lender is owed. A warranty is similar to a guarantee and the two terms may be used interchangeably.

3.6 Straight debt

The term 'straight debt' means a fixed amount of redeemable debt at a fixed rate of interest.

For example, a company might issue ₦200 million of 6% bonds, with a maturity of 15 years. The company will pay interest of ₦12 million each year on the bonds, for 15 years, and at the end of the 15 years, the company will redeem the bonds, usually at par value or face value, and so would return ₦200 million to the bondholders.

3.7 Access to the bond markets for companies

Many companies cannot borrow by issuing bonds in the bond markets. Private companies are prohibited by law from offering bonds to the general public; therefore if these companies want to borrow, they must seek a bank loan or find investors who are willing to invest in their bonds or loan notes.

Large public companies are able to raise capital by issuing bonds in the international bond markets, and they usually pay to have their bonds given a credit rating by one or more credit rating agencies such as Moody's and Standard & Poor's. Investment institutions are often prepared to invest in corporate bonds with a good credit rating (an 'investment grade' rating) if the return ('yield') is attractive. Bonds in the international markets are usually denominated in US dollars or euros, although there are some issues in other currencies such as yen, Swiss francs and British pounds.

Smaller public companies outside the US find it more difficult to issue bonds in the bond market, because the amount of debt they need to raise is often too small to interest major investors, and only major investors buy bonds.

There is a much larger market in the US for corporate bonds, denominated in US dollars. By offering a high fixed rate of interest, companies are often able to issue bonds even though they are not 'investment grade' (i.e. 'sub-investment grade bonds' or 'junk bonds').

The secondary market in bonds is operated by bond dealers in banks, and the liquidity of the secondary market is variable. Many investors in bonds hold them as long-term investments and do not acquire them for short-term reasons. Unlike equity share prices, bond prices are generally fairly stable and do not offer investors an opportunity for quick capital gains from buying and re-selling.

3.8 Debt finance and risk for the borrower

Although debt capital is cheap, particularly in view of the tax relief on interest payments, it can also be a risky form of finance for a company.

- Lenders have a prior right to payment, before the right of shareholders to a dividend. If a company has low profits before interest and a large amount of debt, the profits available for dividends could be very small.
- There is always a risk that the borrower will fail to meet interest payments or the repayment of debt principal on schedule. If a borrower is late with a payment, or misses a payment, there is a default on the loan. A default gives the lenders the right to take action against the borrower to recover the loan.

In comparison with providers of debt capital, equity shareholders do not have similar rights for non-payment of dividends.

Companies should therefore avoid excessive amounts of debt finance, because of the default risk. (However, there are differing views about how much debt finance is 'safe' and how high debt levels can rise before the capital structure of a company becomes too risky.)

3.9 Advantages and disadvantages of debt finance to the investor

The comments about debt finance have so far focused on the borrower. A financial manager also needs to be aware of the attractions and disadvantages of debt capital for the lender or investor.

Advantages

There are significant advantages for an investor to lend money (by purchasing bonds) rather than to invest in equity. Lending is considered safer than investing in equity:

- The loan is usually redeemable, so that the capital will be returned.
- The interest has to be paid by the company, irrespective of how well or badly it has performed.
- The debt might be legally secured on assets of the company – the debt holder can force the company to sell the assets on which the loan is secured if the company defaults. However, most bonds are unsecured.
- Debt ranks higher than equity in a winding up of a company and the liquidation of its assets. Lenders therefore have more chance of getting their investment returned, compared to the equity holders.

Main disadvantage

The main disadvantage of debt finance compared with equity finance for the investor is that:

- The returns from investing in debt bonds are fairly predictable. The interest rate is fixed. There might be some increase or decrease in the market value of bonds, if market yields on bonds change: however, the size of any such capital gain or loss is usually fairly small.
- In contrast, with equity investments, shareholders benefit when the company is successful. Dividends will probably rise in the company's annual profits growth, and there could also be substantial capital gains from increases in the share price.

3.9 Finance leases

Companies can acquire assets with leasing finance instead of buying assets with equity or debt capital. Operating leases offer a means of acquiring assets for the fairly short term. Finance leases are similar to operating leases, except that the lease agreement covers most or all of the asset's expected economic life.

For financial reporting purposes, finance leases are included within liabilities (in the statement of financial position) as a form of debt finance. The main features of a finance lease arrangement are as follows:

- A company acquires a new non-current asset, such as a machine, an item of equipment, a motor vehicle, or even an aeroplane or ship.
- The purchase cost of the leased asset is paid by a lease finance company.
- The lease finance company (the lessor) and the company (the lessee) enter into a lease agreement, which covers all or most of the economic life of the asset.
- Under the terms of the lease agreement, the lessee agrees to make a number of regular fixed payments to the lessor over the term of the lease. These payments are an allowable expense for tax purposes.
- The lessee is responsible for insurance and running and maintenance costs for the asset.

- ❑ The lessor is the legal owner of the asset, and can claim the tax depreciation allowances (capital allowances). For tax purposes, the lessee can claim the full amount of each lease payment as an allowable expense.
- ❑ In law, the lessor is the owner of the asset but for practical purposes, the lessee treats the asset as if it is the owner.
- ❑ For financial reporting purposes, the principle of 'substance over form' applies. The leased asset is reported in the statement of financial position (balance sheet) of the lessee as a non-current asset. This is matched (initially) by a long-term debt obligation to the lessor, which is gradually paid off over the term of the lease.
- ❑ This means that for financial reporting purposes, lease finance is actually reported in the statement of financial position (balance sheet) as a debt obligation, and the regular lease payments are reported as a mixture of finance costs (interest) and repayment of the obligation to the lessor.

**Example: Finance lease**

A company acquires a machine under a finance lease arrangement. The purchase cost of the machine would be ₦100,000. However, the company arranges to make six annual lease payments of ₦19,000 over the term of the lease agreement.

In practice, the company as lessee will make the six annual lease payments and claim the tax relief. The legal owner of the machine is the lessor. In the financial accounts, the company will show the machine as a non-current asset at a cost of ₦100,000, and this will be depreciated over the term of the lease. Initially, there will also be a debt of ₦100,000 in the balance sheet, payable to the lessor. This will be repaid gradually over the term of the lease. For the purpose of the income statement, the lease payments are treated partly as a repayment of the lease 'debt' and partly as an interest cost on this debt.

You do not need to know the details of the financial reporting rules for lease finance. However, you need to be aware that lease finance is a source of 'debt finance' that is widely used by companies of all sizes.

4 Convertible bonds and bonds with warrants attached

Section overview

- Convertible bonds
- Bonds with warrants attached
- Comparison of convertibles and bonds with warrants

Sometimes, companies issue bonds with an equity element included or attached. These bonds are sometimes called 'hybrid debt' securities, because they combine debt and equity features. (For financial reporting purposes, companies are required to segregate the debt from the equity element in the statement of financial position (balance sheet)).

The two main types of hybrid debt instrument are:

- Convertible bonds; and
- Bonds with equity warrants attached.

4.1 Convertible bonds

Convertible bonds are bonds that give their holder the right, but not the obligation, at a specified future date to convert their bonds into a specific quantity of new equity shares.

- If the bondholders choose to exercise the right, they will become shareholders in the company, but will surrender their bonds.
- If the bondholders decide not to exercise their right to convert, the bonds will be redeemed at maturity.



Example: Convertible bonds

A company might issue ₦100 million of 3% convertible bonds. The bonds might be convertible into equity shares after five years, at the rate of 20 shares for each ₦100 of bonds. If the shares are not converted, the company will have the right to redeem them at par immediately. Alternatively, the bonds will be redeemed after ten years.

For the first five years, the company will pay interest on the convertible bonds. After five years, the bondholders must decide whether or not to convert the bonds into shares.

- If the market value of 20 shares is higher than the market value of ₦100 of the convertibles, the bondholders will exercise their right and convert the bonds into shares. They will make an immediate capital gain on their investment. For example, if the share price is ₦6, the bondholders will exchange ₦100 of bonds for 20 shares, and the value of their investment will rise to ₦120.
- If the market value of 20 shares is lower than the market value of ₦100 of the convertibles, the bondholders will not exercise their right to convert, and will hold their bonds until they are redeemed by the company (which will be either immediately or at the end of the tenth year).

Conversion premium

When convertible bonds are first issued, the market value of the shares into which the bonds will be convertible is always less than the market value of the convertibles.

This is because convertibles are issued in the expectation that the share price will rise before the date for conversion. Investors will hope that the market value of the shares will rise by enough to make the market value of the shares into which the bonds will be convertible higher than the value of the convertible as a 'straight bond'.

The amount by which the market value of the convertible exceeds the market value of the shares into which the bonds will be convertible is called the **conversion premium**.



Example: Conversion premium

A company issues 4% convertible bonds at a price of ₦101.50. The bonds will be convertible after six years into equity shares at the rate of 30 shares for every ₦100 of bonds. The current market price of the company's shares is ₦2.50.

The market price of the bonds is ₦101.50 for every ₦100 face value of bonds.

The conversion premium is therefore $₦101.50 - (30 \times ₦2.50) = ₦26$ for every ₦100 of convertibles.

Advantages of convertibles

The advantages of convertibles **for companies** are as follows:

- The company can issue bonds now, and receive tax relief on the interest charges, but hope to convert the debt capital into equity in the future.
- The interest rate on convertibles is lower than the interest rate on similar straight bonds. This is because investors in the convertibles are expected to accept a lower interest rate in return for the option to convert the bonds into equities in the future.
- Occasionally, there is strong demand from investors for convertibles, and companies can respond to investors' demand by issuing convertibles in order to raise new capital.

The advantages of convertibles **for investors** are as follows:

- Investors receive a minimum annual income up to the conversion date, in the form of fixed interest.
- In addition, investors in convertibles will be able to benefit from a rise in the company's share price, and hope to make an immediate capital gain on conversion.
- Convertibles therefore combine some fixed annual income and the opportunity to benefit from a rising share price.

The risk for investors in convertibles is that the share price will not rise sufficiently to make conversion worthwhile. When this happens, it would have been better to invest in straight bonds, which would have paid higher interest.

4.2 Bonds with warrants attached

A company might issue bonds with share warrants attached.

Share warrants are a form of option, giving the holder of a warrant in a company the right, but not the obligation, to subscribe for a specified quantity of new shares in the company at a future date, at a fixed purchase price.



Example: Warrants

A company might issue ten-year 4% bonds with warrants attached. Each ₦1,000 of bonds might give the holder the right to subscribe for ten new shares in the company after four years, at a price of ₦5.50 per share.

- If the share price is higher than ₦5.50 when the date for exercising the warrants arrives, the warrant holder will exercise his right to buy new shares at ₦5.50.
- If the share price is less than ₦5.50 when the date for exercising the warrants arrives, the warrant holder will not exercise the warrants, and will let his rights lapse.

4.3 Comparison of convertibles and bonds with warrants

Bonds with warrants attached are similar to convertibles, and the advantages of issuing them are similar.

The main difference between bonds with warrants and convertibles is that:

- With convertibles, the right to subscribe for equity shares is included in the bond itself, and if the bonds are converted, the investor gives up the bonds in exchange for the equity shares.
- With bonds with warrants, the warrants are detachable from the bonds. The bonds are therefore redeemed at maturity, in the same way as straight bonds. The warrants are separated from the bonds, and the warrant holder either exercises the warrants to subscribe for new shares when the time to do so arrives, or lets the warrants lapse.

Since warrants are detachable from the bonds, they can be traded separately. The right to subscribe for new shares belongs to the owner of the warrants, not the bondholder. This means that an investor can buy bonds with warrants attached when the company issues them, sell the warrants in the stock market and retain the bonds.

Indemnities

Indemnities are contractual obligations of one party (indemnifier) to compensate the loss incurred to the other party (indemnity holder) due to the acts of the indemnitor or any other party. Indemnities form the basis of many insurance contracts.

5 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Summarise the various sources of long-term and short-term finance
- Explain the mechanisms for raising new equity externally including public offer, placing, introduction and rights issue
- Explain how a rights issue works and what is meant by underwriting
- Summarise the nature of debt finance and differentiate between long-, medium- and short-term debt finance
- Describe different components of debt financing including interest, tax relief, access to the bond markets, risk and finance leases
- Explain how convertible bonds and bonds with warrants attached operate

Financial mathematics

Contents

- 1 Simple interest
- 2 Compound interest
- 3 Annuities
- 4 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

D	The role of finance		
	2	Investment decisions	
	a	Explain and apply the key tools of mathematics used in solving business finance problems	
		i	Compound interest and simple interest
		iii	Annuities
		v	Sinking funds and amortisation

Exam context

Accountants use a range of mathematical and statistical techniques in accounting, performance management, financial decision-making, risk analysis and financial management.

This chapter introduces some of the basic elements in financial mathematics: compound and simple interest, and annuities.

Many finance decisions involve computations of the time value of money. Key tools of financial mathematics are therefore the computation of interest.

By the end of this chapter students will be able to:

- .. Explain the difference between simple interest and compound interest
- .. Calculate the final value of an amount invested at a given rate of simple interest
- .. Calculate the final value of an amount invested at a given rate of compound interest
- .. Calculate rates of interest for non-annual periods given the annual rate.
- .. Solve annuity and sinking fund problems

1 Simple interest

Section overview

- Interest
- Simple interest

1.1 Interest

When a person opens a savings account with a bank and deposits money into that account the bank will pay the person money for saving with them. Similarly, if a person borrows money from a bank the bank will expect that person to repay more than they borrowed.

Money is not free to borrow. When a person or entity borrows money the lender will charge interest.



Definition: Interest

Interest is the extra amount an investor receives after investing a certain sum, at a certain rate for a certain time.

Or

Interest is the additional amount of money paid by the borrower to the lender for the use of money loaned to him.

The total interest associated with a loan is the difference between the total repayments and the amount borrowed.

There are two forms of interest:

- Simple interest; and
- Compound interest

A question will specify whether interest is simple or compound. The two types of interest refer to how interest is calculated (not how it is paid or received).

Note: In the expressions that follow, interest rates are always included as decimals.



Illustration:

$$9\% = 0.09$$

In the expression $(1 + r)$, r is the interest rate.

If you are told that the interest rate is 10%, $(1 + r)$ becomes (1.1)

1.2 Simple interest

Simple interest is where the annual interest is a fixed percentage of the original amount borrowed or invested (the principal). Simple interest is interest that is not compounded.



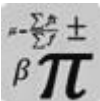
Example:

A person borrows ₦10,000 at 10% with principal and interest to be repaid after 3 years.

	₦
Amount owed at the start of year 1	10,000
Interest for year 1 (10%)	1,000
Interest for year 2 (10%)	1,000
Interest for year 3 (10%)	1,000
Total interest	3,000
Amount owed at the end of year 3	13,000

The closing balance of ₦13,000 must be repaid to the lender at the end of the third year.

This is easy to do for a small number of periods but becomes time consuming as the length of a loan grows.



Formula: Simple interest

Amount repayable at the end of a loan	$S = P(1 + rn)$
Interest due on a loan	$I = Prn$

Where:

S = amount to be paid or received at the end of period n

I = interest charged

P = principal (amount borrowed or invested)

r = period interest rate

n = number of time periods that the loan is outstanding

The interest based on the original principal might be repaid on a periodic basis or accumulate and be repaid at the end.

**Example: Simple interest**

A person borrows ₦10,000 at 10% simple interest for 5 years.

$$\text{Annual interest charge} \quad I = Prn = 10,000 \times 10\% \times 1 \text{ year} = 1,000$$

$$\text{Interest charge over five years} \quad I = Prn = 10,000 \times 10\% \times 5 \text{ years} = 5,000$$

The person might pay the interest on an annual basis (1,000 per annum for 5 years) and then the principal at the end of the loan (10,000 after 5 years) or might pay the principal together with the five years interest at the end of the loan (15,000 after 5 years).

This may be calculated as follows:

$$\text{Amount repayable at the end of 5 years} \quad S = P(1 + rn)$$

$$S = 10,000 \times (1 + [0.1 \times 5])$$

$$S = 10,000 \times (1 + [0.5])$$

$$S = 10,000 \times 1.5$$

$$S = 15,000$$

Periods less than a year

Interest rates given in questions are usually annual interest rates. This means that they are the rate for borrowing or investing for a whole year.

A question might ask about a shorter period. In this case, the annual simple interest rate is pro-rated to find the rate that relates to a shorter period.

**Example: Simple interest**

A person borrows ₦10,000 at 10% simple interest for 8 months

In this case n is a single period of 8 months

$$\text{Annual interest charge} \quad I = Prn = 10,000 \times (10\% \times 8/12) \times 1 = 667$$

$$\text{Amount repayable at the end of 8 months} \quad S = P(1 + rn)$$

$$S = 10,000 \times (1 + [0.1 \times 8/12 \times 1]) \quad S =$$

$$10,667$$



Practice questions

1

- 1** A person borrows ₦100,000 for 4 years at an interest rate of 7%.
What must he pay to clear the loan at the end of this period?
- 2** A person invests ₦60,000 for 5 years at an interest rate of 6%.
What is the total interest received from this investment?
- 3** A person borrows ₦75,000 for 4 months at an interest rate of 8%.
(This is an annual rate)
What must he pay to clear the loan at the end of this period?
- 4** A person borrows ₦60,000 at 8%.
At the end of the loan he repays the loan in full with a cash transfer of ₦88,800.
What was the duration of the loan?
- 5** A person invests ₦90,000 for 6 years.
At the end of the investment she receives a cash transfer of ₦122,400
in full and final settlement of the investment.
What was the interest rate on the investment?

2 Compound interest

Section overview

- Compound interest
- Compound interest for non-annual periods
- Nominal and effective rates
- Alternative approach to finding the final value of a series of payments (receipts)

2.1 Compound interest

Compound interest is where the annual interest is based on the amount borrowed plus interest accrued to date.

The interest accrued to date increases the amount in the account and interest is then charged on that new amount.

One way to think about this is that it is a series of single period investments. The balance at the end of each period (which is the amount at the start of the period plus interest for the period) is left in the account for the next single period. Interest is then accrued on this amount and so on.



Example:

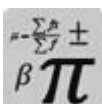
A person borrows ₦10,000 at 10% annual compound interest to be repaid after 3 years.

	₦
Amount owed at the start of year 1	10,000
Interest for year 1 (10%)	1,000
Amount owed at the end of year 1 (start of year 2)	11,000
Interest for year 2 (10%)	1,100
Amount owed at the end of year 2 (start of year 3)	12,100
Interest for year 3 (10%)	1,210
Amount owed at the end of year 3	13,310

The closing balance of ₦13,310 must be repaid to the lender at the end of the third year.

In the above example, the amount owed at each period end is the amount owed at the start plus the annual interest rate, or in other words, the amount owed at the start multiplied by $1 +$ the period interest rate.

This suggests the following formula.



Formula: Compounding formula

$$S_n = S_o \times (1 + r)^n$$

Where:

S_n = final cash flow at the end of the loan (the amount paid by a borrower or received by an investor or lender).

S_o = initial investment

r = period interest rate

n = number of periods

Note that the $(1 + r)^n$ term is known as a compounding factor



Examples: Compounding

A person borrows ₦10,000 at 10% to be repaid after 3 years.

$$S_n = S_o \times (1 + r)^n$$

$$S_n = 10,000 \times (1.1)^3 = 13,310$$

2.2 Compound interest for non-annual periods

It is important to remember that the rate of interest r must be consistent with the length of the period n .

If interest is charged on an annual basis, the annual interest rate must be used but if interest is charged on a six-monthly basis, the six-monthly rate must be used and so on.

A question usually provides an annual rate. If interest is compounded to another period then the periodic rate must be derived from the annual rate.

There are two methods for calculating a rate for a shorter period from an annual rate:

- compounding by parts; or
- continuous compounding

Compounding by parts

A question might state that an investment pays interest at an annual rate compounded into parts of a year. The rate that relates to the part of the year is simply the annual interest divided by the number of parts of the year.



Example: Compounding by parts

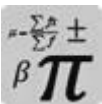
An investment pays interest at 12% compounded quarterly

$$\text{Interest rate per quarter} = 12\%/4 = 3\%$$

An investment pays interest at 12% compounded monthly

$$\text{Interest rate per quarter} = 12\%/12 = 1\%$$

The compounding formula becomes:



Formula: Compounding formula

$$S_n = S_0 \times \left(1 + \frac{r}{m}\right)^{n \times \frac{m}{m}}$$

Where:

r = period interest rate

n = number of periods

m = number of parts of the year

Note you could simply use the previous formula as long as you remember to take the interest rate that relates to the period (say a quarter) and raise $(1 + \text{the period interest rate})$ to the number of periods that the loan is outstanding. For example if the loan is for 2 years and interest is compounded quarterly that would be 8 periods.

**Example:**

A bank lends ₦100,000 at an annual interest rate of 12.55%.

Interest is compounded on a quarterly basis (i.e. every 3 months).

The duration of the loan is 3 years.

How much will the bank's client have to pay?

$$S_n = S_0 \times \left(1 + \frac{r}{m}\right)^{n \times m}$$

$$S_n = 100,000 \times \left(1 + \frac{0.1255}{4}\right)^{3 \times 4}$$

$$S_n = 100,000 \times (1.031375)^{12}$$

$$S_n = 144,877$$

**Practice questions****2**

- 1 A person borrows ₦100,000 for 10 years at an interest rate of 8% compounding annually.
What must he pay to clear the loan at the end of this period?
- 2 A person invests ₦60,000 for 6 years at an interest rate of 6% compounded annually.
What is the total interest received from this investment?
- 3 A person borrows ₦50,000 for 2 years at an interest rate of 12% compounding monthly.
What must he pay to clear the loan at the end of this period?
- 4 A person borrows ₦120,000 for 3 years at 10% compounding quarterly.
What must he pay to clear the loan at the end of this period?
- 5 A person invests ₦200,000 for 4 years compounding semi-annually.
What is the total interest received from this investment?

Continuous compounding

If a loan is compounded continuously, then the equivalent period rate must be calculated.



Formula: Equivalent periodic rate

$$\text{Period rate} = (1 + r)^n - 1$$

Where:

r = Known interest rate for a known period (usually annual)

n = number of times the period for which the rate is unknown fits into the period for which the interest rate is known.

Note that the $(1 + r)^n$ term is a compounding factor but this use recognises that the number of periods might be a fraction.

This sounds much more complicated than it actually is.



Example: Equivalent periodic rates

If the annual interest rate = 10%, what are the following period rates?

Given by:

$$\text{Periodrate} = (1+r)^n - 1$$

6 monthly interest rate?

$$= (1.1)^{\frac{1}{2}} - 1 = 0.049 \text{ or } 4.9\%$$

3 monthly interest rate?

$$= (1.1)^{\frac{1}{4}} - 1 = 0.0241 \text{ or } 2.41\%$$

Interest for a short period can easily be grossed up for a longer period using the compounding factor.



Example: Grossing back equivalent periodic rates

$$\text{Periodrate} = (1+r)^n - 1$$

If the 3-monthly interest rate is 2.41% what is the annual rate?

$$= (1.0241)^4 - 1 = 0.1 \text{ or } 10\%$$

If the annual interest rate is 10% what is the 3-year rate?

$$= (1.1)^3 - 1 = 0.331 \text{ or } 33.1\%$$

We stressed above that it is important to remember that the rate of interest r must be consistent with the length of the period n .



Example:

A bank lends ₦100,000 at an annual interest rate of 12.55% with interest to be charged to the borrower's account on a quarterly basis (i.e. every 3 months).

The duration of the loan is 3 years.

How much will the bank's client have to pay?

Equivalent period rate:

$$\text{Period rate} = (1 + r)^n - 1$$

$$\text{Period rate} = (1.1255)^{\frac{1}{4}} - 1 = 0.03 \text{ or } 3\%$$

3-monthly interest rate	3%
Number of periods (of 3 months in 3 years)	12

Repayment after 3 years:

$$S_n = S_0 \times (1 + r)^n$$

$$\text{Amount repaid} = \text{Amount loaned} \times (1 + r)^n$$

$$\text{repaid} = 100,000 \times (1.03)^{12} = 142,576$$

The lender must pay the borrower ₦142,576 at the end of the loan period.

2.3 Nominal and effective rates

The nominal rate is the “face value” cost of a loan. However, this might not be the true annual cost because it does not take into account the way the loan is compounded.



Example:

A trader wants to borrow ₦1,000,000. He has been offered two different loans.

Loan A charges interest at 10% per annum and loan B at 5% per 6 months.

Which loan should he take?

The nominal interest rates are not useful in making the decision because they relate to different periods. They can be made directly comparable by restating them to a common period. This is usually per annum.

	Loan A	Loan B
	₦	₦
Amount borrowed	1,000,000	1,000,000
Interest added:		50,000
		<hr style="width: 100%;"/>
		1,050,000
	100,000	52,500
	<hr style="width: 100%;"/>	<hr style="width: 100%;"/>
	1,100,000	1,102,500
Total interest	100,000	102,500 (50,000 + 52,500)
Effective rate per annum	$\frac{100}{1,000} \times 100$ = 10%	$\frac{102.5}{1,000} \times 100$ = 10.25%

The effective annual rate could be calculated using:

$$\text{Period rate} = (1 + r)^n - 1$$

Loan A

$$\text{Period rate} = (1.1)^1 - 1 = 0.1 \text{ or } 10\%$$

Loan B

$$\text{Period rate} = (1.05)^2 - 1 = 0.1025 \text{ or } 10.25\%$$

2.4 Alternative approach to finding the final value of a series of payments (receipts)

You may be asked to calculate the result of investing a fixed amount every year (or some other period) at a given rate of compound interest. Usually each investment is made at the start of a period.

This is a geometric progression. The interest accrued at each period end is added to the balance so the amount invested every period is the fixed amount plus the interest that relates to the last period.



Example:

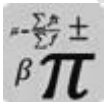
A person invests ₦ 10,000 per annum on the first day of the year at an interest rate of 10% for 3 years compounded annually.

	₦
Amount invested at the start of year 1	10,000
Interest for year 1 (10%)	1,000
	11,000
Amount invested at the start of year 2	10,000
Total invested from the start of year 2	21,000
Interest for year 2 (10%)	2,100
	23,100
Amount invested at the start of year 3	10,000
Total invested from the start of year 3	33,100
Interest for year 3 (10%)	3,310
	36,410

Another way of looking at this is that there are a series of cash flows growing at 10%.

	Year 1	Year 2	Year 3
Amount invested at start of year	10,000	10,000	10,000
Interest received		1,000	2,100
	10,000	11,000	12,100

The formula for the sum a geometric series as follows:



Formula: Sum of the first n terms in a geometric series

Used if the common ratio is more than 1 **and** positive

$$s = \frac{a(r^n - 1)}{r - 1}$$

Where:

a = the first term in the series

r = the common ratio

n = the number of terms

Applying this to the example:



Example:

$$s = \frac{a(r^n - 1)}{r - 1}$$

$$s = \frac{10,000(1.1^3 - 1)}{1.1 - 1}$$

$$s = \frac{10,000(0.331)}{0.1} = 33,100$$

This is the sum of investments at the beginning of each period for three years.

It is not the final amount the investor receives because he will leave the cash on deposit for the third year. Therefore the final amount is:

$$s = 33,100 \times 1.1 = 36,410$$

This is a long-winded explanation of the fact that the formula for the sum of a series must be adjusted to take account of interest that relates to the last period.

Formula: Sum of the first n terms in a geometric series

Used if the common ratio is more than 1 **and** positive

$$s = \frac{a(r^n - 1)}{r - 1} \times (1 + r)$$

Where:

a = the first term in the series

r = the common ratio

n = the number of terms



Example:

Revisiting the above example

$$s = \frac{a(r^n - 1)}{r - 1} \times (1 + r)$$

$$s = \frac{10,000(1.1^3 - 1)}{1.1 - 1} \times (1.1)$$

$$s = \frac{10,000(0.331)}{0.1} \times 1.1 = 36,410$$

3 Annuities

Section overview

- Annuities
- Calculating the final value of an annuity
- Sinking funds

3.1 Annuities

An annuity is a series of regular periodic payments of equal amount.

Examples of annuities are:

- ₦30,000 each year for years 1 – 5
- ₦500 each month for months 1 – 24.

There are two types of annuity:

Ordinary annuity – payments (receipts) are in arrears i.e. at the end of each payment period

Annuity due – payments (receipts) are in advance i.e. at the beginning of each payment period.



Illustration: Annuities

Assume that it is now 1 January 2020

A loan is serviced with 5 equal annual payments.

Ordinary annuity The payments to service the loan would start on 31 December 2020 with the last payment on 31 December 2024.

Annuity due The payments to service the loan would start on 1 January 2020 with the last payment on 31 January 2024.

All payments (receipts) under the annuity due are one year earlier than under the ordinary annuity.

3.2 Calculating the final value of an annuity

Questions often require the calculation of the future value of an annuity. The following formula can be used.



Formula: Future value of an annuity

Ordinary annuity

$$S_n = \frac{X(1+r)^n - 1}{r}$$

Annuity due

$$S_n = \frac{X(1+r)^n - 1}{r} \times (1+r)$$

Where:

S_n = final cash flow at the end of the loan (the amount paid by a borrower or received by an investor or lender).

X = Annual investment

r = period interest rate

n = number of periods



Example:

A savings scheme involves investing ₦100,000 per annum for 4 years (on the last day of the year).

If the interest rate is 10%, what is the sum to be received at the end of the 4 years?

$$S_n = \frac{X(1+i)^n - 1}{i}$$

$$S_n = \frac{100,000(1.1)^4 - 1}{0.1}$$

$$S_n = \frac{100,000(1.4641 - 1)}{0.1}$$

$$S_n = \frac{46,410}{0.1} = ₦464,100$$



Example:

A savings scheme involves investing ₦100,000 per annum for 4 years (on the first day of the year).

If the interest rate is 10% what is the sum to be received at the end of the 4 years?

$$S_n = \frac{X(1+r)^n - 1}{r} \times (1+r)$$

$$S_n = \frac{100,000(1.1)^4 - 1}{0.1} \times 1.1$$

$$S_n = \frac{100,000(1.4641 - 1)}{0.1} \times 1.1$$

$$S_n = \frac{46,410}{0.1} \times 1.1 = ₦510,510$$

3.3 Sinking funds

A business may wish to set aside a fixed sum of money at regular intervals to achieve a specific sum at some future point in time. This is known as a sinking fund.

The question will ask you to calculate the fixed annual amount necessary to build to a required amount at a given interest rate and over a given period of years.

The calculations use the same approach as above but this time solving for X as Sn is known.



Example:

A company will have to pay ₦5,000,000 to replace a machine in 5 years. The company wishes to save up to fund the new machine by making a series of equal payments into an account which pays interest of 8%. The payments are to be made at the end of the year and then at each year end thereafter.

What fixed annual amount must be set aside so that the company saves ₦5,000,000?

$$Sn = \frac{X(1+i)^n - 1}{i}$$

$$5,000,000 = \frac{X(1.08)^5 - 1}{0.08}$$

$$5,000,000 = \frac{X(1.469 - 1)}{0.08}$$

$$5,000,000 = \frac{X(0.469)}{0.08}$$

$$X = \frac{5,000,000 \times 0.08}{0.469} = \text{₦}852,878$$

**Practice questions****3**

- 1** A man wants to save to meet the expense of his son going to university.
He intends to put ₦ 50,000 into a savings account at the end of each of the next 10 years.
The account pays interest of 7%.
What will be the balance on the account at the end of the 10 year period?
- 2** A proud grandparent wishes to save money to help pay for his new born grand daughter's wedding.
He intends to save ₦5,000 every 6 months for 18 years starting immediately.
The account pays interest of 6% compounding semi-annually (every 6 months)
What will be the balance on the account at the end of 18 years?
- 3** A business wishes to start a sinking fund to meet a future debt repayment of ₦ 100,000,000 due in 10 years.
What fixed amount must be invested every 6 months if the annual interest rate is 10% compounding semi-annually if the first payment is to be made in 6 months?

4 Chapter review

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the difference between simple interest and compound interest
- Calculate the final value of an amount invested at a given rate of simple interest
- Calculate the final value of an amount invested at a given rate of compound interest
- Calculate rates of interest for non-annual periods given the annual rate
- Solve annuity and sinking fund problems.

Solutions to practice questions

Solutions

1

$$1 \quad S = P(1 + rn) \quad S = 100,000(1 + [0.07 \times 4])$$

$$S = P(1 + rn) \quad S = 100,000 \times 1.28 = \text{N}128,000$$

$$2 \quad I = Prn \quad I = 60,000 \times 0.06 \times 5 = \text{N}18,000$$

$$3 \quad S = P(1 + rn) \quad S = 75,000(1 + [\frac{4}{12} \times 0.08]) = \text{N}77,000$$

$$4 \quad S = P(1 + rn)$$

$$88,800 = 60,000(1 + 0.08n)$$

$$88,800 = 60,000 + 4,800n$$

$$\frac{88,800 - 60,000}{4,800} = n$$

$$n = 6 \text{ years}$$

$$5 \quad S = P(1 + rn)$$

$$122,400 = 90,000(1 + r6)$$

$$122,400 = 90,000 + 540,000r$$

$$\frac{122,400 - 90,000}{540,000} = r$$

$$r = 0.6(0r6\%)$$

Solutions

2

$$1 \quad S_n = S_0 \times (1 + r)^n \quad S_n = 100,000 \times 1.08^{10}$$

$$S_n = 100,000 \times 2.1589 = \text{N}215,892$$

$$2 \quad S_n = S_0 \times (1 + r)^n \quad S_n = 60,000 \times 1.06^6$$

$$S_n = 60,000 \times 1.485 = \text{N}85,111$$

$$3 \quad S_n = S_0 \times (1 + r)^n \quad S_n = 50,000 \times 1.01^{24}$$

$$S_n = 50,000 \times 1.27 = \text{N}63,487$$

$$4 \quad S_n = S_0 \times (1 + r)^n \quad S_n = 120,000 \times 1.025^{12}$$

$$S_n = 120,000 \times 1.345 = \text{N}161,387$$

$$5 \quad S_n = S_0 \times (1 + r)^n \quad S_n = 200,000 \times 1.04^8$$

$$S_n = 200,000 \times 1.369 = \text{N}273,714$$

Solutions

3

1

$$S_n = \frac{X(1+i)^n - 1}{i}$$

$$S_n = \frac{50,000(1.07)^{10} - 1}{0.07}$$

$$S_n = \frac{50,000(1.967 - 1)}{0.07}$$

$$S_n = \frac{48,350}{0.07} = \text{N}690,714$$

2

$$S_n = \frac{X(1+r)^n - 1}{r} \times (1+r)$$

$$S_n = \frac{5,000(1.03)^{36} - 1}{0.03} \times 1.03$$

$$S_n = \frac{5,000(2.898 - 1)}{0.03} \times 1.03$$

$$S_n = \frac{9,490}{0.03} \times 1.03 = \text{N}325,823$$

3

$$S_n = \frac{X(1+r)^n - 1}{r}$$

$$100,000,000 = \frac{X(1.05)^{20} - 1}{0.05}$$

$$100,000,000 = \frac{X(2.653 - 1)}{0.05}$$

$$X = \frac{100,000,000 \times 0.05}{1.653}$$

$$X = \text{N} 3,024,803$$

Investment decisions 1

Contents

- 1 Discounting
- 2 Net present value (NPV) method of investment appraisal
- 3 Discounting annuities and perpetuities
- 4 Internal rate of return (IRR)
- 5 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

D	The role of finance	
	2	Investment decisions
	a	Explain and apply the key tools of mathematics used in solving business finance problems
	ii	Discounting
	iv	Present value of annuities
	b	Identify and apply the following investment appraisal techniques
	iii	Discounted payback
	iv	Net present value
	v	Internal rate of return

Exam context

Accountants use a range of mathematical and statistical techniques in accounting, performance management, financial decision-making, risk analysis and financial management. Many finance decisions involve computations of the time value of money. Key tools of financial mathematics are therefore the computation of interest.

The previous chapter described calculations of simple and compound interest. This chapter explains discounting, which is the reverse of compounding. It also describes the application of discounting arithmetic to investment appraisal and investment decisions.

By the end of this chapter students will be able to:

- Explain the difference between discounting and compounding
- Calculate the present value of future cash flows using the formula or tables
- Calculate the present value of annuities flows using the formula or tables
- Calculate net present value from information provided
- Calculate the discounted payback period
- Calculate internal rate of return

1 Discounting

Section overview

- The time value of money
- Discounting
- Discount tables

1.1 The time value of money

One of the basic principles of finance is that a sum of money today is worth more than the same sum in the future. If offered a choice between receiving ₦10,000 today or in 1 year's time a person would choose today.

A sum today can be invested to earn a return. This alone makes it worth more than the same sum in the future. This is referred to as the time value of money.

The impact of time value can be estimated using one of two methods:

- Compounding estimates future cash flows that will arise as a result of investing an amount today at a given rate of interest for a given period.
 - An amount invested today is multiplied by a compound factor to give the amount of cash expected at a specified time in the future assuming a given interest rate.
- Discounting estimates the present day equivalent (present value which is usually abbreviated to **PV**) of a future cash flow at a specified time in the future at a given rate of interest
 - An amount expected at a specified time in the future is multiplied by a discount factor to give the present value of that amount at a given rate of interest.
 - The discount factor is the inverse of a compound factor for the same period and interest rate. Therefore, multiplying by a discount factor is the same as dividing by a compounding factor.
 - Discounting is the reverse of compounding.

1.2 Discounting

Formula: Discount factor

$$\text{Discount factor} = \frac{1}{(1 + r)^n}$$

Where:

r = the period interest rate (cost of capital)

n = number of periods



Example: Discounting

A person expects to receive ₦13,310 in 3 years.

If the person faces an interest rate of 10%, what is the present value of this amount?

$$\begin{aligned} \text{Presentvalue} &= \text{Futurecashflow} \times \frac{1}{(1+r)^n} \\ \text{Presentvalue} &= 13,310 \times \frac{1}{(1.1)^3} \\ \text{Present value} &= 10,000 \end{aligned}$$

Emphasis



Illustration: Discounting is the reverse of compounding

Compounding

$$\text{Futurevalue} = \text{Amounttoday} \times (1+r)^n$$

Rearranging (and renaming the “amount today” as present value)

$$\text{Presentvalue} = \text{Futurevalue} \times \frac{1}{(1+r)^n}$$

Interpreting present values

The present value of a future cash flow is the amount that an investor would need to invest today to receive that amount in the future. This is simply another way of saying that discounting is the reverse of compounding.

It is important to realise that the present value of a cash flow is the equivalent of its future value. Using the above example to illustrate this, ₦10,000 today is exactly the same as ₦13,310 in 3 years at an interest rate of 10%. The person in the example would be indifferent between the two amounts. He would look on them as being identical.

Also the present value of a future cash flow is a present day cash equivalent. The person in the example would be indifferent between an offer of ₦10,000 cash today and ₦13,310 in 3 years.

Using present values

Discounting cash flows to their present value is a very important technique. It can be used to compare future cash flows expected at different points in time by discounting them back to their present values.



Example: Comparing cash flows.

A borrower is due to repay a loan of ₦120,000 in 3 years.

He has offered to pay an extra ₦20,000 as long as he can repay after 5 years.

The lender faces interest rates of 7%. Is the offer acceptable?

$$\text{Existing contract} \quad PV = 120,000 \times \frac{1}{(1.07)^3} = \text{₦}97,955$$

$$\text{Client's offer} \quad \text{Presentvalue} = 140,000 \times \frac{1}{(1.07)^5} = \text{₦}99,818$$

The client's offer is acceptable as the present value of the new amount is greater than the present value of the receipt under the existing contract.



Example: Comparing cash flows

An investor wants to make a return on his investments of at least 7% per year.

He has been offered the chance to invest in a bond that will cost ₦200,000 and will pay ₦270,000 at the end of four years.

In order to earn ₦270,000 after four years at an interest rate of 7%, the amount of his investment now would need to be:

$$PV = 270,000 \times \frac{1}{(1.07)^4} = \text{₦}206,010$$

The investor would be willing to invest ₦206,010 to earn ₦270,000 after 4 years.

However, he only needs to invest ₦200,000.

This indicates that the bond provides a return in excess of 7% per year.



Example: Comparing cash flows

How much would an investor need to invest now in order to have ₦100,000 after 12 months, if the compound interest on the investment is 0.5% each month?

The investment 'now' must be the present value of ₦100,000 in 12 months, discounted at 0.5% per month.

$$PV = 100,000 \times \frac{1}{(1.005)^{12}} = \text{₦}94,190$$

Present values can be used to appraise large projects with multiple cash flows. This is covered in section 2 of this chapter.

1.3 Discount tables

Discount factors can be calculated as shown earlier but can also be obtained from discount tables. These are tables of discount rates which list discount factors by interest rates and duration.



Illustration: Discount tables (extract)

(Full tables are given as an appendix to this text).

Discount rates (r)						
(n)	5%	6%	7%	8%	9%	10%
1	0.952	0.943	0.935	0.926	0.917	0.909
2	0.907	0.890	0.873	0.857	0.842	0.826
3	0.864	0.840	0.816	0.794	0.772	0.751
4	0.823	0.792	0.763	0.735	0.708	0.683

Where:

n = number of periods



Example: Discount factors from formula or tables

Calculate the present value of ₦60,000 received in 4 years assuming a cost of capital of 7%.

From formula

$$PV = 60,000 \times \frac{1}{(1.07)^4} = 45,773$$

From table (above)

$$PV = 60,000 \times 0.763 = 45,780$$

The difference is due to rounding. The discount factor in the above table has been rounded to 3 decimal places whereas the discount factor from the formula has not been rounded.

2 Net present value (NPV) method of investment appraisal

Section overview

- Introduction to discounted cash flow (DCF) analysis
- Calculating the NPV of an investment project
- Linking discounting and compounding
- Advantages and disadvantages of the NPV method
- Discounted payback period

2.1 Introduction to discounted cash flow (DCF) analysis

Discounted cash flow is a technique for evaluating proposed investments, to decide whether they are financially worthwhile.

There are two methods of DCF:

- Net present value (NPV) method:** the cost of capital r is the return required by the investor or company
- Internal rate of return (IRR) method:** the cost of capital r is the actual return expected from the investment.

All cash flows are assumed to arise at a distinct point in time (usually the end of a year). For example, sales of ₦20m in year four are discounted as if they arose as a single amount at the end of year 4.

2.2 Calculating the NPV of an investment project

Approach

Step 1: List all cash flows expected to arise from the project. This will include the initial investment, future cash inflows and future cash outflows.

Step 2: Discount these cash flows to their present values using the cost that the company has to pay for its capital (cost of capital) as a discount rate. All cash flows are now expressed in terms of 'today's value'.

Step 3: The net present value (NPV) of a project is the difference between the present value of all the costs incurred and the present value of all the cash flow benefits (savings or revenues).

- The project is acceptable if the NPV is positive.
- The project should be rejected if the NPV is negative.



Example: NPV appraisal

A company with a cost of capital of 10% is considering investing in a project with the following cash flows.

Year	₦(m)
0	(10,000)
1	6,000
2	8,000

Should the project be undertaken?

NPV calculation:

Year	Cash flow	Discount factor (10%)	Present value
0	(10,000)	1	(10,000)
1	6,000	$\frac{1}{(1.1)}$	5,456
2	8,000	$\frac{1}{(1.1)^2}$	6,612
NPV			<u>2,068</u>

The NPV is positive so the project should be accepted.

Note that the above example refers to year 0, year 1 etc. This actually refers to points in time. "Year 0" is now. "Year 1" is at the end of the first year and so on.

Sometimes they are referred to as t0, t1, t2 etc.



Practice questions

1

- 1 A company is considering whether to invest in a new item of equipment costing ₦53,000 to make a new product.

The product would have a four-year life, and the estimated cash profits over the four-year period are as follows.

Year	₦
1	17,000
2	25,000
3	16,000
4	12,000

Calculate the NPV of the project using a discount rate of 11%

- 2 A company is considering whether to invest in a new item of equipment costing ₦65,000 to make a new product.

The product would have a three-year life, and the estimated cash profits over this period are as follows.

Year	₦
1	27,000
2	31,000
3	15,000

Calculate the NPV of the project using a discount rate of 8%

2.3 Linking discounting and compounding



Example:

Expected annual cash flows from a project are:

Year	₦(m)
0	(50,000)
1	10,000
2	20,000
3	42,000

NPV calculation (cost of capital is 10%)

Year	Cash flow	Discount factor (10%)	Present value
0	(50,000)	1	(50,000)
1	10,000	$\frac{1}{(1.1)}$	9,091
2	20,000	$\frac{1}{(1.1)^2}$	16,529
3	42,000	$\frac{1}{(1.1)^3}$	31,555
NPV			<u>7,175</u>

Compounding calculation

	₦(m)
Investment in Year 0	(50,000)
Interest required (10%), Year 1	<u>(5,000)</u>
Return required, end of Year 1	(55,000)
Net cash flow, Year 1	<u>10,000</u>
	(45,000)
Interest required (10%), Year 2	<u>(4,500)</u>
Return required, end of Year 2	(49,500)
Net cash flow, Year 2	<u>20,000</u>
	(29,500)
Interest required (10%), Year 3	<u>(2,950)</u>
Return required, end of Year 3	(32,450)
Net cash flow, Year 3	<u>42,000</u>
Future value, end of Year 3	<u>9,550</u>

The cash flows are identical in each model:

$$7,175 = 9,550 \times \frac{1}{(1.1)^3} \quad \text{or} \quad 9,550 = 7,175 \times (1.1)^3$$

2.4 Advantages and disadvantages of the NPV method

The **advantages** of the NPV method of investment appraisal are that:

- ❑ NPV takes account of the timing of the cash flows by calculating the present value for each cash flow at the investor's cost of capital.
- ❑ DCF is based on cash flows, not accounting profits. It is therefore much more suitable than the ARR method for investment appraisal (see next chapter).
- ❑ It evaluates all cash flows from the project, unlike the payback method which considers only those cash flows in the payback period.
- ❑ It gives a single figure, the NPV, which can be used to assess the value of the investment project. The NPV of a project is the amount by which the project should add to the value of the company, in terms of 'today's value'.
- ❑ The NPV method provides a decision rule which is consistent with objective of maximisation of shareholders' wealth. In theory, a company ought to increase in value by the NPV of an investment project (assuming that the NPV is positive).

The main **disadvantages** of the NPV method are:

- ❑ The time value of money and present value are concepts that are not easily understood
- ❑ There might be some uncertainty about what the appropriate cost of capital or discount rate should be for applying to a project.

2.5 Discounted payback period

When assessing an investment decision using the NPV method, it is sometimes useful to calculate the discounted payback period. This is the length of time it will take before the positive returns from the investment, measured as discounted values, pay back the amount invested.

Discounted payback may be relevant to investment decisions when a company has a policy of not investing unless the discounted payback period is less than, say 4 years.



Example: discounted payback period

An example of a NPV calculation, together with calculation of the discounted payback period, is shown below. This is for an investment costing ₦ 10,000 million, where the cost of capital is 10%.

Year	Cash flow ₦ million	Discount factor 10%	Present value ₦ million	Cumulative NPV ₦ million
0	(10,000)	1.000	(10,000)	(10,000)
1	2,000	0.909	1,818	(8,182)
2	3,000	0.826	2,478	(5,704)
3	3,000	0.751	2,253	(3,451)
4	4,000	0.683	2,732	(719)
5	4,000	0.621	2,484	1,765
NPV			<u>1,765</u>	

- ❑ In this example, the five year project has a positive NPV of ₦1,765 million, but the project does not pay back in discounted terms until Year 5, when the cumulative NPV changes from negative to positive.
- ❑ It could be estimated that discounted payback occurs $(719/2,484) = 0.29$ of the way through Year 5, which is ($\times 12$ months) about 3.5 months of Year 5.

3 Discounting annuities and perpetuities

Section overview

- Annuities
- Perpetuities
- Application of annuity arithmetic

3.1 Annuities

An annuity is a constant cash flow for a given number of time periods. A capital project might include estimated annual cash flows that are an annuity.

Examples of annuities are:

- ₦30,000 each year for years 1 – 5
- ₦20,000 each year for years 3 – 10
- ₦500 each month for months 1 – 24.

The present value of an annuity can be computed by multiplying each individual amount by the individual discount factor and then adding each product. This is fine for annuities of just a few periods but would be too time consuming for long periods. An alternative approach is to use the annuity factor.

An annuity factor for a number of periods is the sum of the individual discount factors for those periods.

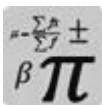


Example:

Calculate the present value of ₦50,000 per year for years 1 – 3 at a discount rate of 9%.

Year	Cashflow	Discount factor at 9%		Present value
1	50,000	$\frac{1}{(1.09)}$	= 0.917	45,850
2	50,000	$\frac{1}{(1.09)^2}$	= 0.842	42,100
3	50,000	$\frac{1}{(1.09)^3}$	= 0.772	38,600
NPV				<u>126,550</u>
or:				
1 to 3	50,000		2.531	126,550

An annuity factor can be constructed by calculating the individual period factors and adding them up but this would not save any time. In practice, a formula or annuity factor tables are used.



Formula: Annuity factor (discount factor of an annuity)

There are two versions of the annuity factor formula:

	Method 1	Method 2
Annuity factor	$= \frac{1}{r} \left(1 - \frac{1}{(1+r)^n} \right)$	$= \left(\frac{1 - (1+r)^{-n}}{r} \right)$

Where:

r = discount rate, as a proportion

n = number of time periods



Example: Present value of an annuity factor

Year	Cashflow	Discount factor	Present value
1 to 3	50,000	2.531 (W)	126,550

Working: Calculation of annuity factor

Method 1:

$$\begin{aligned}
 &= \frac{1}{r} \left(1 - \frac{1}{(1+r)^n} \right) \\
 &= \frac{1}{0.09} \left(1 - \frac{1}{(1.09)^3} \right) \\
 &= \frac{1}{0.09} \left(1 - \frac{1}{1.295} \right) \\
 &= \frac{1}{0.09} (1 - 0.7722) \\
 &= \frac{1}{0.09} (0.2278) = 2.531
 \end{aligned}$$

Method 2:

$$\begin{aligned}
 &= \left(\frac{1 - (1+r)^{-n}}{r} \right) \\
 &= \left(\frac{1 - (1.09)^{-3}}{0.09} \right) \\
 &= \left(\frac{1 - 0.7722}{0.09} \right) \\
 &= \frac{0.2278}{0.09} \\
 &= 2.531
 \end{aligned}$$


Illustration: Annuity factor table (extract)

(Full tables are given as an appendix to this text).

(n)	Discount rates (r)					
	5%	6%	7%	8%	9%	10%
1	0.952	0.943	0.935	0.926	0.917	0.909
2	1.859	1.833	1.808	1.783	1.759	1.736
3	2.723	2.673	2.624	2.577	2.531	2.487
4	3.546	3.465	3.387	3.312	3.240	3.170
5	4.329	4.212	4.100	3.993	3.890	3.791

Where:

n = number of periods

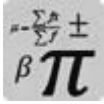

Practice questions
2

- 1 A company is considering whether to invest in a project which would involve the purchase of machinery with a life of five years. The machine would cost ₦556,000 and would have a net disposal value of ₦56,000 at the end of Year 5. The project would earn annual cash flows (receipts minus payments) of ₦200,000. Calculate the NPV of the project using a discount rate of 15%.
- 2 A company is considering whether to invest in a project which would involve the purchase of machinery with a life of four years. The machine would cost ₦1,616,000 and would have a net disposal value of ₦301,000 at the end of Year 4. The project would earn annual cash flows (receipts minus payments) of ₦500,000. Calculate the NPV of the project using a discount rate of 10%.

3.2 Perpetuities

A perpetuity is a constant annual cash flow 'forever', or into the long-term future.

In investment appraisal, an annuity might be assumed when a constant annual cash flow is expected for a long time into the future.



Formula: Perpetuity factor

$$\text{Perpetuity factor} = \frac{1}{r}$$

Where:

r = the cost of capital



Examples: Present value of perpetuities

Cash flow
2,000 in perpetuity, starting
in Year 1
Cost of capital = 8%

Present value

$$= \frac{1}{r} \times \text{Annual cash flow}$$

$$= \frac{1}{0.08} \times 2,000 = 25,000$$

3.3 Application of annuity arithmetic

Equivalent annual costs

An annuity is multiplied by an annuity factor to give the present value of the annuity.

This can work in reverse. If the present value is known it can be divided by the annuity factor to give the annual cash flow for a given period that would give rise to it.



Illustration: Equivalent annual costs

What is the present value of ₦10,000 per annum from t1 to t5 at 10%?

Time	Cash flow	Discount factor	Present value
1 to 5	₦10,000	3.791	₦37,910

What annual cash flow from t1 to t5 at 10% would give a present value of ₦37,910?

	₦37,910
Divide by the 5 year, 10% annuity factor	÷3.791
	₦10,000

This can be used to address the following problems.



Example:

A company is considering an investment of ₦70,000 in a project. The project life would be five years.

What must be the minimum annual cash returns from the project to earn a return of at least 9% per annum?

Investment = ₦70,000

Annuity factor at 9%, years 1 – 5 = 3.890

Minimum annuity required = ₦17,995 (= ₦70,000/3.890)

Loan repayments



Example: Loan repayments

A company borrows ₦10,000,000.

This is to be repaid by 5 equal annual payments at an interest rate of 8%.

Calculate the payments.

The approach is to simply divide the amount borrowed by the annuity factor that relates to the payment term and interest rate

Amount borrowed	₦10,000,000
Divide by the 5 year, 8% annuity factor	÷3.993
Annual repayment	₦2,504,383

Sinking funds (alternative approach to that seen earlier)

A person may save a constant annual amount to produce a required amount at a specific point in time in the future. This is known as a sinking fund.

**Example: Sinking fund**

A man wishes to invest equal annual amounts so that he accumulates ₦5,000,000 by the end of 10 years.

The annual interest rate available for investment is 6%.

What equal annual amounts should he set aside?

Step 1: Calculate the present value of the amount required in 10 years.

$$PV = ₦5,000,000 \times \frac{1}{(1.06)^{10}} = ₦2,791,974$$

Step 2: Calculate the equivalent annual cash flows that result in this present value

Present value	₦2,791,974
Divide by the 10 year, 6% annuity factor	7.36
Annual repayment	₦379,344

If the man invests ₦379,344 for 10 years at 6% it will accumulate to ₦5,000,000.

4 Internal rate of return (IRR)

Section overview

- Internal rate of return (IRR)
- Calculating the IRR of an investment project
- Advantages and disadvantages of the IRR method

4.1 Internal rate of return (IRR)

The internal rate of return method (IRR method) is another method of investment appraisal using DCF.

The internal rate of return of a project is the discounted rate of return on the investment.

- It is the average annual investment return from the project
- Discounted at the IRR, the NPV of the project cash flows must come to 0.
- The internal rate of return is therefore the discount rate that will give a net present value of zero.

The investment decision rule with IRR

A company might establish the minimum rate of return that it wants to earn on an investment. If other factors such as non-financial considerations, risk and uncertainty are ignored:

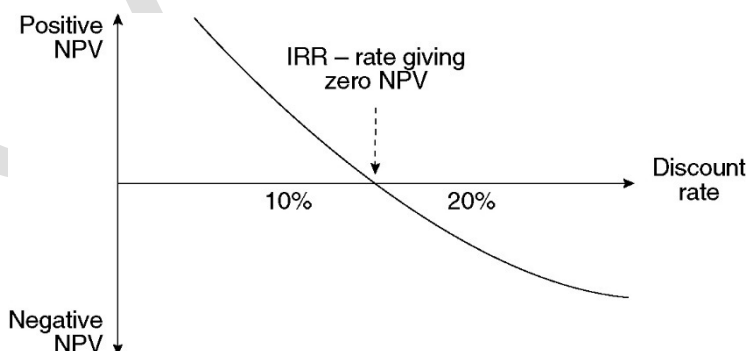
- If a project's IRR is equal to or higher than the minimum acceptable rate of return, it should be undertaken
- If the IRR is lower than the minimum required return, it should be rejected.

Since NPV and IRR are both methods of DCF analysis, the same investment decision should normally be reached using either method.

The internal rate of return is illustrated in the diagram below:



Illustration: IRR



4.2 Calculating the IRR of an investment project

The IRR of a project can be calculated by inputting the project cash flows into a financial calculator. In your examination, you might be required to calculate an IRR without a financial calculator. An approximate IRR can be calculated using interpolation.

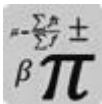
To calculate the IRR, you should begin by calculating the NPV of the project at two different discount rates.

- ❑ One of the NPVs should be positive, and the other NPV should be negative. (This **is** not essential. Both NPVs might be positive or both might be negative, but the estimate of the IRR will then be less reliable.)
- ❑ Ideally, the NPVs should both be close to zero, for better accuracy in the estimate of the IRR.

When the NPV for one discount rate is positive and the NPV for another discount rate is negative, the IRR must be somewhere between these two discount rates.

Although in reality the graph of NPVs at various discount rates is a curved line, as shown in the diagram above, using the interpolation method we assume that the graph is a straight line between the two NPVs that we have calculated. We can then use linear interpolation to estimate the IRR, to a reasonable level of accuracy.

The interpolation formula



Formula: IRR interpolation formula

$$\text{IRR} = A\% + \left(\frac{\text{NPV}_A}{\text{NPV}_A - \text{NPV}_B} \right) \times (B - A)\%$$

Ideally, the NPV at A% should be positive and the NPV at B% should be negative.

Where:

NPV_A = NPV at A%

NPV_B = NPV at B%

**Example: IRR**

A business requires a minimum expected rate of return of 12% on its investments.

A proposed capital investment has the following expected cash flows:

Year	Cash flow	Discount factor at 10%	Present value at 10%	Discount factor at 15%	Present value at 15%
0	(80,000)	1.000	(80,000)	1,000	(80,000)
1	20,000	0.909	18,180	0.870	17,400
2	36,000	0.826	29,736	0.756	27,216
3	30,000	0.751	22,530	0.658	19,740
4	17,000	0.683	11,611	0.572	9,724
NPV			<u>+ 2,057</u>		<u>(5,920)</u>

Using

$$\text{IRR} = A\% + \left(\frac{\text{NPV}_A}{\text{NPV}_A - \text{NPV}_B} \right) \times (B - A)\%$$

$$\text{IRR} = 10\% + \left(\frac{2,057}{2,057 - (-5,920)} \right) \times (15 - 10)\%$$

$$\text{IRR} = 10\% + \left(\frac{2,057}{2,057 + 5,920} \right) \times 5\%$$

$$\text{IRR} = 10\% + \left(\frac{2,057}{7,977} \right) \times 5\%$$

$$\text{IRR} = 10\% + 0.258 \times 5\% = 10\% + 1.3\%$$

$$\text{IRR} = 11.3$$

Conclusion

The IRR of the project of 11.3% is less than the target return of 12%.

The project should be rejected.



Practice questions

3

1 The following information is about a project:

Year	₦
0	(53,000)
1	17,000
2	25,000
3	16,000
4	12,000

This project has an NPV of ₦2,210 at a discount rate of 11%.

Estimate the IRR of the project.

2 The following information is about a project:

Year	₦
0	(65,000)
1	27,000
2	31,000
3	15,000

This project has an NPV of ₦(1,515) at a discount rate of 8%.

Estimate the IRR of the project.

4.3 Advantages and disadvantages of the IRR method

The main **advantages** of the IRR method of investment appraisal are:

- As a DCF appraisal method, it is based on cash flows, not accounting profits.
- Like the NPV method, it recognises the time value of money.
- It is easier to understand an investment return as a percentage return on investment than as a money value NPV in ₦.
- For accept/reject decisions on individual projects, the IRR method will reach the same decision as the NPV method.

The **disadvantages** of the IRR method are:

- It is a relative measure (% on investment), not an absolute measure in ₦. Because it is a relative measure, it ignores the absolute size of the investment. For example, it may be difficult to identify the better investment out of the following where the cost of capital is, say, 10%:
 - an investment with an IRR of 15% or
 - an investment with an IRR of 20%.

- ❑ If the investments are mutually exclusive, and only one of them can be undertaken the correct choice will depend on the size of each of the investments. This means that the IRR method of appraisal can give an incorrect decision if it is used to make a choice between mutually exclusive projects
- ❑ Unlike the NPV method, the IRR method does not indicate by how much an investment project would add to the value of the company.

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5 Chapter review

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the difference between discounting and compounding
- Calculate the present value of future cash flows using the formula or tables
- Calculate the present value of annuities flows using the formula or tables
- Calculate net present value from information provided
- Calculate the discounted payback period
- Calculate internal rate of return

Solutions to practice questions

Solutions

1

1 NPV calculation:

Year	Cash flow ₦	Discount factor (11%)	Present value ₦
0	(53,000)	1	(53,000)
1	17,000	$\frac{1}{(1.11)}$	15,315
2	25,000	$\frac{1}{(1.11)^2}$	20,291
3	16,000	$\frac{1}{(1.11)^3}$	11,699
4	12,000	$\frac{1}{(1.11)^4}$	7,905
NPV			<u>2,210</u>

The NPV is positive so the project should be accepted.

2 NPV calculation:

Year	Cash flow ₦	Discount factor (8%)	Present value ₦
0	(65,000)	1	(65,000)
1	27,000	$\frac{1}{(1.08)}$	25,000
2	31,000	$\frac{1}{(1.08)^2}$	26,578
3	15,000	$\frac{1}{(1.08)^3}$	11,907
NPV			<u>(1,515)</u>

The NPV is negative so the project should be rejected.

Solutions**2****1** NPV calculation:

Year	Cash flow ₦	Discount factor (11%)	Present value ₦
0	(556,000)	1	(556,000)
5	56,000	$\frac{1}{(1.15)^5}$	27,842
1 – 5	200,000	$= \frac{1}{0.15} \left(1 - \frac{1}{1.15^5}\right)$	<u>670,431</u>
NPV			<u>142,273</u>

The NPV is positive so the project should be accepted.

2 NPV calculation:

Year	Cash flow ₦	Discount factor (11%)	Present value ₦
0	(1,616,000)	1	(1,616,000)
4	301,000	$\frac{1}{(1.1)^4}$	205,587
1 – 4	500,000	$= \frac{1}{0.11} \left(1 - \frac{1}{1.1^4}\right)$	<u>1,584,932</u>
NPV			<u>174,519</u>

The NPV is positive so the project should be accepted.

Solutions

3

- 1 NPV at 11% is ₦2,210. A higher rate is needed to produce a negative NPV. (say 15%)

Year	Cash flow ₦	Discount factor at 15%	Present value at 15% ₦
0	(53,000)	1,000	(53,000)
1	17,000	0.870	14,790
2	25,000	0.756	18,900
3	16,000	0.658	10,528
4	12,000	0.572	<u>6,864</u>
NPV			<u>(1,918)</u>

Using

$$\text{IRR} = A\% + \left(\frac{\text{NPV}_A}{\text{NPV}_A - \text{NPV}_B} \right) \times (B - A)\%$$

$$\text{IRR} = 10\% + \left(\frac{2,210}{2,210 - (-1,918)} \right) \times (15 - 10)\%$$

$$\text{IRR} = 10\% + \left(\frac{2,210}{2,210 + 1,918} \right) \times 5\%$$

$$\text{IRR} = 10\% + \left(\frac{2,210}{4,128} \right) \times 5\%$$

$$\text{IRR} = 10\% + 0.535 \times 5\% = 10\% + 2.7\%$$

$$\text{IRR} = 12.7\%$$

Solutions**3**

- 2 NPV at 8% is ₦(1,515). A lower rate is needed to produce a positive NPV. (say 5%)

Year	Cash flow ₦	Discount factor at 5%	Present value at 5% ₦
0	(65,000)	1,000	(65,000)
1	27,000	0.952	25,704
2	31,000	0.907	28,117
3	15,000	0.864	<u>12,960</u>
NPV			<u>1,781</u>

Using

$$\text{IRR} = A\% + \left(\frac{\text{NPV}_A}{\text{NPV}_A - \text{NPV}_B} \right) \times (B - A)\%$$

$$\text{IRR} = 5\% + \left(\frac{1,781}{1,781 - (-1,515)} \right) \times (8 - 5)\%$$

$$\text{IRR} = 5\% + \left(\frac{1,781}{1,781 + 1,515} \right) \times 3\%$$

$$\text{IRR} = 5\% + \left(\frac{1,781}{3,296} \right) \times 3\%$$

$$\text{IRR} = 5\% + 0.540 \times 3\% = 5\% + 1.6\%$$

$$\text{IRR} = 6.6\%$$

Investment decisions 2

Contents

- 1 Capital expenditure, investment appraisal and capital budgeting
- 2 Accounting rate of return (ARR) method
- 3 The payback method of capital investment appraisal
- 4 Relevant costs in investment decisions
- 5 Comparison of investment appraisal methods
- 6 Non-financial considerations
- 7 Social and environmental issues
- 8 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

D	The role of finance		
	2	Investment decisions	
		b	Identify and apply the following investment appraisal techniques
		i	Accounting rate of return
		ii	Payback period

Exam context

It is generally more appropriate to use discounting methods for capital investment appraisal, but other methods are described in this chapter, which also draws attention to the use of relevant costs and also non-financial considerations in investment decisions.

By the end of this chapter students will be able to:

- Explain the concepts of capital expenditure, investment appraisal and capital budgeting
- Calculate the accounting rate of return for an investment
- Calculate the payback period for an investment
- Discuss the concept of relevant costs for decision making
- Compare the advantages and disadvantages of different investment appraisal techniques
- Comment on non-financial considerations for investment appraisal such as strategic and operational considerations, capacity and resource utilisation, social and environmental considerations and quality.

1 Capital expenditure, investment appraisal and capital budgeting

Section overview

- Capital expenditure
- Investment appraisal
- Capital budgeting
- Features of investment projects
- Methods of investment appraisal
- The basis for making an investment decision

1.1 Capital expenditure

Capital expenditure is spending on non-current assets, such as buildings and equipment, or investing in a new business. As a result of capital expenditure, a new non-current asset appears on the statement of financial position (balance sheet), possibly as an 'investment in subsidiary'.

In contrast **revenue expenditure** refers to expenditure that does not create long-term assets, but is either written off as an expense in the income statement in the period that it is incurred, or that creates a short-term asset (such as the purchase of inventory).

Capital expenditure initiatives are often referred to as investment projects, or 'capital projects'. They can involve just a small amount of spending, but in many cases large amounts of expenditure are involved.

A distinction might possibly be made between:

- essential capital spending to replace worn-out assets and maintain operational capability
- discretionary capital expenditure on new business initiatives that are intended to develop the business and make a suitable financial return on the investment.

1.2 Investment appraisal

Before capital expenditure projects are undertaken, they should be assessed and evaluated. As a general rule, projects should not be undertaken unless:

- they are expected to provide a suitable financial return, and
- the investment risk is acceptable.

Investment appraisal is the evaluation of proposed investment projects involving capital expenditure. The purpose of investment appraisal is to make a decision about whether the capital expenditure is worthwhile and whether the investment project should be undertaken.

1.3 Capital budgeting

Capital expenditure by a company should provide a long-term financial return, and spending should therefore be consistent with the company's long-term corporate and financial objectives. Capital expenditure should therefore be made

with the intention of implementing chosen business strategies that have been agreed by the board of directors.

Many companies have a capital budget, and capital expenditure is undertaken within the agreed budget framework and capital spending limits. For example, a company might have a five-year capital budget, setting out in broad terms its intended capital expenditure for the next five years. This budget should be reviewed and updated regularly, typically each year.

Within the long-term capital budget, there should be more detailed spending plans for the next year or two.

- Individual capital projects that are formally approved should be included within the capital budget.
- New ideas for capital projects, if they satisfy the investment appraisal criteria and are expected to provide a suitable financial return, might be approved provided that they are consistent with the capital budget and overall spending limits.

Investment appraisal and capital budgets

Investment appraisal therefore takes place within the framework of a capital budget and strategic planning. It involves

- Generating capital investment proposals in line with the company's strategic objectives.
- Forecasting relevant cash flows relating to the project
- Evaluating the projects
- Implementing projects which satisfy the company's criteria (i.e. projects that will earn a satisfactory return on investment)
- Monitoring the performance of investment projects to ensure that they perform in line with expectations.

1.4 Features of investment projects

Many investment projects have the following characteristics:

- The project involves the purchase of an asset with an expected life of several years, and involves the payment of a large sum of money at the beginning of the project. Returns on the investment consist largely of net income from additional profits over the course of the project's life.
- The asset might also have a disposal value (residual value) at the end of its useful life.
- A capital project might also need an investment in working capital. Working capital also involves an investment of cash.

Alternatively a capital investment project might involve the purchase of another business, or setting up a new business venture. These projects involve an initial capital outlay, and possibly some working capital investment. Financial returns from the investment might be expected over a long period of time, perhaps indefinitely.

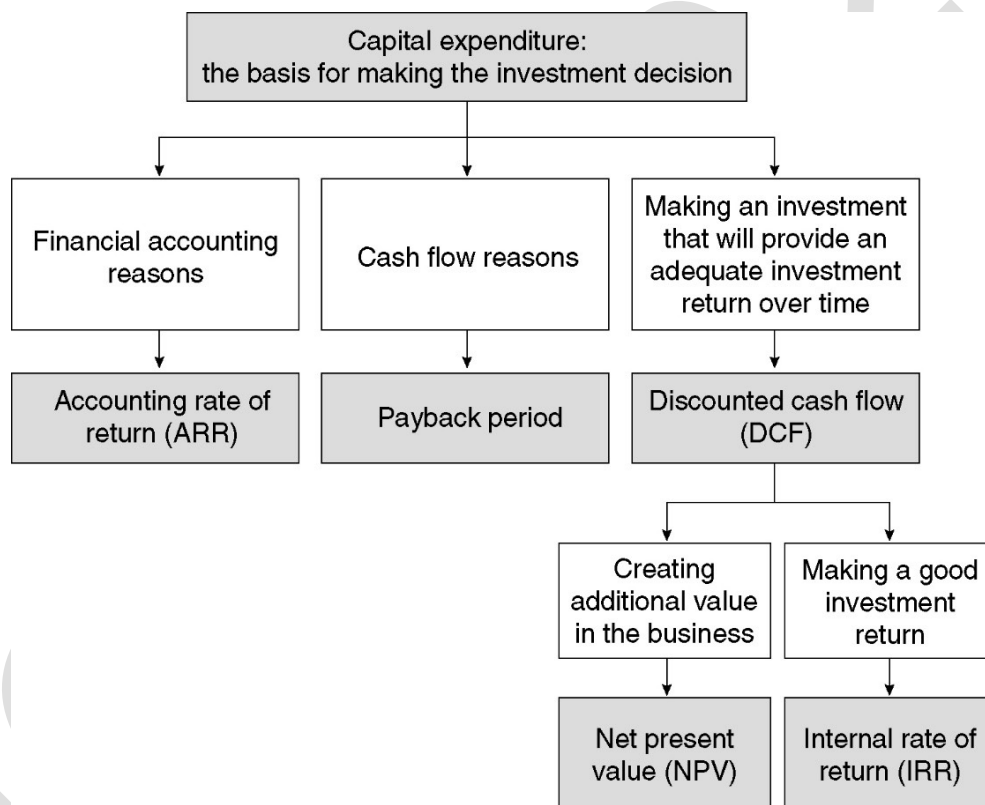
1.5 Methods of investment appraisal

There are four methods of evaluating a proposed capital expenditure project. Any or all of the methods can be used, but some methods are preferable to others, because they provide a more accurate and meaningful assessment.

The four methods of appraisal are:

- ❑ Accounting rate of return (ARR) method
- ❑ Payback method
- ❑ Discounted cash flow (DCF) methods:
 - Net present value (NPV) method
 - Internal rate of return (IRR) method

Each method of appraisal considers a different financial aspect of the proposed capital investment.



1.6 The basis for making an investment decision

When deciding whether or not to make a capital investment, management must decide on a basis for decision-making. The decision to invest or not invest will be made for **financial reasons** in most cases, although non-financial considerations could be important as well. These are discussed later.

There are different financial reasons that might be used to make a capital investment decision. Management could consider:

- ❑ the effect the investment will have on the accounting return on capital employed, as measured by financial accounting methods. If so, they might

use **accounting rate of return (ARR) /return on investment (ROI)** as the basis for making the decision

- ❑ the time it will take to recover the cash invested in the project. If so, they might use the **payback period** as the basis for the investment decision
- ❑ the expected investment returns from the project. If so, they should use **discounted cash flow (DCF)** as a basis for their decision. DCF considers both the size of expected future returns and the length of time before they are earned.

There are two different ways of using DCF as a basis for making an investment decision:

- ❑ **Net present value (NPV) approach.** With this approach, a present value is given to the expected costs of the project and the expected benefits. The value of the project is measured as the net present value (the present value of income or benefits minus the present value of costs). The project should be undertaken if it adds value. It adds value if the net present value is positive (greater than 0).
- ❑ **Internal rate of return (IRR) approach.** With this approach, the expected return on investment over the life of the project is calculated, and compared with the minimum required investment return. The project should be undertaken if its expected return (as an average percentage annual amount) exceeds the required return.

2 Accounting rate of return (ARR) method

Section overview

- Decision rule for the ARR method
- Definition of ARR
- Advantages and disadvantages of using the ARR method

The accounting rate of return (ARR) from an investment project is the accounting profit, usually before interest and tax, as a percentage of the capital invested. It is similar to return on capital employed (ROCE), except that whereas ROCE is a measure of financial return for a company or business as a whole, ARR measures the financial return from specific capital project.

The essential feature of ARR is that it is based on accounting profits, and the accounting value of assets employed.

2.1 Decision rule for the ARR method

The decision rule for capital investment appraisal using the ARR method is that a capital project meets the criteria for approval if its expected ARR is higher than a minimum target ARR or minimum acceptable ARR.

Alternatively the decision rule might be to approve a project if the return on capital employed (ROCE) of the company as a whole will increase as a result of undertaking the project.

2.2 Definition of ARR

If accounting rate of return (ARR) is used to decide whether or not to make a capital investment, we calculate the expected annual accounting return over the life of the project. The financial return will vary from one year to the next during the project; therefore we have to calculate an **average annual return**.

If the ARR of the project exceeds a target accounting return, the project would be undertaken. If its ARR is less than the minimum target, the project should be rejected and should not be undertaken

Unfortunately, a standard definition of accounting rate of return does not exist. There are two main definitions:

- Average annual profit as a percentage of the **average investment** in the project
- Average annual profit as a percentage of the **initial investment**.

You would normally be told which definition to apply. If in doubt, assume that capital employed is the **average** amount of capital employed over the project life.

$$\text{Capital employed} = \left[\frac{\text{Initial cost of equipment} + \text{Residual value}}{2} \right] + \text{Working capital}$$

However, you might be expected to define capital employed as the total initial investment (capital expenditure + working capital investment).

Profits will vary from one year to the next over the life of an investment project. As indicated earlier, profit is defined as the accounting profit, after depreciation but before interest and taxation. Since profits vary over the life of the project, it is

normal to use the **average annual profit** to calculate ARR.

Profit is calculated using normal accounting rules, and this is after the deduction of depreciation on non-current assets.

2.3 Advantages and disadvantages of using the ARR method

The main **advantages** of the ARR are that:

- It is fairly easy to understand. It uses concepts that are familiar to business managers, such as profits and capital employed.
- It is easy to calculate.

However, there are significant **disadvantages** with the ARR method.

- It is based on accounting profits, and not cash flows. However investments are about investing cash to obtain cash returns. Investment decisions should therefore be based on cash flows, and not accounting profits.
- Accounting profits are an unreliable measure. For example, the annual profit and the average annual investment can both be changed simply by altering the rate of depreciation and the estimated residual value.
- The ARR method ignores the timing of the accounting profits. Using the ARR method, a profit of ₦10,000 in Year 1 and ₦90,000 in Year 2 is just as valuable as a profit of ₦90,000 in Year 1 and ₦10,000 in Year 2. However, the timing of profits is significant, because the sooner the cash returns are received, the sooner they can be reinvested to increase returns even more.
- The ARR is a percentage return, relating the average profit to the size of the investment. It does not give us an absolute return. However the absolute return can be significant. For example if the ARR on an investment of ₦1,000 is 50%, the average profit is ₦500; whereas if the ARR on an investment of ₦1 million is 20%, the average annual profit will be ₦200,000. An accounting return of ₦200,000 on an investment of ₦1 million might be preferred to an accounting return of 50% on an investment of ₦1,000.
- When using the ARR method for investment appraisal, a decision has to be made about what the minimum target ARR should be. There is no rational economic basis for setting a minimum target for ARR. Any such minimum target accounting return is a subjective target, with no economic or investment significance.

3 The payback method of capital investment appraisal

Section overview

- Definition of payback
- Decision rule for the payback method
- Advantages and disadvantages of the payback method

3.1 Definition of payback

Payback is measured by **cash flows, not profits**.

It is the length of time before the cash invested in a project will be recovered (paid back) from the net cash returns from the investment project.

For example, suppose that a project will involve capital expenditure of ₦80,000 and the annual net cash returns from the project will be ₦30,000 each year for five years. The expected payback period is:

$$\frac{\text{₦}80,000}{\text{₦}30,000} = 2.67 \text{ years}$$

3.2 Decision rule for the payback method

Using the payback method, a maximum acceptable payback period is decided, as a matter of policy. The expected payback period for the project is calculated.

- If the expected payback is within the maximum acceptable time limit, the project is acceptable.
- If the expected payback does not happen until after the maximum acceptable time limit, the project is not acceptable.

The **time value of money** is ignored, and the total return on investment is not considered.

3.3 Advantages and disadvantages of the payback method

The **advantages** of the payback method for investment appraisal are as follows:

- Simplicity – The payback is easy to calculate and understand.
- The method analyses cash flows, not accounting profits. Investments are about investing cash to earn cash returns. In this respect, the payback method is better than the ARR method.
- Payback is often used together with a DCF method, particularly by companies that have liquidity problems and do not want to tie up cash for long periods. Payback can be used to eliminate projects that will take too long to pay back. Investments that pass the payback test can then be evaluated using one of the DCF methods.

The **disadvantages** of the payback method are as follows:

- It ignores all cash flows after the payback period, and so ignores the total cash returns from the project. This is a significant weakness with the payback method.

- ❑ It ignores the timing of the cash flows during the payback period. For example, for an investment of ₦100,000, cash flows of ₦10,000 in Year 1 and ₦90,000 in Year 2 are no different from cash flows of ₦90,000 in Year 1 and ₦10,000 in Year 2, because both pay back after two years. However it is clearly better to receive ₦90,000 in Year 1 and ₦10,000 in Year 2 than to receive ₦10,000 in Year 1 and ₦90,000 in Year 2.

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4 Relevant costs in investment decisions

Section overview

- Relevant costs and decision-making
- Relevant cost of materials
- Relevant cost of existing equipment
- Relevant cost of investment in working capital
- Opportunity costs

4.1 Relevant costs and decision-making

You should already be familiar with the concept that when any decision is evaluated in accounting, relevant costs should be used for the evaluation. Since the ARR method uses accounting profits and not cash flows, it is a poor investment appraisal method that should not be used for making investment decisions.

Relevant costs are used for payback method analysis and for DCF analysis. DCF analysis is described in the next chapter.

Definition of relevant costs and benefits

Relevant costs and benefits are future cash flows arising as a direct consequence of the decision under consideration.

- Relevant costs are **cash flows**. Any items of cost that are not cash flows must be ignored for the purpose of decision. For example, depreciation expenses are not cash flows and must always be ignored.
- Relevant costs are **future** cash flows. Costs that have already been incurred are not relevant to a decision that is being made now. The cost has already been incurred, whatever decision is made, and it should therefore not influence the decision. For example, a company might incur initial investigation costs of ₦20,000 when looking into the possibility of making a capital investment. When deciding later whether to undertake the project, the investigation costs are irrelevant, because they have already been spent. These costs are also called sunk costs.
- Relevant costs are also **costs that will arise as a direct consequence of the decision**, even if they are future cash flows. If the costs will be incurred whatever decision is taken, they are not relevant to the decision.

Some examples of relevant costs are given below, but you should already be familiar with the concept of relevant costs from your previous studies.

4.2 Relevant costs of materials

When materials will have to be purchased for a project, because there are no existing inventories of the materials, their relevant cost is their future purchase cost.

However if the materials required for a project are already held in inventory, their relevant cost depends on circumstances.

- If the materials are in regular use, and quantities consumed for the investment project would be replaced in the normal course of trading

operations, the relevant cost of the materials is their current replacement cost.

- If the materials will not be replaced if they are used for the investment project, their relevant cost is the higher of:
 - their net disposal value and
 - the net contribution that could be earned using the materials for another available use.

4.3 Relevant cost of existing equipment

When new capital equipment will have to be purchased for a project, the purchase cost of the equipment will be a part of the initial capital expenditure, and so a relevant cost.

However, if an investment project will also make use of equipment that the business already owns, the relevant cost of the equipment will be the higher of:

- the current disposal value of the equipment, and
- the present value of the cash flows that could be earned by having an alternative use for the equipment.

4.4 Relevant cost of investment in working capital

It is important that you should understand the relevance of investment in working capital for cash flows.

Strictly speaking, an investment in working capital is not a cash flow. However, it should be treated as a cash flow, because:

- when capital investment projects are evaluated, it is usual to estimate the cash profits for each year of the project
- however, actual cash flows will differ from cash profits by the amount of the increase or decrease in working capital.

You should be familiar with this concept from cash flow statements.

- If there is an increase in working capital, cash flows from operations will be lower than the amount of cash profits. The increase in working capital can therefore be treated as a cash outflow, to adjust the cash profits to the expected cash flow for the year.
- If there is a reduction in working capital, cash flows from operations will be higher than the amount of cash profits. The reduction in working capital can therefore be treated as a cash inflow, to adjust the cash profits to the expected cash flow for the year.

4.5 Opportunity costs

Opportunity costs are the benefits forgone by using assets or resources for one purpose, instead of using them in the most profitable alternative way. Opportunity costs are commonly measured as contribution forgone, but might also be measured as a present value (in DCF analysis).

When resources have more than one alternative use, and are in limited supply, their opportunity cost is the contribution forgone by using them for one purpose and so being unable to use them for another purpose.

5 Comparison of investment appraisal methods

Section overview

- Comparison of investment appraisal methods

5.1 Comparison of investment appraisal methods

A comparison of the four investment appraisal methods is given in the table below. The **key points to note** are that:

- DCF is superior to the ARR and payback methods of investment appraisal
- It is often equally as good to use NPV or IRR
- However, NPV has two advantages over IRR
 - The NPV method indicates the value that the investment should add (if the NPV is positive) or the value that it will destroy (if the NPV is negative).
 - When there are two or more mutually exclusive projects, the NPV will always identify the project that should be selected. This is the project that will provide the highest value (NPV).
- The IRR method has the advantage of being more easily understood by non-accountants
- Another disadvantage of the IRR method is that a project might have two or more different IRRs, when some annual cash flows during the life of the project are negative. (The mathematics that demonstrate this point are not shown here.)

ARR	Payback	Discounted cash flow
<i>Disadvantages</i>	<i>Advantages</i>	<i>Advantages</i>
Financial profits, not cash flows	Cash flows, not accounting values	Based on investment cash flows, not accounting profit
Balance sheet values, not cash investment cost.	Focus on recovering the cost of the investment	Recognises the time value of money Recognises all cash flows, over the full life of the project By far the best investment appraisal method Required return is based on the organisation's cost of finance.

ARR	Payback	Discounted cash flow	
	<i>Disadvantages</i>	<i>NPV</i>	<i>IRR</i>
	Choice of maximum payback period is arbitrary	Indicates the increase in the value of the company that should be expected if it were to undertake the investment.	More easily understood than NPV by a non-accountant.
	Ignores cash from the project after payback	If a choice has to be made between two (or more) mutually exclusive projects , the NPV method is more reliable than IRR.	
	Ignores the time value of money.		

6 Non-financial considerations

Section overview

- The nature of non-financial considerations
- Strategic considerations
- Operational considerations
- Capacity utilisation and resource utilisation
- Measurements of quality
- Performance through quality
- Qualitative performance
- Make-or-buy decisions: non-financial considerations

6.1 The nature of non-financial considerations

Investment decisions often need to embrace non-financial considerations as well as financial considerations. Non-financial considerations may be both quantitative and qualitative.

Non-financial considerations could include:

- quality
- speed (for example, speed of service or speed of delivery)
- reliability
- efficiency
- achieving a specific non-financial target
- meeting customer needs/customer satisfaction
- social and environmental issues

6.2 Strategic considerations

Non-financial measures are needed because success in achieving some strategic objectives cannot be measured in money terms alone or in terms of financial performance measurements. Some strategic objectives are therefore set in terms of a non-financial performance target and actual results are compared with this non-financial target. For example:

- market share (as a target for competitive strategy and sales strategy)
- number of new products developed (as a target for innovation strategy)
- quality measures (where quality is a key strategic objective for meeting customer needs and expectations).

6.3 Operational considerations

Many operational targets are set and operational performance measured by non-financial performance indicators (NFPIs). In this case investment appraisal must be undertaken with consideration to relevant NFPIs.

For example, measures of success in meeting customer needs include:

- customer service measures, such as average time to respond to customer calls, and average time to meet customer orders
- customer satisfaction reports
- measures of repeat business obtained or customer loyalty.

Measures of performance in relation to the management of employees might include:

- staff turnover rates
- absenteeism and sickness rates
- productivity ratios or similar productivity measurements.

6.4 Capacity utilisation and resource utilisation

Measures of performance appraisal in relation to the utilisation of resources include capacity utilisation ratios such as:

- hotel room occupancy rates (hotels)
- machine utilisation rates
- proportion of seats filled (airlines, cinemas).

Capacity utilisation is an important aspect of appraisal because successful performance often depends on the extent to which available key resources are used.

In a manufacturing business, a company may have invested heavily in special production equipment. If the machines are used to 98% of their capacity, this would indicate that operations are performing well. On the other hand, if the machines are operating at only 40% capacity, this would indicate scope for improvement.

Other examples of capacity utilisation measures are:

- The capacity utilisation of classrooms in a school (actual number of students as a percentage of capacity)
- The utilisation of bed space in a hospital (actual patient days compared with maximum capacity)
- The utilisation of seats in a bus service or train service, compared with capacity
- The utilisation of space in transport vehicles, compared with capacity.

Actual capacity utilisation is usually reported as a percentage of total capacity.

6.5 Measurements of quality

Quality targets may be a major element in strategic planning and investment appraisal. Quality is associated with meeting customer needs and expectations.

Quality performance can be measured and evaluated in relation to the key performance objectives of quality, speed, dependability (reliability), flexibility and cost. For example:

Performance objective	Performance measure
Quality	Percentage of items rejected or scrapped Average number of defects per unit produced Average time between machine breakdowns Number of customer complaints Number or cost of warranty claims
Speed	Average time between receiving an order and completing the work Throughput cycle time Transport times
Dependability	Percentage of customer orders met from inventory Percentage of orders or items delivered late Average delays
Flexibility	Average set-up time New product development time Range of products
Cost	Variations Cost per operating hour/per machine hour Labour productivity Throughput, contribution

Another approach to quality performance measurement is to use a combination of operational measures, financial measures and customer measures. For example:

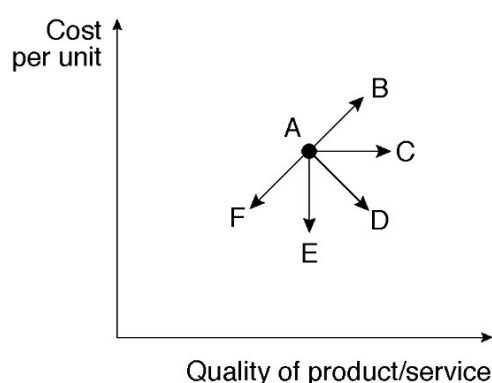
- Operational measures**
 - percentage of items rejected
 - time lost in production
- Financial measures**
 - the cost per unit produced
 - quality costs
- Customer measures**, such as:
 - number of customer complaints
 - number of claims under warranty
 - change in total market share.

6.6 Performance through quality

Cost and quality are inter-connected issues. Business entities provide goods or services to customers that combine a particular cost per unit (and sales price per unit) with a perceived level of quality. In a competitive business environment, companies should be trying either:

- to provide customers with more quality for a given cost per unit or
- to provide products of a given quality for a lower cost.

In the following diagram, the current position for a company in a competitive market is shown as point A. The company has six strategic options, A to F.



- Strategy A.** This is a do-nothing strategy. In a competitive business environment, it is the strategy most likely to result in eventual business failure. Companies cannot 'do nothing'. Like their competitors, they need to seek ways of providing more value to customers, by reducing costs or improving quality.
- Strategy B.** This strategy is to improve the quality of the product or service, and increasing the cost per unit to achieve the quality improvement.
- Strategy C.** This is a strategy of more quality for the same cost – improving the quality of the product or service without any change in the cost per unit.
- Strategy D.** This is a strategy of improving quality and at the same time reducing the cost per unit. This is the strategy most likely to succeed over the long term, but improving quality and reducing costs may be difficult to achieve.
- Strategy E.** This is a strategy of maintaining the same quality, but at a lower cost per unit.
- Strategy F.** This is a strategy of 'going down-market', and providing a cheaper product or service, but at a lower standard of quality.

Strategy A is the least likely to succeed and Strategy D the most likely to succeed. The likely success of the other strategies will depend on competitive conditions in the market (what competitors are doing) and on customer preferences.

6.7 Qualitative performance

Qualitative performance is performance that is not measured and expressed in quantitative terms. Qualitative performance targets may be expressed in general terms, such as:

- being the 'best' or 'better than competitors'
- 'meeting customer needs'
- 'high quality'.

Where possible, performance targets should be quantified. A quantified target provides a specific objective for achievement, and actual performance can be measured against it. With qualitative targets, assessing performance may be a matter of judgement and subjective opinion.

In many cases, it is possible to convert qualitative targets into quantitative targets. For example, an objective of achieving high quality can be expressed in quantitative quality targets. Similarly, 'being better than the competition' can be converted into quantitative targets, by identifying the ways in which the company wants to 'beat' the opposition. Even 'meeting customer needs' can be quantified, by identifying what customer needs are, or by measuring customer views in an attitude survey.

In some cases, however, it may be difficult to quantify critical performance targets. In particular, it may be difficult to set quantitative targets for:

- brand recognition, or
- reputation.

These can, however, be critical success factors.

- The commercial success of many companies is reinforced by a strong brand that the company reinforces through advertising and maintains through quality.
- The commercial success of a company may be put at risk by a 'bad' reputation. For example, a well-known footwear company suffered a decline in sales some years ago following media reports that its suppliers used child labour. Some oil companies promote an image of being environmentally-conscious, perhaps in the expectation that it will obtain longer-term benefits from a socially and environmentally-friendly image.

6.8 Make-or-buy decisions: non-financial considerations

When relevant costs are used to make a decision as to whether to invest internally or outsource production, it is assumed that the decision should be based on financial considerations and whether the decision will add to profit (cash flows).

In reality, however, managers are likely to think about non-financial issues as well as financial issues when making outsourcing decisions. The non-financial considerations in any decision will depend on the circumstances, and will vary from one decision to another. Non-financial considerations can influence a decision.

Non-financial considerations that will often be relevant to a make-or-buy decision include the following.

- ❑ When work is outsourced, the entity loses some control over the work. It will rely on the external supplier to produce and supply the outsourced items. There may be some risk that the external supplier will:
 - produce the outsourced items to a lower standard of quality, or
 - fail to meet delivery dates on schedule, so that production of the end-product may be held up by a lack of components.
- ❑ The entity will also lose some flexibility. If it needs to increase or reduce supply of the outsourced item at short notice, it may be unable to do so because of the terms of the agreement with the external supplier. For example, the terms of the agreement may provide for the supply of a fixed quantity of the outsourced item each month.
- ❑ A decision to outsource work may have implications for employment within the entity, and it may be necessary to make some employees redundant. This will have cost implications, and could also adversely affect the relationship between management and other employees.
- ❑ It might be appropriate to think about the longer-term consequences of a decision to outsource work. What might happen if the entity changes its mind at some time in the future and decides either (a) to bring the work back in-house or (b) to give the work to a different external supplier? The problem might be that taking the work from the initial external provider and placing it somewhere else might not be easy in practice, since the external supplier might not be co-operative in helping with the removal of its work.

The non-financial factors listed above are all reasons against outsourcing work. There might also be non-financial **benefits** from outsourcing work to an external supplier.

- ❑ If the work that is outsourced is not specialised, or is outside the entity's main area of expertise, outsourcing work will enable management to focus their efforts on those aspects of operations that the entity does best. For example, it could be argued that activities such as the management of an entity's fleet of delivery vehicles, or the monthly payroll work, should be outsourced because the entity itself has no special expertise on these areas.
- ❑ The external supplier, on the other hand, may have specialist expertise which enables it to provide the outsourced products or services more efficiently and effectively. For example a company might outsource all its IT support operations, because it cannot recruit and retain IT specialists. An external service provider, on the other hand, will employ IT specialists.

7 Social and environmental issues

Section overview

- Introduction
- Environmental footprint (ecological footprint)
- Carbon neutrality
- Social footprint
- Social ecology
- Accounting, the economic model and sustainability reporting
- Sustainable development

7.1 Introduction

The purpose of economic activity is to create economic wealth. It is now recognised, much more than in the past, that economic activity also has an environmental impact and a social effect. An organisation is said to create an 'environmental footprint' and a 'social footprint' - a visible mark on the environment and on society. (The word 'footprint' is intended to have the same meaning as in everyday use, when we speak of leaving a footprint in the sand, as a mark that we leave behind where we have been.)

The social footprint may be either beneficial or damaging. The environmental footprint is almost inevitably damaging.

7.2 Environmental footprint (ecological footprint)

An environmental footprint, also called an ecological footprint, is a term that means the impact that an entity has on the environment, in terms of:

- the amount of raw materials that it uses to make its products or services, where the raw materials are subject to depletion (see note).
- non-renewable resources that it uses to make its products or services
- the quantity of wastes and emissions that it creates in the process.

Note: Raw materials subject to depletion are raw materials that can be renewed, but where the current total rate of consumption exceeds the total current rate of renewal. Fish stocks and hard wood timber are examples.

In the past, it was accepted that in order to grow, companies (and economic activity as a whole) had to increase their environmental footprint. With the recognition today that the world cannot go on increasing its environmental footprint, many leading companies are looking for ways to reduce the size of their own particular footprint and 'tread more softly'.

Reducing an environmental footprint involves the development and implementation of policies for:

- better (more efficient) resource management, and using different resources
- 'green' procurement policies
- waste minimisation and waste management (for example, policies on reducing pollution and recycling waste).

The measurement of environmental footprint

There have been attempts to measure environmental footprint, using a common measure for all activities. It can be measured in terms of the area of productive land and aquatic ecosystems that have been used, from whatever global source. An environmental footprint for any economic activity or any company can therefore be measured in terms of hectares of productive land or aquatic ecosystems.

One widely-used method of footprint analysis for the economic activity of nation states is to identify four methods of environmental consumption:

- energy use
- the built environment (land covered by a human settlement and its connecting infrastructure, such as roadways)
- food products
- forestry products.

For each category, it is possible to measure the land area used for these activities within the country, in global hectares, to obtain a total environmental footprint for the country. This is then converted into an environmental footprint per head of the population.

Countries that consume most environmental resources and create most environmental damage relative to other countries are those with the highest environmental footprint per head of the population.

7.3 Carbon neutrality

The effect on the environment of economic activities by individual companies may be measured in terms of emissions of carbon-based pollutants, such as the release of carbon dioxide into the atmosphere.

Some environmentally-conscious companies already measure their impact on carbon pollution, and might have a stated environmental policy of being 'carbon neutral'.

Carbon neutrality exists when a company is able to counterbalance its use of carbon products, and particularly its carbon dioxide emissions, with activities that reduce the amount of carbon dioxide in the atmosphere such as growing trees or plants (which absorb carbon dioxide from the atmosphere). Some companies have also tried to reduce their impact on carbon dioxide pollution by switching to the use of fuel and energy that does not involve carbon consumption.

One company has listed some of the initiatives it has taken to create a sustainable business as:

- Setting a target of zero waste generation and zero waste emissions
- Conserving energy and resources such as oil, coal, natural gas, water and minerals
- Recycling materials to reduce the need for disposals
- Reducing packaging waste
- Making, using, handling and transporting materials safely and in an environmentally-friendly way and in compliance with local regulations
- Managing land efficiently to increase habitats for wild life

- Developing new products and processes that reduce the environmental risks.

7.4 Social footprint

A social footprint is the effect of economic activity on society and people. In general, economic activity is seen as providing benefits for society, although some companies are much more 'people-friendly' than others. Some companies, for example, use child labour and/or pay subsistence-level wages to their workers.

Companies might seek to measure the contribution of their activities towards society in terms of:

- Total numbers employed or increase in the total number of employees
- The proportion of the total work force employed in different parts of the world
- The proportion of the total work force that is female or from different ethnic groups
- Health and safety at work (for example, numbers of employees injured each year per 1,000 of the work force).

7.5 Social ecology

There are critics of the Western capitalist approach to environmentalism. Social ecologists argue that the environmental crisis has been caused by companies seeking growth, profits and economic self-interest. Nothing fundamental has changed. Companies are still trying to get bigger and more profitable, even though they use environmental ideology to express their plans and ambitions. They argue that the environmental crisis cannot be averted without a radical change in human society.

The following comments are illustrative of the thinking of social ecologists.

- Environmental problems are caused by companies that seek continued growth in size and profits.
- Social ecologists also argue that the structure of society and the future of the environment are closely linked.
- They argue that most environmentalists focus, wrongly, on improving technology to improve the environment, or even on restricting population size. These environmentalists are focusing on symptoms of the environmental problems, not its root causes; so they will not find any lasting solution.
- A truly 'green' entrepreneur cannot possibly survive in today's capitalist culture, because by using ecologically/environmentally sound methods they would be at a disadvantage to more ruthless rivals who will produce at a lower cost.

7.6 Accounting, the economic model and sustainability reporting

The capitalist system creates incentives for maximising wealth, and it is based on the assumption that wealth can only be increased through continual economic growth. This is the 'economic model' of society. As a result, growth-seeking

economic activities continue, in spite of growing concerns for the environment, and recognition that continual growth in its current form cannot be sustained.

Accounting has developed in support of the economic model. Financial reporting measures the consequences of a company's activities in terms of the use of the assets that it owns and the liabilities for which it has the direct responsibility for payment. Current accounting practice does not allow companies to report the consequences of their actions on external assets that it does not own, and the creation of liabilities for which it does not have to pay directly.

Investment decisions by large companies are made using accounting techniques such as discounted cash flow analysis, which focuses exclusively on economic consequences of investment, and does not measure or evaluate the environmental and social impact.

In the past, companies ignored their consumption of natural resources such as air and water because they assumed that supplies of these items were both limitless and free. This is no longer the case. It can now be argued that whereas companies are increasing economic wealth through growth and the search for profit maximisation, society may well be getting poorer because of the damage that economic activity is having on the environment and society.

As companies have become increasingly aware of environmental issues, and begin to accept that economic growth might not be sustainable, they have become more interested in measuring sustainability and environmental impact.

Traditional accounting methods do not provide for this type of measurement, and to the extent that companies (and society) want environmental and social impacts to be measured, traditional accounting is inadequate. Alternative measurement and reporting systems that recognise the need for economic activity to be **sustainable** have therefore been considered, although there is as yet no widely-accepted standard measurement and reporting system.

It seems quite possible that as systems for reporting sustainability are developed, the accountancy profession will be closely involved, because of its long experience with measurement and performance reporting systems.

7.7 Sustainable development

A problem with accounting for sustainable development is to identify what 'sustainable development' actually means. A generally-accepted definition provided by the Brundtland Report (for the World Commission on Environment and Development, 1987) is: development that meets the needs of the present without compromising the ability of future generations to meet their own needs.'

However, there are practical difficulties with this definition:

- What are the needs of the present? Presumably, these are more than simply survival needs, because current levels of consumption are, in many parts of the world, well above survival level.
- What are the needs of future generations? Are these just survival needs? If so, there is presumably an assumption that economic wealth will decline.
- Over what time period should the needs of future generations be measured? In theory, future needs should be measured into the long-term future. However, companies and governments plan for the future over much shorter time frames.

- ❑ Do we mean the needs of all people in all societies, or is sustainability measured in terms of individual countries or regions of the world?

Since companies plan for the future and report their performance within fairly short time frames, reporting for sustainable development by companies is likely to focus on relatively short-term measures of sustainability.

Another definition of sustainable development is: 'a dynamic process which enables all people to realise their potential and improve their quality of life in ways which simultaneously protect and enhance the Earth's life support system' (Forum for the Future).

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8 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Explain the concepts of capital expenditure, investment appraisal and capital budgeting
- Calculate the accounting rate of return for an investment
- Calculate the payback period for an investment
- Discuss the concept of relevant costs for decision making
- Compare the advantages and disadvantages of different investment appraisal techniques
- Comment on non-financial considerations for investment appraisal such as strategic and operational considerations, capacity and resource utilisation, social and environmental considerations and quality.

Professional ethics in accounting and business

Contents

- 1 Fundamental principles of ethical behaviour
- 2 The role of regulatory and professional bodies
- 3 Corporate codes of ethics
- 4 Ethical conflicts and dilemmas
- 5 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

B		The role of professional accountants in business and society	
	a	Explain from the perspective of the public interest, the role of professional accountants in business and society.	
	b	Explain the basic principles of ethics and its importance to professional accountants.	

Exam context

This chapter explains the role of professional accountants and the ethical principles that they are required to apply. Professional ethics is a pervasive topic throughout the ICAN professional examinations, and you should be prepared for an exam question to touch on an aspect of ethical behaviour for accountants.

Professional accountants play an important role in business and society. This chapter explains what is meant by the public interest and how accountants must always focus on behaving in the public interest.

One of the fundamental mechanisms for maintaining integrity and trust in the accounting industry in order to serve the public interest is to comply with a code of ethics whether in practice or industry. This chapter introduces corporate and professional codes of ethics describing threats to the fundamental ethical principles and appropriate safeguards.

By the end of this chapter students will be able to:

- Describe what is meant by business ethics;
- State the fundamental principles of the IFAC Code of Ethics;
- Explain what is meant by the public interest and why this is so important for accountants;
- Discuss the purpose of a code of ethics;
- Define whistleblowing;
- Define and discuss the contents and benefits of a corporate code of ethics;
- Identify situations where ethical conflicts and threats may arise;
- Suggest safeguards against ethical threats and dilemmas and ideas for resolving ethical dilemmas;
- Explain the rule in the ICAN Code of Ethics on NOCLAR.

1 Fundamental principles of ethical behaviour

Section overview

- Business ethics
- Principles from IFAC Code of Ethics
- Organisational values
- Acting in the public interest

Ethics is a subject that has become critically important in a business environment in which failure to adhere to proper standards can have a devastating effect on organisations, investors, suppliers, employees and customers.

1.1 Business ethics



Definition: Ethics

Ethics is concerned with what individuals or society as a whole, consider to be right or wrong.

The term “ethics” can be defined or used in a number of ways. For instance:

- Ethics is a system of moral principles.
- Ethics refers to the rules of conduct recognised in respect to a particular class of human actions or a particular group (for example, medical ethics, business ethics, professional ethics)

There is no universal standard of right or wrong. Opinions of individuals about right and wrong vary widely. Factors that affect ethical views (both personal ethics and business ethics) include the following:

Factor	Comment
Culture	<p>Ethical views differ between cultures. What is immoral or even illegal in some cultures is acceptable behaviour in others.</p> <p>A major problem for multinational or global companies is achieving a common code of business ethics to apply in all countries in which the company operates.</p>
Law	<p>Illegal behaviour is unethical, even when the law differs between countries. Company codes of ethics typically state that the company’s employees should always comply with the local law in the countries in which they operate.</p>
Consequences	<p>Sometimes, whether an act is ethical or unethical is judged by the consequences it will have.</p>
Codes of ethics	<p>When there is a formal code of ethics, behaviour can be judged in terms of whether or not it complies with the code. Codes of ethics are issued by professional bodies, such as accountancy bodies.</p>

Law and ethics

Some unethical behaviour is against the law. However, much behaviour is not illegal but might be unethical.

Business Ethics

Ethics apply to organisations as well as to individuals and groups of people. Companies might be driven by the profit motive, and all their actions might be determined by doing whatever is necessary to maximise profits. On the other hand, companies might recognise the need – and the benefits – of acting in an ethical way.

Business ethics is concerned with how people and institutions should behave in the world of commerce. In particular, it involves examining appropriate constraints on the pursuit of self-interest, or (for firms) profits, when the actions of individuals or firms affects others.

Business ethics are the ethics of business behaviour, and the 'rights' and 'wrongs' of:

- how individuals act at work, especially in dealing with other people, and
- how different business organisations deal with each other.

Professional ethics

Members of a profession often face complex scenarios. In some cases, the ethical course of action might not be immediately apparent. Professions usually issue a code of ethics in order to guide members in such situations. Members of a profession, such as accountants, are expected to behave in accordance with professional codes of ethics, and to maintain standards of moral behaviour that are 'expected' from a professional body.

This applies to both student members and full members of an institute like ICAN.

1.2 Principles from IFAC Code of Ethics

Every professional accountancy body has issued a code of conduct and code of ethics for its members and student members. It applies to accountants working in public practice (working for clients, for example as auditors) and accountants in business (for example, working for a company or government department).

The IFAC Code is issued by the International Ethics Standards Board for Accountants (IESBA) of the International Federation of Accountants, whose members include the professional accountancy bodies of most countries. Each professional accountancy body has its own code of ethics based on the IFAC Code.

The IFAC Code sets out the ethical requirements for professional accountants and states that any member body of IFAC (such as ICAN) or any individual firm of accountants may not apply ethical standards that are less strict than those in the IFAC Code.

The IFAC Code therefore establishes a minimum world-wide code of ethical conduct for accountants.

Both the IFAC Code and the ICAN Code are principles-based codes of ethics. A principles-based code of ethics for accountants is a code that specifies general principles of ethical behaviour, and requires the professional accountant to act in accordance with the principles. The accountant is required to use judgement in

deciding whether in each case a particular course of action is a 'proper' or 'ethical' one.

Professional accountants are required to comply with the following fundamental principles:

- integrity
- objectivity
- professional competence and due care
- confidentiality (with an exception for acts of NOCLAR)
- professional behaviour.

Integrity

An accountant must be honest and straightforward in his professional and business dealings. This includes a requirement for 'fair dealing' and a requirement to be truthful.

Objectivity

An accountant must not allow his professional or business judgement to be affected by:

- bias (personal prejudice)
- conflicts of interest
- undue influence from others: for accountants in business, this includes undue pressure from the employer (senior management).

For accountants in public practice, 'integrity' is often associated with independence of mind and judgement. For accountants in business, the concept of independence is not relevant: however, accountants in business should try to apply the principle of objectivity in all the work that they do.

For accountants in business, the concept of integrity also means observing the terms of his or her employment, but avoiding involvement in any activity that is illegal. If asked or encouraged to become involved in unlawful activity, the accountant must say no.

Professional competence and due care

An accountant has a duty to maintain his professional knowledge and skills at a level that enables him to provide a competent professional service to his clients or employer. This includes a requirement to keep up to date with developments in areas of accounting that are relevant to the work that he does.

Accountants should also act in accordance with relevant technical and professional standards when doing their work for clients or employer. Technical and professional standards include:

- standards issued by IFAC (such as International Standards on Auditing) or a similar national regulatory body
- financial reporting standards (IFRSs)
- standards and regulations of the member's professional accountancy body
- relevant legislation.

Confidentiality

Accountants must respect the confidentiality of information obtained in the course of his work. This applies to the confidentiality of information within the firm or employer's organisation, as well as to confidentiality of information about clients (for accountants in professional practice).

However, there are some circumstances when the disclosure of confidential information is permitted or even required by law. In 2017, ICAN introduced a new section into its Code of Ethics on Non-Compliance with Laws and Regulations (NOCLAR), which says that professional accountants must not be constrained by confidentiality from reporting acts of NOCLAR by a client, an employer, or a manager or employee of an employer.

Professional behaviour

Accountants are required to observe relevant laws and regulations, and to avoid any actions that would discredit the accountancy profession.

This requirement covers advertising by accountants, which must be truthful and must not disparage the services provided by 'rival' firms.

1.3 Organisational values

In order to put the above principles into practice organisations need to adopt values that promote adherence to the principles. Such values include the following:

- Openness – Individuals should be open about their actions. This means providing full and complete information and reasoning behind a decision as required.
- Trust – Relying on the information provided by colleagues and accepting their judgements.
- Honesty – Individuals should be honest and should avoid telling lies. They should not only tell the truth but be prepared to give complete information on which others might depend. Individuals earn the trust of other people by developing a reputation for honesty. When there is trust, people are more willing to work constructively together.
- Respect – Treating others with courtesy and allowing them their dignity. Respect should be both given and earned.
- Empowerment – Those who are entrusted with responsibilities must have the authority to fulfil those responsibilities.
- Accountability – Individuals must understand their responsibilities and be held accountable for them. They must accept their responsibilities and this requires effective communication.

1.4 Acting in the public interest

It is a responsibility of the accountancy profession 'not to act exclusively to satisfy the needs of a particular client or employer'. When the demands or needs of a client or employer appear to be contrary to the public interest, accountants should consider the public interest.

Professional codes of ethics do not provide a clear definition of public interest, but it is usual to associate the public interest with matters such as:

- detecting and reporting any serious misdemeanour or crime
- protecting health and public safety
- preventing the public from being misled by a statement or action by an individual or an organisation
- exposing the misuse of public funds and corruption in government
- revealing the existence of any conflict of interests of those individuals who are in a position of power or influence.

2 The role of regulatory and professional bodies

Section overview

- Purpose of codes of ethics
- Promotion of ethical awareness by professional bodies and regulators
- Profession compared to occupation
- Role of the accountant in promoting ethical behaviour
- Whistleblowing procedures

2.1 Purpose of codes of ethics

The principle of professional behaviour imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession.

A code of ethics reinforces the moral principles and commitments of an organisation by spelling out acceptable and responsible behaviour in a way that is clear to all within the organisation. It also tells others what the organisation stands for and what to expect when doing business with it.

The ICAN Code of Ethics and Conduct states that the principle of professional behaviour imposes an obligation on members to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession.

2.2 Promotion of ethical awareness by professional bodies and regulators

Professional bodies have a crucial role to play in promoting ethical awareness. They formulate, promote and enforce acceptable levels of behaviour within the sphere of their influence. They are able to take the concerns of a profession into account through processes of consultation and debate with the members of the profession. They are able to set standards of behaviour and communicate these standards through a code of ethics and through their examination and training systems.

Professional bodies are also responsible for representing the concerns of the profession and explaining the approaches that the profession has adopted in order to resolve ethical conflicts to the public at large.

Regulatory bodies are able to set minimum standards through their system of regulation. If specific practices considered to be unethical become widespread the authority can take action against these by amending the regulations or by introducing new rules.

2.3 Profession compared to occupation

The word 'professional' is associated with a highly-qualified group of individuals who carry out a particular type of highly-skilled work. Examples of professions are doctors and surgeons, dentists, lawyers, actuaries and accountants.

A profession arises when any trade or occupation transforms itself through "the development of formal qualifications based upon education, apprenticeship, and examinations, the emergence of regulatory bodies with powers to admit and discipline members, and some degree of monopoly rights."

All professions involve technical, specialised and highly skilled work often referred to as "professional expertise." Training for this work involves obtaining degrees and professional qualifications without which entry to the profession is barred.

Characteristics of a profession

Professions are typically regulated by statute with the responsibilities of enforcement delegated to a professional body, whose function is to define, promote, oversee, support and regulate the affairs of its members.

In the UK and Nigeria, professional bodies often have a charter. (The accountancy profession has several different professional bodies.). The professional body has the power to:

- admit new members to the profession
- award qualifications to individuals who achieve a required standard of skill or competence
- expel members from the profession, for unprofessional conduct.

Other features of a profession include:

- High entry requirements.
- An extensive period of rigorous academic training in a particular area.
- A need to pass a set of examinations before being able to practice.
- A need for continued professional development after qualification.
- Strict membership rules including a code of ethics.
- A system of disciplinary procedures.
- The existence of a relationship of trust with clients.
- An assumption that the professional will always act in the best interests of the client in preference to self-interest.
- An expectation that the professional will act in the public interest.

2.4 Role of the accountant in promoting ethical behaviour

The general public has high expectations of the accountancy profession.

- Many non-accountants do not have much understanding of accounting issues, but they rely on accountants to ensure that financial reporting is reliable and 'fair', and that management is not 'cheating' by presenting misleading and inaccurate figures in their accounts.
- Auditors are also seen, by many members of the public (rightly or wrongly), as a safeguard against fraud.

- ❑ The public continues to believe that the accountancy profession is an ethical profession that offers some protection to society against the 'excesses' of capitalism.

A role of the accountancy bodies should be to reinforce this public perception of an ethical profession. They do this by issuing codes of conduct, including codes of ethics, and expecting all their members to comply.

This point is made at the beginning of the IFAC Code: 'A distinguishing mark of the accountancy profession is its acceptance of its responsibility to act in the public interest. Therefore a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest, a professional accountant should observe and comply with the ethical requirements of this Code.'

2.5 Whistleblowing procedures



Definition: Whistleblowing

'Whistleblowing' means reporting suspicions of illegal or improper behaviour to a person in authority.

In a normal situation, employees report to their supervisor or manager. If an employee has concerns about a transaction or a plan of action, and thinks that it might be unethical (illegal or against the company's code of ethical conduct) he or she should normally report the concern to the supervisor or manager.

A problem arises whenever:

- ❑ the supervisor or manager is involved in the illegal or unethical activity, or
- ❑ the employee has spoken to the supervisor or manager about the problem, but the supervisor or manager has taken no action and has ignored the matter, or dismissed it as something that is not important.

In these situations, the employee would have to report his or her concerns through a different reporting channel. In practice, this could mean reporting the matter to a director or a committee of the board of directors. Some companies have established procedures that allow employees to report their concerns ('blow the whistle').

3 Corporate codes of ethics

Section overview

- Definition
- The contents of a corporate code of ethics
- Benefits of a corporate code of ethics

3.1 Definition



Definition: Corporate code of ethics

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

The effectiveness of a code of ethics depends on the leadership of the company – 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 a company drives its ethical behaviour, and a code of ethics provides useful guidance.

3.2 The contents of a corporate code of ethics

A corporate code of ethics is normally quite short, dealing with each point in just a few sentences, and sometimes in just one sentence.

There is no standard format or content for a code of ethics, but a typical code contains:

- general statements about ethical conduct by employees
- specific reference to the company's dealings with each stakeholder group, such as employees, customers, shareholders and local communities.

General statements about ethical conduct

A code of conduct should specify that **compliance with local laws** is essential. In addition, employees should **comply with the policies and procedures** of the company. There might be a statement that any employee who fails to comply with the company's code of conduct will face disciplinary action.

The code might also include an **overview of business conduct**, and the need to protect the company's reputation and 'good name'.

It might also contain statements about the values of the company, such as:

- acting at all times with integrity
- protecting the environment
- the 'pursuit of excellence'
- respect for the individual.

Dealings with stakeholder groups

A code of conduct might address its main concerns about its dealings with stakeholder groups and its ethical treatment of each group.

- ❑ **Employees.** A code of ethics might include statements about:
 - human rights, including the right of all employees to join legally- authorised organisations such as a trade union or political party
 - equal opportunities for all employees, regardless of gender, race, ethnic origin, religion, age, disability or sexual orientation
 - refusal to tolerate harassment of employees by colleagues or managers
 - concern for the health and safety of employees
 - respect for the privacy of confidential information about each employee
 - company policy on giving or receiving entertainment or bribes.
- ❑ **Customers.** A code of ethics might include statements about:
 - fair dealing with customers
 - product safety and/or product quality
 - the truthfulness of advertisements
 - respect for the privacy of confidential information about each customer.
- ❑ **Competitors.** A code of ethics might include statements about:
 - fair dealing with competitors
 - the use of techniques for obtaining information about competitors (industrial spying)
- ❑ **Shareholders.** A code of ethics might not include much about shareholders, because the relationship between a company and its shareholders might be contained in a code of corporate governance that the company follows. The key issue with shareholders is to maintain and develop trust and confidence, which might be achieved through disclosure of information (openness and transparency).

3.3 Benefits of a corporate code of ethics

It has been suggested that there are three reasons why companies might develop a code of ethics. These reasons are progressive, which means that companies might begin by having a code of ethics for the first reason, but then progress to the second and third reasons as they gain experience with implementing the code and appreciating its potential benefits.

- ❑ **Reason 1: Managing for compliance.** The company wants to ensure that all its employees comply with relevant laws and regulations, and conduct themselves in a way that the public expects. For example, companies providing a service to the general public need to ensure that their employees are polite and well-behaved in their dealings with customers.
- ❑ **Reason 2: Managing stakeholder relations.** A code of ethics can help to improve and develop the relations between the company and its stakeholders, by improving the trust that stakeholders have in the company.

- ❑ Reason 3: **Creating a value-based organisation.** A company might recognise the long-term benefits of creating an ethical culture, and encouraging employees to act and think in a way that is consistent with the values in its code of ethics. (It could be argued that an ethical company is more likely to be successful in business in the long term. (However, there is no firm evidence to prove this point, and it is therefore a matter of opinion).

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4 Ethical conflicts and dilemmas

Section overview

- Situations where ethical conflicts can arise
- Main threats to ethical behaviour
- Work situations where ethical dilemmas might be faced
- Safeguards against ethical threats and dilemmas
- Resolution of ethical dilemmas
- Non-compliance with laws and regulations (NOCLAR)

Problems for an individual at work can arise when he is expected to behave in a way that is illegal or in a way that he considers unethical even though it would not be illegal.

Professional accountants will be faced with conflicts of interest and ethical dilemmas that they have to address.

4.1 Situations where ethical conflicts can arise

Ethical dilemmas arise when the accountant has to consider two or more seemingly incompatible ethical obligations.

Ethical dilemmas are often caused when an accountant faces a conflict of interest. **A conflict of interest** arises when an accountant has a duty to two or more parties.



Example: Conflict of interest

The draft annual report of a company might contain claims about the company's success in reducing carbon emissions. An accountant might know that an analysis carried out by the company does not support such claims.

This brings into conflict the accountant's duty of confidentiality to his employer and his duty to protect the public interest.

4.2 Main threats to ethical behaviour

A professional accountant has to comply with the following fundamental principles which are repeated here for convenience):

- ❑ **Integrity** – to be straightforward and honest in all professional and business relationships; to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
- ❑ **Professional Competence and Due Care** – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- ❑ **Confidentiality** – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

- ❑ **Professional Behaviour** – to comply with relevant laws and regulations and avoid any action that discredits the profession.

A broad range of relationships and circumstances could compromise a professional accountant's ability to comply with these fundamental principles.

These threats fall into one or more of the following categories:

- ❑ **Self-interest threat** – the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behaviour;
- ❑ **Self-review threat** – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the himself/herself, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;
- ❑ **Advocacy threat** – the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised;
- ❑ **Familiarity threat** – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
- ❑ **Intimidation threat** – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, for example, attempts to exercise undue influence over the professional accountant.

4.3 Work situations where ethical dilemmas might be faced

Conflicts of interest arise from various sources. Examples include situations where an accountant may be asked to:

- ❑ perform work which he does not have the appropriate knowledge or experience to perform;
- ❑ produce information which is incorrect or misleading;
- ❑ complete work to a deadline that is too tight to allow the task to be completed with the necessary standard of professional care;
- ❑ take a decision on a matter in which he has a personal involvement, such as where he has a family or personal relationship with the client;
- ❑ advise a company that is in direct competition with an existing client;
- ❑ support two clients who are in competition with one another.

4.4 Safeguards against ethical threats and dilemmas

Safeguards are actions or other measures that may eliminate threats or reduce them to an acceptable level. They fall into two broad categories:

- ❑ Safeguards created by the profession, legislation or regulation; and
- ❑ Safeguards in the work environment.

Safeguards created by the profession, legislation or regulation include:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.
- Effective, well-publicised complaint systems operated by the employing organization, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behaviour.
- An explicitly stated duty to report breaches of ethical requirements placed on members of a profession.

4.5 Resolution of ethical dilemmas

The ICAN Code offers a framework through which ethical dilemmas may be addressed.

When faced with ethical conflicts, the decision-taker should consider:

- the facts of the situation
- the ethical principles involved
- related fundamental principles
- relevant internal procedures
- the alternative courses of action
- consequences of each alternative course of action.

If a significant conflict cannot be resolved, a professional accountant may consider obtaining professional advice from ICAN or from legal advisors.

If the ethical conflict cannot be resolved, a professional accountant must refuse to remain associated with the matter creating the conflict. This might involve resignation.

4.6 Non-compliance with laws and regulations (NOCLAR)

In 2017, ICAN adopted a recommendation by the International Ethics Board for Accountants (IESBA) on Non-Compliance with Laws and Regulations (NOCLAR), and added it to the ICAN Code of Ethics.

An act of NOCLAR by a client or an employer (or by a manager or other employee of an employer) is an act that is contrary to prevailing laws and regulations. The laws and regulations to which this NOCLAR rule applies are those that directly affect the client's or employer's financial statements, or its business in a material or fundamental way. Acts of NOCLAR can include bribery, fraud or false accounting.

When a professional accountant becomes aware of an act of NOCLAR, he or she must report it to the appropriate authorities, and they are not constrained in such cases by the principle of confidentiality. Accountants can no longer turn a blind eye to NOCLAR: doing nothing when made aware of such an act is no longer acceptable.

5 Chapter review

Chapter review

Before moving on to the next chapter check that you can:

- Describe what is meant by business ethics
- State the fundamental principles of the IFAC code of ethics
- Explain what is meant by the public interest and why this is so important for accountants
- Discuss the purpose of a code of ethics
- Define whistleblowing
- Define and discuss the contents and benefits of a corporate code of ethics
- Identify situations where ethical conflicts and threats may arise
- Suggest safeguards against ethical threats and dilemmas and ideas for resolving ethical dilemmas
- Explain the rule in the ICAN Code of Ethics on NOCLAR

Management and leadership

Contents

- 1 Functions: leadership, management and supervision
- 2 Classical theories of management
- 3 Other theories of management
- 4 Leadership style
- 5 Theories of leadership: contingency theories
- 6 Leadership qualities
- 7 Conflict
- 8 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

C		Management and organisational behaviour	
	1	Basic management functions	
	a	Give various definitions of management.	
	b	Identify and explain types of management skills.	
	c	Explain the following basic management functions, their importance and application in the field of accounting:	
		i	Planning;
		ii	Organising;
		iii	Controlling;
		iv	Coordinating;
		v	Directing; and
		vi	Supervising.
	d	Identify and explain the various management roles.	
	2	Management, individual and organisational behaviour	
	c	Explain the relationship between leadership and management.	
	e	Identify and explain conflict management and various resolution mechanisms.	
	h	State and explain the various management theories with emphasis on scientific, administrative and other modern management theories; such as Frank and Lillian Gilbreth's motion theory, Herzberg's Hygiene, Motivation factor theory and other related theories.	
	i	Explain the uses of technology business modeling	
	j	Explain project management	
	k	Explain emotional intelligence	
	l	Explain social thinking	

Exam context

This is the first of a series of chapters on behavioural aspects of business activities. There is a large number of theories about leadership and management, and this chapter provides a summary of many of them.

Organisations will generally benefit through strong leadership providing a clear vision and coherent long-term strategy. Organisations will also benefit from strong management who are able to run operations effectively on a day-to-day basis and keep stakeholders generally satisfied.

By the end of this chapter students will be able to:

- Define leadership, management and supervision;
- Explain the functions and roles of management;
- Explain the classical theories of management including Taylor, the Gilbreths, Fayol, Urwick, Weber and Mayo;
- Describe modern and other theories of management including Drucker, Kanter, Mintzberg, Ouchi, McGregor and operations research;
- Summarise the trait theories of leadership including Lippitt and White, Blake and Mouton, Tannenbaum and Schmidt, Ashridge and Likert;
- Explain contingency theories of leadership including Fiedler, Hersey and Blanchard and Handy;
- Describe the various leadership qualities including the theories of Adair, Bennis, Kotter and Heifetz;
- Explain how conflict arises and is managed in the workplace.

1 Functions: leadership, management and supervision

Section overview

- Definition of leadership
- Definition of management
- Definition of supervision

An organisation consists of many individuals, who should be working towards common goals or objectives. Individuals are given direction and co-ordinated by their managers and leaders. This chapter looks at the role of the leader, manager and supervisor, and how these roles differ.

1.1 Definition of leadership

It is often assumed that 'leadership' and 'management' mean the same thing. In business organisations, individuals are put into positions of formal authority, and in that position they are expected to provide leadership to subordinates or team members. It is certainly the case that in formal business organisations, managers are expected to provide leadership. However, leadership and management are different, and not all managers are good leaders.

Leadership means giving a lead to others. A leader gives guidance and direction, and other ('followers') follow the lead that they are given.

It might be tempting to think of a leader as someone who tells other people what to do, but there are different ways of leading, and 'telling' is just one of them.

Followers look to their leaders for direction and guidance. Leaders also influence others, and can inspire them and motivate them.

1.2 Definition of management

Management is about planning, controlling, putting appropriate organisation structures in place (organising), as well as communicating and co-ordinating. The functions of management can be listed as follows:

- ❑ **Planning:** Making decisions about what should be done in the future, and setting targets for achievement. Planning ranges between short-term tactical planning and long-term strategic planning.
- ❑ **Organising.** Organising the resources of the organisation, including its employees, in order to put plans into action.
- ❑ **Controlling.** Monitoring actual performance, often by comparing actual performance with planning targets, and taking control measures when actual performance falls short of target.
- ❑ **Coordinating.** Coordinating the efforts and activities of the many individuals within an organisation, so that they all work constructively towards the same goals and targets.
- ❑ **Directing.** Instructing other people what to do. Managers take decisions and when they do so, they ask other people to carry out their decisions and do what they have decided.
- ❑ **Supervising.** Monitoring the work of subordinates or team colleagues within the organisation, and helping them to perform to the best of their abilities.

The functions or roles of management can be expressed in different ways. Herzberg for example stated that management has ten roles, which are to act as:

- figurehead
- leader
- point of liaison or communicator
- monitor
- disseminator (communicator of information)
- spokesperson
- entrepreneur
- disturbance handler (dealing with problems)
- resource allocator (organiser)
- negotiator.

Giving leadership to employees is an element of management. Leadership is not the same as management, but it is an aspect or feature of management.

Planning, organising, co-ordinating and communicating all require leadership, because they involve giving guidance and direction to employees.

Several writers have analysed in detail the difference between leadership and management. The ideas of some of these writers are explained more fully later in this chapter.

Management functions and their importance to accounting

One of the fundamental roles of accountants in business is to provide information to management. Information of a suitable quality (reliable/accurate, comprehensive, clear, timely) is used by management to make decisions and help them perform their functions.

For example, accountants help management to prepare budgets (planning) and produce regular budgetary control reports (control). They provide information to assist with one-off decision making, such as capital investment decisions (deciding). They report regularly to management on the current state of the business (monitoring).

Management need information to do their job. Without management, much of the purpose of accounting in business would disappear.

1.3 Definition of supervision

Supervision means 'looking over' someone else. It is management by overseeing the performance or activities of an individual or group of individuals, and making sure that the work of the group or individuals is performed properly.

Supervision is also called 'front line management' and 'supervisory management'. It is the lowest level of management in an organisation structure.

The main function of supervisors is to provide administrative management. However, in addition to performing an administrative task, supervisors might also be expected to:

- develop staff, possibly by 'empowering' them and encouraging them to take on responsibility, and
- help to train them (through 'on-the-job-training').

2 Classical theories of management

Section overview

- Scientific and classical theories of management
- F W Taylor (1856 – 1915) and scientific management
- Frank and Lillian Gilbreth and motion study
- Henri Fayol (1841 – 1925) and principles of management
- Principles of organisations – Lyndall Urwick
- Weber (1864 – 1920) and bureaucracy
- Elton Mayo (1880 – 1949) and the human relations school
- Classical and human relations theories of management: a summary

2.1 Scientific and classical theories of management

Early theories of management were concerned with:

- the roles of the manager and
- how managers might perform their roles better and more effectively.

These theories focused mainly on the management of work (rather than the management of people at work). 'Classical' theories of organisation and management are associated with theorists such as:

- Taylor and the scientific school of management
- Fayol, and
- Weber.

2.2 F W Taylor (1856 – 1915) and scientific management

Frederick Taylor was a US engineer who is considered the founder of 'scientific management'. Scientific management is concerned with applying scientific techniques of analysis and experimentation to improve the efficiency of work.

Taylor studied the relationship between people and the tasks that they perform. His approach was to analyse the tasks that individuals perform at work, and break them down into smaller units of work. Each small unit of work was then analysed to find ways in which they could be performed with the greatest efficiency (in the shortest time). Experimentation was used to find ways of improving efficiency for each small unit of work, and Taylor measured the time that it took to carry out each small task.

Taylor is considered the originator of 'time and motion study'. Scientific management resulted in:

- dividing larger tasks into much smaller units,
- employing individuals to specialise in each small unit of work, and therefore
- increasing efficiency through the division of work and specialisation.

Taylor is probably best known for the experiments he carried out into shovelling coal at the Bethlehem Steel Works in the US. Taylor succeeded in improving productivity through:

- analysing the tasks involved in shovelling coal

- ❑ experimenting with different types of shovel (for example, different sizes of shovel and shovels with different lengths of handle) and the amount of coal that should be shovelled in a single action, and
- ❑ introducing work specialisation within shovelling operations.

The four underlying principles of scientific management

Taylor suggested that there should be four underlying principles in scientific management.

- ❑ There should be a science of work, based on the analysis of work methods and work times, with a view to finding the most efficient way of carrying out tasks. A fair level of performance or efficiency can be identified. Workers should be rewarded through higher pay if they succeed in performing more efficiently than the expected or standard level.
- ❑ Workers should be selected carefully. They should have the skills and abilities that are well-suited to the work. They should also be trained in how to do the work efficiently.
- ❑ The scientifically-selected and trained workers and the science of work should be brought together for the best results and greatest efficiency.
- ❑ There should be an equal division of work between the workers and management, and workers and managers should operate closely together. (This was not the normal practice at the time, in the US in the late 1800s.) The management should take over all the work from the workers for which they are more capable.

Criticisms of scientific management

Scientific management is still associated with work study and time and motion study. It has been strongly criticised because it results in dull, repetitive and monotonous work. Tasks are reduced to such small units, such as tasks on a large production line in a factory, that they demoralise the workers who do the jobs. There is a risk that when employees are doing dull, repetitive work, their efficiency will be low because they are not at all interested in what they are doing.

However, some of the principles of scientific management are valid, and continue to be applied. In particular, the scientific study of work can help to improve the organisation of work procedures and methods.

2.3 Frank and Lillian Gilbreth and motion study

Like F W Taylor, the Gilbreths are associated with scientific management, and their main work was done at about the same time.

Whereas Taylor is best known for 'Time study' the Gilbreths are associated with 'Motion study'. Together, they were the originators of time and motion study.

The Gilbreths studied how work was done and the physical motions that were undertaken to complete a job. Although they worked in the early 1900s, they used film as part of their study method. By seeing how people moved in doing their work, they set out to identify ways of improving the way that it was done – and gaining productivity improvements and reducing costs in doing so. For example, they studied the number of motions that were needed to complete a task, and the time for each motion, and used this scientific analysis to work out whether the work could be done more efficiently.

At the time, the work of the Gilbreths was as innovative as the work of F W Taylor. The criticisms of their work are much the same as for the scientific management movement in general.

2.4 Henri Fayol (1841 – 1925) and principles of management

The ideas of Henri Fayol are probably close to the ideas that many individuals hold about management and the functions of management. Fayol argued that managers are given formal authority within an organisation structure and they are responsible (to their superiors) for the effective use of their authority.

Fayol suggested that there are five main tasks of management:

- to plan (and look ahead)
- to organise
- to command: today, the word 'command' should probably be replaced by 'provide leadership'
- to co-ordinate, and
- to control (by monitoring performance and inspecting output).

He believed that there are principles of good management that apply to all types of organisation, and that these principles should therefore be applied consistently. The principles are:

- Division of Work** – When employees are specialized, output can increase because they become increasingly skilled and efficient.
- Authority** – Managers must have the authority to give orders, but they must also keep in mind that with authority comes responsibility.
- Discipline** – Discipline must be upheld in organizations, but methods for doing so can vary.
- Unity of Command** – Employees should have only one direct supervisor.
- Unity of Direction** – Teams with the same objective should be working under the direction of one manager, using one plan. This will ensure that action is properly coordinated.
- Subordination of Individual Interests to the General Interest** – The interests of one employee should not be allowed to become more important than those of the group. This includes managers.
- Remuneration** – Employee satisfaction depends on fair remuneration for everyone. This includes financial and non-financial compensation.
- Centralization** – This principle refers to how close employees are to the decision-making process. It is important to aim for an appropriate balance.
- Scalar Chain** – Employees should be aware of where they stand in the organization's hierarchy, or chain of command.
- Order** – The workplace facilities must be clean, tidy and safe for employees. Everything should have its place.
- Equity** – Managers should be fair to staff at all times, both maintaining discipline as necessary and acting with kindness where appropriate.
- Stability of Tenure of Personnel** – Managers should strive to minimize employee turnover. Personnel planning should be a priority.

- ❑ **Initiative** – Employees should be given the necessary level of freedom to create and carry out plans.
- ❑ **Esprit de Corps** – Organizations should strive to promote team spirit and unity

2.5 Principles of organisations – Lyndall Urwick

According to Urwick an organisation is built on ten principles:

- ❑ **Objective** - Every organisation and every part of the organisation must be an expression of the purpose of the undertaking concerned, or it is meaningless and therefore redundant.
- ❑ **Specialisation** - The activities of every member of any organised group should be confined, as far as possible, to the performance of a single function.
- ❑ **Co-ordination** - The purpose of organising per se, as distinguished from the purpose of the undertaking, is to facilitate co-ordination and thus unity of effort.
- ❑ **Authority** - In every organised group the supreme authority must rest somewhere. There should be a clear line of authority to every individual in the group
- ❑ **Responsibility** - The responsibility of the superior for the acts of the subordinate is absolute.
- ❑ **Definition** - The content of each position, both the duties involved, the authority and responsibility contemplated and the relationships with other positions should be clearly defined in writing and published to all concerned.
- ❑ **Correspondence** - In every position, the responsibility and the authority should correspond.
- ❑ **Span of control** - No person should supervise more than five, or at most, six direct subordinates whose work interlock.
- ❑ **Balance** - It is essential that the various units of an organisation should be kept in balance.
- ❑ **Continuity** - Re-organisation is a continuous process: in every undertaking specific provision should be made for it

2.6 Weber (1864 – 1920) and bureaucracy

Max Weber was a German sociologist, who studied the growth in the number, size and power of large bureaucratic organisations. He suggested that bureaucracy provides an organisation structure in which human activity is 'rationalised' and co-ordinated.

He argued that an 'ideal' bureaucracy has the following characteristics.

- ❑ There should be a hierarchy of authority, from top management down to workers at the bottom. Offices (management positions) should be ranked in hierarchical order, with information flowing up the chain of command and instructions and directions passing down the chain.
- ❑ An ideal bureaucracy should operate in an impersonal and impartial way. There should be a clear statement of duties, responsibilities, standardised procedures and expected behaviour.

- There should be written rules of conduct.
- There should be promotion of individuals within the organisation, based on their achievement.
- There should be division of labour and specialisation of work.
- The ideal bureaucracy will achieve efficiency in operations.

Weber was also interested in authority, and how men and women claim authority over others, so that others will do what they ask. He defined authority as 'getting things done by giving orders, and having those orders accepted as justified and legitimate.' (He made a distinction between authority and power. Power is getting things done by using force or the threat of force or punishments.)

He identified three types of legitimate authority.

- Traditional.** Weber suggested that authority based on tradition pre-dates modern society. Traditional authority is associated with the hereditary power of royal families and chieftains and the 'head of the household', with leadership passing from father to son when the father dies.
- Rational-legal.** This form of authority is associated with bureaucracies. Authority is rational, because it is used to achieve clear goals with maximum efficiency. It is legal, because it is based on an impartial system of rules and procedures, and is exercised through the management position that the individual in authority occupies.
- Charismatic.** Authority is based on charisma when the individual has special personal qualities that inspire others to do what the individual asks. Weber argued that authority based on charisma depends on the individual for its existence, and so is inherently unstable and short-lived.

Weber believed that bureaucracies would continue to grow in number and size, because they provide a rational organisation for co-ordinating human activities, based on a hierarchy of authority. He recognised, however, that large bureaucracies lead to the 'depersonalisation' of work.

Bureaucracy is often condemned because of 'red tape', 'pen-pushing' and 'soul-destroying work'. However, in spite of the criticisms, many large organisations today are bureaucracies. Government organisations in particular are usually bureaucratic, because bureaucracy operates with clear and impartial rules and procedures. Weber's comments on the 'ideal' bureaucracy may therefore remain valid, even today.

Rosemary Stewart on bureaucracy

Rosemary Stewart is a modern (UK) writer on management theory. She has summarised the four main features of bureaucracy as follows:

- Specialisation.** There is specialisation of work, but this applies to the job, not the individual who does the job. This means that there is continuity. When one person leaves the job, the job continues, and another person fills the same position.
- Hierarchy of authority.** There is a distinction between 'management' and 'workers'. Within management, there is a hierarchy with clearly-defined levels of authority and 'ranks' of managers.
- A system of rules.** The rules of a bureaucracy provide impersonal and efficient rules and procedures. Individuals within a bureaucracy must know what the rules are to do their job successfully.

- ❑ **Impersonal.** In a bureaucracy, the exercise of authority and the system of privileges and rewards are based on a clear set of rules.

Stewart also suggested reasons for the growth of bureaucracy.

- ❑ The **growing size of organisations.** Large organisations need some bureaucratic structure to function efficiently.
- ❑ **Greater complexity of work.** Complexity makes it necessary to have specialisation of tasks within an organisation. Job-holders often need to be 'experts' in their work to deal with the complex issues involved.
- ❑ **Scientific management.** A scientific approach to management is widely used. This approach supports a rational way of organising work and having formal procedures for getting work done.
- ❑ The **demand for equality of treatment.** Citizens expect to be treated equally by organisations. Bureaucracies provide impartiality and should ensure equal treatment for all.

2.7 Elton Mayo (1880 – 1949) and the human relations school

Elton Mayo is regarded as the founder of the human relations movement of management theory. Between 1927 and 1932, he was involved in a set of experiments on productivity at the Hawthorne Works in Illinois (USA). The Hawthorne works were a production site of Western Electric, a manufacturer of telephone equipment.

The original aim of the experiments was a scientific management study into the effect on productivity of changes in working conditions, such as lighting, rest periods during the day, the length of the working day and pay incentives. Six individual workers were selected to take part in the experiments, and their conditions of working were varied in various ways, to see how the changes would affect their productivity. The results of the experiments were unexpected. Even when the working conditions for the six workers were changed back to 'normal' (for example, when they were given shorter rest breaks and longer working hours), their productivity continued to rise. Mayo tried to explain why productivity continued to rise when working conditions were made worse.

Mayo suggested that the reason for improving productivity among the workers could be explained by:

- ❑ the motivation and commitment of the individuals in the experiment, and
- ❑ the relationship between the employees and management.

Productivity had improved, he argued, because the six workers had become a team, who developed social relationships with each other as well as a work relationship. The team responded positively, because the workers felt that they were contributing freely to the experiments, without any coercion from management.

Mayo developed several arguments, all related to the effect of positive motivation on productivity.

- ❑ Work has a social value for workers. Mayo disagreed with the view of F W Taylor, that workers are motivated only by self-interest. The 'informal organisation' is important in affecting workers' attitudes.
- ❑ The productivity of workers is affected by their self-esteem. In the Hawthorne experiments, the self-esteem of the six individuals increased because they had been selected to do the experiments.

- ❑ Work satisfaction lies in recognition, security and a sense of belonging, rather than money rewards.
- ❑ Motivation (and productivity) is affected by the relationship between management and workers. Managers need to communicate with workers. When there is no communication, conflicts are inevitable, and workers resent the focus of management on cutting costs and improving efficiency. Management must therefore develop and apply 'people skills' in order to motivate their workers.

Mayo concluded that a lack of attention to human relationships was a major weakness in earlier theories of management. Managers should become more involved with their workers, and earn the respect of the workers. The result would be improved motivation amongst workers and higher productivity.

It is worth considering that although the ideas of Mayo might seem 'obvious' today, he was the first management theorist to draw attention to the social aspects of working and the effects of motivation on performance.

2.8 Classical and human relations theories of management: a summary

The early writers on management theory suggested that there is a set of concepts and rules that apply universally to all managers and management tasks. Scientific management was based on the belief that certain principles should be applied to the study of work and work methods, in order to improve efficiency. Fayol argued that all managers have a similar role in organisations, no matter what the type or size of organisation, and there are principles of good management that should be applied in every organisation. Weber identified the characteristics of an ideal bureaucracy. Mayo identified the significance of human relations, and argued that it applies to all individuals at work.

Modern writers on management theory have questioned whether 'universal rules' of good management do exist. Various ideas have been put forward that challenge 'classical theories'.

3 Other theories of management

Section overview

- Peter Drucker (1909 – 2005)
- Rosabeth Moss Kanter
- Henry Mintzberg
- William Ouchi: Theory Z
- McGregor: Theory X and Theory Y
- Management science approach – Operations Research (OR)
- Differences between classical and modern theories of management

There are many writers on management theory, and there is no single ‘modern theory’ of management. The ideas of some well-known writers are described here.

3.1 Peter Drucker (1909 – 2005)

Peter Drucker was a leading writer on management theory for many years until his death in 2005, and he wrote on a wide range of subjects.

He suggested that there are five areas or categories of management responsibility:

- ❑ **Setting objectives.** Managers set objectives for the organisation, and decide on targets for the achievement of those objectives, which they then communicate to other people in the organisation.
- ❑ **Organising work.** Managers organise the work that is done, by dividing it into activities and jobs. They integrate the jobs into a formal organisation structure and select and appoint people to do the jobs.
- ❑ **Motivating and communicating.** Managers need to motivate their employees. They must also communicate with their employees so that they can do their work.
- ❑ **Measuring.** Managers measure performance, perhaps by comparing it against a target or yardstick (benchmark). They analyse and assess performance, and communicate their findings, both to their superiors and their subordinates.
- ❑ **Developing people.** Managers need to develop their employees and also themselves. Drucker wrote that the manager ‘brings out what is in their employees or he stifles them. He strengthens their integrity or he corrupts them.’

Drucker disagreed with the views of Fayol that general principles of management apply to managers in all types of organisation. He argued that managing a commercial business is different from managing other types of organisation, because the business manager has a key responsibility for the economic performance of the business. Managers perform well and justify their existence and their authority only if they produce the economic results (for example, profits) that are expected.

Drucker therefore suggested that there are three aspects to the responsibilities of managers in business:

- ❑ **Managing the business.** Business managers are responsible for matters such as innovation and marketing. Drucker was one of the first management theorists to argue for 'putting the customer first' – a basic concept on which modern ideas of marketing are based.
- ❑ **Managing managers.** Managers need to be managed. One way of doing this is to give them targets for achievement and monitoring their performance. Drucker was the first theorist to use the term 'management by objectives'.
- ❑ **Managing workers and their work.** Managers need to set objectives for their team and divide their work into manageable activities. Managers also need to motivate staff and communicate with their team as well as measure and review their performance. Managers are also responsible for developing their people.

3.2 Rosabeth Moss Kanter

Kanter has written widely on management topics, but is probably best known for her work on the inefficiencies of modern bureaucracy, and what organisations need to do to succeed in the modern business environment.

She argued that over time, traditional bureaucratic organisations had become unacceptably slow. A long hierarchical chain of command meant that information passed slowly through the organisation, and decisions took a long time to make.

The world of business had changed, economic circumstances were different, competition had increased, the pace of change was much faster and new technology (particularly developments in computerisation and communications technology) had made the 'old ways of doing things' within a bureaucratic organisation very inefficient.

In her book *Teaching Elephants to Dance* (1989) she argued that today's 'corporate elephants' need to learn to dance as nimbly and speedily as mice if they are to survive in an increasingly competitive and rapidly changing world:

'If the main game of business is indeed like Alice in Wonderland croquet, then running it requires faster action, more creative manoeuvring, more flexibility and closer partnerships with employees and customers than was typical in the corporate bureaucracy. It requires more agile, livelier management that pursues opportunity without being bogged down by cumbersome structures or weighty procedures that impede action. Corporate giants, in short, must learn to dance.'

Kanter argued that the re-birth and success of business organisations will depend on:

- ❑ innovation (developing new products, services and operating methods)
- ❑ entrepreneurship (taking business risks)
- ❑ participative management (encouraging all employees to participate in making decisions about work).

Kanter has argued in favour of 'empowerment', which means giving more authority and power to the individual worker, instead of relying on managers to tell their workers what to do. Empowerment is needed to get the best out of individuals at work.

She has also argued in favour of 'flatter' organisation structures, and getting rid of the hierarchies of management and long chains of command that characterise large bureaucracies. (When workers are empowered and given more authority to

make decisions for themselves, the need for supervision by management is reduced. Empowerment and flatter organisation structures are therefore consistent with each other.)

3.3 Henry Mintzberg

Henry Mintzberg is another modern management theorist who has written on a wide range of topics. He is particularly well-known for research that he carried out into what managers actually do. According to classical theorists such as Fayol, the role of managers is to plan, organise, command, co-ordinate and control.

Mintzberg suggested that reality is different. His research into the activities of managers made the following discoveries:

- ❑ A lot of management work is disjointed. Planning, for example, is done on a day-to-day basis, when time permits between more urgent or immediate tasks.
- ❑ Managers spend some of their time on routine duties of a ceremonial nature, such as meeting with important visitors.
- ❑ Managers prefer informal verbal communication to formal written communications, such as reports and briefing notes. Communicating informally by word of mouth is much faster and more effective than communication through the formal information system.
- ❑ Management activities and decisions are based largely on judgement and intuition. General principles of management are not relevant to management practice. In practice, managers do many of their tasks quickly and superficially.

Mintzberg suggested that managers perform three main roles, which can be further analysed into 10 different functions. Together, these ten roles provide an integrated picture of what managers do.

Mintzberg: managerial roles

Interpersonal	Informational	Decision-making
Figurehead	Monitor	Initiator or improver, and changer
Liaison	Disseminator	Disturbance handler
Leader	Spokesman	Resource allocator Negotiator

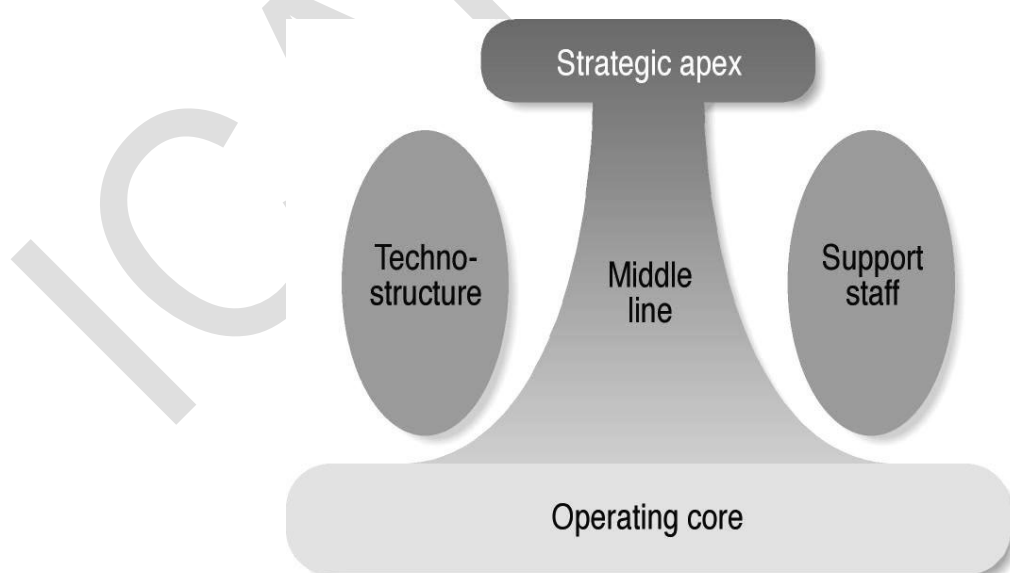
- ❑ **Interpersonal role.** Managers spend much of their time performing interpersonal roles:
 - As a **figurehead**. Managers often perform a ceremonial role, representing the organisation at events and as a 'public face' of the organisation. Managers also represent their organisation in its dealings with other organisations. Other people might refuse to deal with anyone except the manager, because of the manager's formal position and status.
 - As a **leader**. Managers also deal with relations between individuals inside the organisation, providing leadership (hiring, firing, training, motivating and so on).
 - **Liaison**. Managers of groups within an organisation act as a link or bridge with other groups. For example, different departments often

communicate with each other through their managers. Managers therefore fulfil a role of obtaining information from other sources and other groups.

- ❑ **Information role.** Managers also have an information role.
 - **Monitor.** Managers build and use 'intelligence-gathering' systems and monitor the information they receive. They gather information from formal and informal sources, and develop an extensive knowledge of the organisation as a result.
 - **Disseminator.** Managers disseminate information, acting as a channel of information within the group and with others.
 - **Spokesman.** Managers act as a spokesperson for the group, in a 'public relations' capacity.
- ❑ **Decision-making role.** Managers make decisions.
 - **Initiator of change or improvements.** They have an entrepreneurial role, and take initiatives.
 - **Disturbance handler.** They have a role in resolving conflicts and disputes, and dealing with other similar unexpected problems.
 - **Resource allocator.** They decide how resources should be used, for example what the available money should be spent on and how employees should use their time (what work they should do).
 - **Negotiator.** They negotiate with others, and reach decisions through joint agreement.

Mintzberg and organisation structure

Mintzberg also challenged the view that the bureaucratic organisation structure is the ideal form of organisation in all circumstances. He suggested that there are five elements or 'building blocks' in an organisation, and the way that the organisation operates depends on which of these elements is dominant.



- ❑ **Strategic apex.** This is the top management in the organisation.
- ❑ **Operating core.** This represents the basic work (basic operations) of the organisation, and the individuals who carry out this work.

- ❑ **Middle line.** These are the managers and the management structure between the strategic apex and the operating core.
- ❑ **Support staff.** These are the staff who provide support for the operating core, such as secretarial staff, cleaning staff, repair and maintenance staff, and so on.
- ❑ **Technostructure.** These are staff without direct line management responsibilities, but who provide technical support to the organisation. They include accountants and IT specialists.

Mintzberg argued that the way in which an organisation functions depends on which of these five groups has the greatest influence.

- ❑ When the strategic apex is powerful, the organisation is entrepreneurial. The leaders give the organisation its sense of direction and take most of the decisions.
- ❑ When the technostructure is dominant, the organisation often has the characteristics of a bureaucracy, with organising, planning and controlling prominent activities. The technical experts have a strong influence over the way the organisation is managed. The organisation continually seeks greater efficiency.
- ❑ When the organisation is divisionalised and local managers are given extensive authority to run their own division in the way that they consider best, the middle line is dominant.
- ❑ Some organisations are dominated by their operating core, where the basic 'workers' are highly-skilled and seek to achieve proficiency in the work that they do. Examples might be schools, universities and hospitals, where the teachers and doctors can have an exceptionally strong influence.
- ❑ Mintzberg identified a type of organisation that he called an 'adhocracy'. This is an organisation with a complex and disordered structure, making extensive use of teamwork and project-based work. This type of organisation will be found in a complex and dynamic business environment, where innovation is essential for success. These organisations might establish working relationships with external consultancies and experts. The 'support staff' element can therefore be very important.

3.4 William Ouchi: Theory Z

William Ouchi made a study of Japanese companies and compared them with companies in the US. His aim was to identify the reasons why Japanese companies performed better than US companies, and in particular why Japanese companies produced better-quality products than their US competitors and achieved much better productivity.

His study of Japanese companies found that in Japan, managers have a high level of trust in their workers, and assume that workers have a strong loyalty towards their company and are interested in team working. Companies in turn show loyalty to their employees, who have employment for life; however, promotion and career progression is slow. Decision-making in Japanese companies is also 'collective', with workers participating in decision-making and management trying to achieve universal agreement and acceptance before decisions are taken.

Ouchi was not the first management theorist to suggest that companies in other countries could learn from the success of Japanese companies. However, his work is notable because he suggested that the most efficient type of organisation

for the US might be one that combined features of 'typical' US and Japanese companies.

He called his recommended approach to management 'Theory Z', and he put forward his ideas in a book *Theory Z: How American management can meet the Japanese challenge* (1981).

The essential features of Theory Z, and how Theory Z compares with typical US and Japanese management practice, is set out below.

Typical American company	Typical Japanese company	Theory Z
Short-term employment	Lifetime employment	Long-term employment: not necessarily for life, but much longer than the current average in the US
Decision-making by individual managers with the authority to decide	Collective (or 'consensual') decision making	Collective (or 'consensual') decision making
Individual responsibility	Collective responsibility	Individual responsibility (Notice that here, Ouchi favours the American model over the Japanese model)
Rapid promotion. Quick career progression	Slow evaluation of performance and slow promotion. Take time to learn the business	Slow evaluation of performance and slow promotion
Formal control mechanisms and control measures	Implicit (informal) control mechanisms	Implicit(informal) control, but with explicit (formal) control measures
Specialised career path for employees	Non-specialised career path	Moderately specialised career path
Concern for the employee as an employee	Wider concern for the employee as a person	Wider concern for the employee as a person, including concern for the family of the employee

3.5 McGregor: Theory X and Theory Y

Douglas McGregor (in *The Human Side of Enterprise*, 1960) suggested that there are two different approaches to managing people. Each approach is based on a different view of whether individuals can be motivated at work. McGregor called the two management approaches Theory X and Theory Y.

Theory X

The Theory X approach to management is an authoritarian style. The manager instructs his employees and tells them what to do. The Theory X approach is based on the following views about people at work:

- The average person dislikes work and will avoid having to do any if at all possible.
- Individuals must therefore be forced to work towards the organisation's objectives, with the threat of punishment for not working properly.
- The average person prefers to be directed, wants to avoid responsibility, has no ambition and wants security more than anything else.

Theory Y

The Theory Y approach to management is a participative management style, in which the manager encourages his employees to participate in decision-making. The Theory Y approach is based on the following views about people at work:

- Putting effort into work is as natural as play.
- Individuals will apply self-direction and self-control to work towards the objectives of the organisation, without the need for constant supervision or the threat of punishments.
- The strength of an individual's commitment to the organisation's objectives is related to the rewards associated with achieving those objectives.
- Individuals usually accept and then seek responsibility.
- At work, the intellectual potential of the average person is only partly utilised. Individuals have much more potential that could be utilised.

The implications of McGregor's theory

The Theory Y approach to management is consistent with a participative approach to decision-making, where the manager gives all the relevant information to his employees and encourages them to contribute to solving problems and deciding what should be done.

McGregor suggested that a Theory Y approach is not always possible, or advisable.

- Theory Y is difficult to put into practice in a factory environment.
- There will be some situations when the manager must exercise his authority, because this is the only way of getting results. (For example, a manager must decide what to do when his subordinates cannot agree and are arguing amongst themselves.)

However, McGregor argued that Theory Y can often be used to manage managers and professionals. When it is possible to get the commitment of employees to the objectives of the organisation, it is better to explain problems fully to them. The employees will exert self-direction and self-control to do better work and achieve better results than if they are told what to do by an authoritarian manager.

For a Theory Y approach to management to work, employees must be positively motivated to work and emotionally mature, and the work must be sufficiently responsible to allow them some flexibility (some choice in how they set about the work). In these circumstances, a Theory Y approach will lead to much better results for the organisation than a Theory X management style.]

3.6 Management science approach – Operations Research (OR)

Operations research

Operations research (also referred to as operational research) is a type of decision-making and problem-solving methodology that uses analytical techniques (which are generally scientifically and mathematically based) to help ultimately make better decisions. Operations research techniques include:

- ❑ **Network analysis** – This involves identifying the different components of a project, how long each component will take to complete, the earliest and latest start and finish times for each component and the order in which components can be completed. One key objective of network analysis is to identify the critical path – the series of components which sequentially represent the short potential duration of the project.

Network analysis can be used as a foundation for planning resources in a cost-effective manner and identifying where bottlenecks and slack (periods of extra time where the delay in completing a component would not impact the overall completion time of the project) exist.

- ❑ **Game theory** – This involves studying mathematical models of conflict and cooperation to help make strategic decisions. Rules are specified which represent the various choices of action available and help determine what the potential and likely outcomes of various courses of action will be.

A number of different game theory styles exist including:

- Zero-sum games – this is where one person's gain is another's loss – frequently used by military strategists
- Many-person (or non-zero-sum) games – these are used to study economic behaviour where the objective is that for the greater good it pays for parties to cooperate – e.g. in a bargaining situation.

- ❑ **Queuing theory** – This describes using mathematical methods for analysing and predicting the delays and congestion of waiting and queuing. The objective is to identify ways to improve the process to make it quicker – for example improving traffic flow, processing shipping orders more efficiently, reducing the average time per call in a service department or call centre and improving flow through shops, factories and hospitals.

- ❑ **Simulation** – Simulation involves building a model that represents a real system then conducting experiments on the model. This allows the researcher to better understand the behaviour and evaluate different strategies for operating the system.

The researcher can adjust input parameters to test differing hypotheses (sometimes called 'what-if' scenarios) and predict future behaviour prior to making an informed strategic decision.

Simulation is now one of the most widely used operational research techniques which first became popular in the 1940's when 'Monte Carlo' simulation was used to simulate atomic bomb raids (Monte Carlo was the code name). It is now found almost everywhere including:

- computer systems e.g. data base management and networks
- manufacturing – e.g. materials handling
- Government – e.g. traffic control
- Business – e.g. cash flow analysis

- Mathematical logic** – Mathematical logic is integral to most of the other techniques described here. It is used to reflect the relationships between the various components, variables and parameters within something that is being modelled.

The logic is constructed so as to include an 'objective function' with which different solutions can be evaluated and constraints tested that restricts feasible values.

- Mathematical optimization** – In broad terms, mathematical optimization is a technique used in management science, mathematics and computer science to select the optimal solution from a set of available alternatives.

The solution is derived by either maximizing (e.g. profit) or minimizing (e.g. cost) a real function by systematically selecting input values from within a feasible range.

- Mathematical modelling** – Mathematical modelling is a way of describing a system using mathematical concepts and language. Defining a system using mathematical modelling allows the researcher to better understand the content and effect of the different components and make predictions about behaviour.

The holistic approach adopted includes three steps:

- Step 1: Develop a set of potential solutions to a problem. Note that this may include many iterations of solution
- Step 2: Analyse the alternatives derived in step 1 to identify a much smaller sub-set of most likely workable solutions
- Step 3: Apply simulated implementation to the alternatives derived in step 2 to identify and refine the best solution. If possible this should be tested out in 'real-world' situations with psychology and management science techniques playing an important role.

Due to its bias towards computational and statistical techniques, operations research has strong ties to computer science and analytical science.

OR in practice

In practice, operations research is used by management to either:

- maximise something (e.g. profit, yield, utilisation or performance); or
- minimise something (e.g. loss, cost or risk).

Some other real-world examples of applying OR in practice are:

- critical path analysis for project planning
- routing (e.g. for transport or people)
- supply chain management
- scheduling

- ❑ determining optimal prices

By its nature, OR requires skilled labour which often involves the employment of specialists. This can of course be costly so is normally seen either as an internal department within a larger company or accessed via an outsourced operations research bureaux.

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Example: Operational Research

Prior to opening the new terminal 5 at London Heathrow airport a large number of people were used to simulate passenger traffic for a forecast busy day. The simulation involved testing check-in queues, visa processing, immigration control and the baggage system,

Management were able to analyse the operations including waiting times, customer satisfaction, incidences of backlog and lost baggage in order to modify the operations prior to the new terminal opening to the public.

Subsequently, when the new terminal 5 opened to the public all significant operational issues were avoided.

3.7 Differences between classical and modern theories of management

Classical theories of management attempted to identify general rules of management and organisation that should apply to all types of organisation.

Modern theories of management have successfully challenged many of the ideas in classical management theory such as:

- ❑ The classical view focused on improving efficiency without considering the human element. For example, when Taylor's concepts are applied the effort of workers initially increases in intensity. However, this persistent intensity can lead to a reduction in morale, erosion in goodwill and ultimately conflict between labour and management.
- ❑ Taylor and his scientific management concepts are often criticized for treating humans in the workplace as machines or clones rather than individuals. This led to significant revolt in the mid-19th to mid-20th centuries and an overall strengthening of unions, a trait which has somewhat reversed in modern times.
- ❑ Classical management theories become complex and difficult to apply in larger organizations as the volume of employees expands and with it the variety of personalities and motivations. The increased diversity of personnel arguably better responds as a whole to more modern approaches compared to the 'one-size-fits-all' classical approach.
- ❑ Classical theories were developed at times of highly labour-intensive industries and factories primarily in the manufacturing industry. This was a period when classical theories were perhaps more suited and output metrics could better be measured using classical techniques. Conversely, modern business has transitioned to a much greater service orientation where the personal touch, individualism and client service all play a much greater role and modern human relations approaches are arguably better suited.

However some aspects of classical management theory are still valid – for example, a scientific management approach to improvements in efficiency has some validity, and the ideas of Mayo have been substantially developed and extended by more modern writers.

Modern theories include the view that the most suitable approach to management varies according to circumstances, and what is best in one situation is not necessarily the best in another. Each organisation, and each management problem, should therefore be considered according to the circumstances. This approach to management is called '**contingency theory**' – meaning that the best solution will depend on the situation.

4 Leadership style

Section overview

- The importance of effective leadership
- Effective leadership and leadership style
- Trait theories of leadership
- Lippitt and White's leadership styles
- Blake and Mouton's grid
- Tannenbaum and Schmidt's leadership continuum
- The Ashridge model
- Likert's leadership styles

4.1 The importance of effective leadership

Leadership involves interpersonal skills and an ability to motivate others.

Effective leadership within an organisation involves:

- guiding and directing others to achieve the goals of the organisation
- making the best use of the knowledge, skills and talent of others in the organisation
- developing the knowledge, skills and talent of others in the organisation.

Effective leadership therefore increases the effectiveness of the organisation, by getting the best out of employees to achieve the aims and objectives of the organisation.

4.2 Effective leadership and leadership style

Since leadership is an aspect of management, it is necessary to establish whether there are any particular skills that a manager should have to be an effective leader. What makes a person a good leader? Are people born to be leaders? Can leadership skills be taught and learned?

Several writers have considered whether effective leadership is a matter of how the leader behaves – the leader's style – and there are differing views about what personal characteristics or style might make a good leader.

There are several types of theory about effective leadership style:

- Personal characteristics** ('traits' or 'qualities'). There is a view that a leader must possess certain personal qualities of leadership. The best leaders are 'charismatic'. These characteristics are natural, and some individuals are born with them. They cannot be taught.
- It depends on **circumstances**. 'Contingency theories' of effective leadership take the view that the requirements for effective leadership vary according to circumstances. Different styles of leadership are the most effective in different circumstances and situations.
 - Leadership styles range from domineering (autocratic or authoritarian) to democratic or even 'laissez-faire'. The most suitable leadership style depends on circumstances.
 - Some writers have argued that there is a 'best' leadership style.

- Others have argued that the most appropriate leadership style depends on circumstances (**'contingency theory'** of leadership).

The differing views about effective leadership can probably be appreciated by looking at several theories of leadership style.

4.3 Trait theories of leadership

A trait theory of leadership is that there is a set of personal qualities and characteristics that make a good leader. Individuals either have these qualities or they do not. Some people are therefore 'born leaders'.

Trait theory may have an immediate 'popular' appeal. Descriptions of great leaders in history often refer to the leader's personal qualities that distinguished him or her as someone special and a natural leader.

However, a serious problem with trait theory is that there are many different traits that could be attributed to an effective leader. Some of the more 'obvious' traits are listed below:

- Physical vitality and energy
- Intelligence and good judgement
- Eagerness to accept responsibility
- Enthusiasm and self-confidence
- Competence in the tasks
- Understanding their followers and their needs
- Skill in dealing with people (interpersonal skills or 'soft skills')
- Having a powerful need for achievement
- A capacity to motivate others
- Decisiveness
- Trustworthiness
- Assertiveness
- Flexibility

It is not necessarily obvious which of these traits are more important than the others in making an effective leader.

Another problem with trait theory is that if leadership skills are natural skills that an individual either has or does not have, this means that leadership skills cannot be learned. Organisations would therefore have to look for natural leaders and promote them, without being able to do anything to improve leadership skills through training and development.

Trait theories of leadership are now largely discredited as a means of identifying leaders. However, if an effective leader is identified and described, it is almost certain that he or she will possess some of the traits in the above list.

4.4 Lippitt and White's leadership styles

In 1938/1939 Lippitt and White carried out an investigation into leadership styles, using groups of schoolchildren working on arts and crafts projects, such as making masks. Three different types of leaders were assigned to the groups, and

the behaviour of the children with each of the different types of leader was studied.

The three types of leadership style for the groups were:

- ❑ **Authoritarian or autocratic leadership style.** The leader continually gave orders and instructions without offering any consultation.
- ❑ **Democratic style.** The leader offered guidance and encouragement to the children, and participated actively with the group.
- ❑ **Laissez-faire style.** The leader gave the children the knowledge they needed to do the work, but did not become involved and did not participate in the activities of the group.

The study looked at the effects of the different leadership styles on the behaviour and the output of the group members. Their findings are summarised below.

Groups with democratic leaders	Groups with autocratic leaders	Groups with laissez-faire leaders
Morale was high.	Two types of behaviour were found in group members:	These were the worst-performing groups.
Relationships between the group members and between the group members and the leader were friendly.	<i>Aggressive behaviour:</i> These individuals were rebellious. They constantly demanded attention from the leader and often blamed others when things went wrong.	Productivity (quantity produced) was low. Quality of output was low. Satisfaction of group members was low.
The group members showed themselves capable of working independently, with the leader out of the room.	<i>Apathetic behaviour:</i> These group members placed few demands on the leader and showed not much interest	Group members were unable to work independently.
There was a reasonable amount of originality in the work done by the group members	The quality of the output of children in this group was less than the quality produced by groups with a democratic leader.	Group members did not cooperate with each other.
The quality of their output was higher than the quality produced by groups with an authoritarian leader.	The quantity of their output was higher than the quantity produced by groups with a democratic leader.	
The quantity of their output was lower than the quantity produced by groups with an authoritarian leader.		

The conclusions from the study were that:

- ❑ The democratic style of leadership was 'best', providing high quality of output, reasonable originality and productivity, and high satisfaction of group members.
- ❑ However, some of the boys in the study preferred the authoritarian style of leadership.

4.5 Blake and Mouton's grid

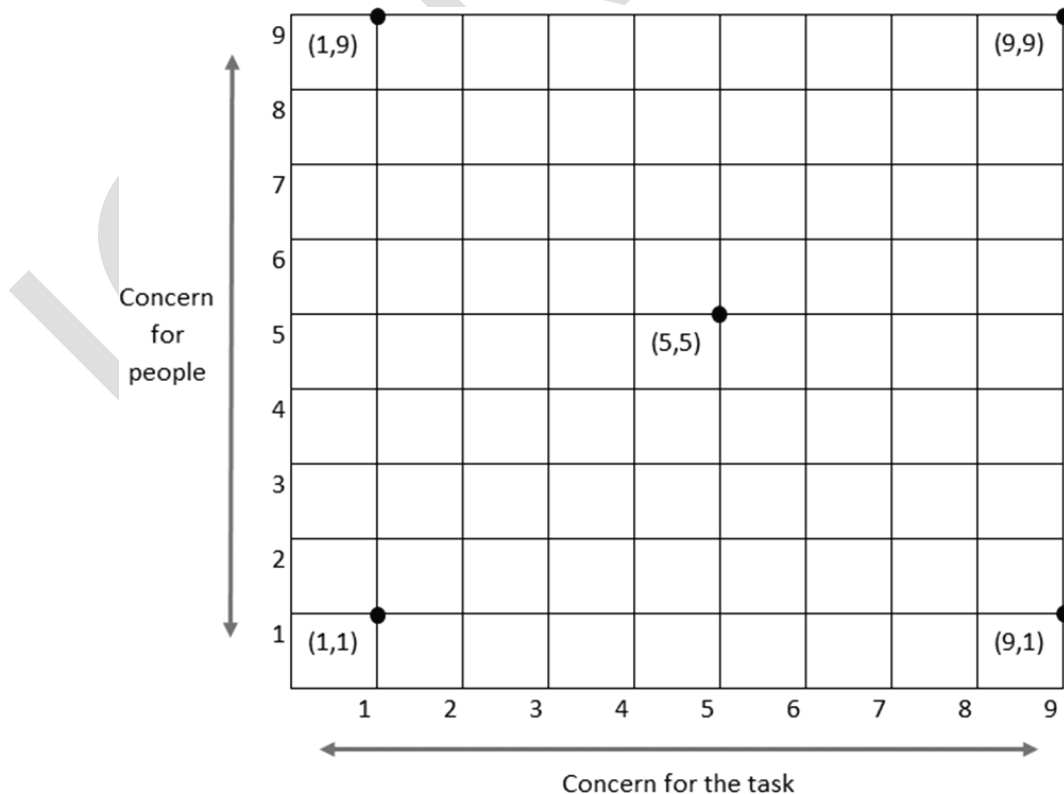
Robert Blake and Janet Mouton (1964) argued that there are two basic elements in leadership behaviour:

- ❑ **Concern for the task.** This includes a concern for achieving targets, the volume of output, work efficiency and so on.
- ❑ **Concern for people.** This includes personal commitment, ensuring good working relationships with others (particularly subordinates), maintaining good interpersonal relationships, and keeping the trust and respect of the group.

These two concerns are independent of each other and a leader or manager can be either weak or strong in showing either concern.

Blake and Mouton devised a grid, often known as Blake's grid, which shows these two elements of leadership, one on each axis of the grid. Each axis of the grid is numbered from 1 to 9.

- ❑ A score of 1 indicates lowest level of concern.
- ❑ A score of 9 indicates the highest level of concern.
- ❑ Individual managers or leaders can be placed on the grid, according to their concern for the task and their concern for people.



Style	
(1,1): Impoverished style	The leader gives little effort to getting work done and has a lazy approach. The worst type of leader possible.
(1,9): Country club style	Low concern for getting the task done, but high concern for people and maintaining good relations.
(9,1): Authoritarian, compliance style	The leader concentrates on efficiency, and getting the work done, with little concern for people. Will seek to eliminate people from the work if at all possible (for example through automation).
(5,5): Middle-of the road style: 'organisation man'	Does enough to get the job done, but may not be pushing to extend the boundaries of what is possible.
(9,9): Team management	High concern for the task and high concern for people. Provides effective leadership to the team. The most effective type of leader.

Managers/leaders show differing amounts of concern for the task and concern for people, and so may be placed anywhere on the grid.

Blake and Mouton argued that the most effective leaders show high concern for both the task and for people.

4.6 Tannenbaum and Schmidt's leadership continuum

Tannenbaum and Schmidt (1958) developed a model to describe different styles of leadership. They did not argue that one style was the best. Instead, they suggested that leaders might start with one style (an authoritarian or autocratic style), and then change their style (towards more delegation of authority to subordinates) as the group members gain experience and become more mature.

They argued that providing leadership has two main elements:

- Leaders may exercise their authority and make all the decisions for the group. Leaders who behave in this way are authoritarian.
- Leaders might also give the group members freedom to make their own decisions. A democratic leader delegates decision-making, although they also identified an 'abdicates' style of leadership, which is similar to a laissez-faire style.

Tannenbaum and Schmidt described the balance between using authority and allowing freedom to subordinates as a continuum or spectrum. The balance can range from strict authoritarian leadership at one end of the continuum to delegation of virtually all decision-making responsibilities at the other end.

Their continuum is shown in the diagram below. Every leadership style involves a varying balance between using authority and giving freedom to subordinates.



It is important to remember that although the leader delegates authority, he must always retain responsibility for the decisions, actions and performance of his subordinates.

A task of the leader is to develop the individual members of the team and the team as a unit. He should therefore delegate authority and ask the team to make decisions according to the level of their abilities and maturity. **Over time, however, a leader's style should move from the left of the continuum towards the right hand side.**

Tannenbaum and Schmidt identified seven levels of delegated freedom on their continuum.

Level		
1	Tells	The manager takes the decisions and announces his decision to the team.
2	Tells and sells	The manager takes the decisions, but then 'sells his decision to the group. He explains the reasons for the decision, emphasising the benefits for the team.
3	Tells and talks	The manager takes the decision, presents his decision to the team with the background ideas that led to the decision, and then invites questions. This makes it easier for the team to understand the decision and agree with it, and to understand the issues involved and the implications of the decision.
4	Consults	The manager announces a provisional decision and invites the group members to discuss it. The manager then takes into consideration the views of the team members, and may change his decision. The team members therefore have some influence over the decision.
5	Involves	The manager presents the problem to the team, perhaps suggesting some options. He asks for suggestions about what should be done. He then decides. The team members are therefore closely involved in the decision. This style is appropriate when the team has a high level of knowledge and experience.
6	Delegates	The manager explains the situation to the team, defines the parameters and asks the team to decide. The manager therefore delegates the decision-making entirely, within the stated limits. This leadership style requires a mature team.
7	Abdicates	The manager allows the team to identify the problems, develop options, make a decision and develop action plans for a solution – within the stated limits of his own authority.

4.7 The Ashridge model

A research team from Ashridge College in the UK identified and explained four different styles of leadership:

- Tells
- Sells
- Consults
- Joins

Tells style

A 'tells' style of leadership is dictatorial. The leader makes decisions and imposes them on his subordinates, expecting them to be obeyed without question.

The main advantages of the 'tells' style are:

- Speed of decision-making: the leader does not need to consult anyone before making the decision.
- It will probably result in better decisions when the subordinate is inexperienced or lacks the required understanding to contribute usefully to discussions of problems.

The disadvantages of a 'tells' style are greatest when there is no requirement for fast decisions and the subordinates have experience and skills that they can contribute to discussions. When the leader has a 'tells' style:

- The views of subordinates are ignored
- Any initiative or creativity the subordinates might contribute is lost
- There is too much dependence on one person, the leader.

Sells style

A 'sells' style of leadership is autocratic. An autocratic leader makes his own decisions but then tries to 'sell' them to his subordinates. This means that there is a small amount of consultation about decisions, but not much.

The advantages of a 'sells' style are that:

- Subordinates at least know why certain decisions have been made
- The leader is not dictatorial

However, with a 'sells' style the leader is imposing his views on subordinates and the communication is largely one-way.

Consults style

A 'consults' style is a democratic style of leadership. The leader asks for comments from subordinates before making a decision, and the comments from subordinates might persuade him to change his mind or alter his view about something.

The advantages of a 'consults' style are:

- Greater interest and involvement for subordinates.
- Therefore possibly stronger motivation amongst subordinates.
- The ability of subordinates to contribute their knowledge and experience to the decision-making process.
- The opportunity for subordinates to gain better insights and understanding through being involved in the decision-making discussions.

The disadvantages of a 'consults' style are that:

- Subordinates might not have sufficient knowledge or experience to contribute effectively.
- The decision-making process might be slowed down too much, and is unlikely to be desirable at times of crisis when quick decisions are needed.

Joins style

A 'joins' style of leadership is called a 'laissez-faire' style by some management theorists. With this style, the subordinate is allowed to get on with his work and do whatever he likes, within established guidelines and constraints.

The potential advantages are high motivation and commitment from subordinates.

The potential problems are that:

- Individuals often need guidance from a leader.
- Co-ordination between subordinates might be poor.
- There is a risk that the actions of subordinates might undermine the authority of the leader.
- The potential risks are too great if the subordinates are insufficiently knowledgeable and experienced.

Conclusion

Research by an Ashridge College team concluded that:

- Subordinates prefer a ‘consults’ style of leadership.
- The worst style of leadership is inconsistency in style.

4.8 Likert’s leadership styles

Writing in the 1960s, Rensis Likert identified four different leadership styles.

Leadership style	Features of the style
<i>Exploitative authoritative</i>	The leader has a low concern for people. He uses threats and other fear-based methods to get others to do what he instructs. Communication is almost entirely a downward process, from the leader to the subordinates.
<i>Benevolent authoritative</i>	The leader is authoritarian, but also shows concern for people. He is a ‘benevolent dictator’. He uses rewards to encourage performance. He listens to concerns of people lower down in the organisation, but he is often told by subordinates what they think he would like to hear. Most decisions are taken by the leader. There is not much teamwork among the subordinates.
<i>Consultative</i>	The leader makes a genuine attempt to listen to his subordinates. He has substantial trust in his subordinates, but not enough to let them take major decisions (which he takes himself). There is some two-way vertical communication between leader and subordinates, and some horizontal communications between subordinates, with a moderate amount of teamwork and cooperation.
<i>Participative</i>	The leader engages subordinates in the decision-making process. He has complete confidence in his subordinates, who feel a responsibility for the organisation’s goals. People are psychologically close and work well together. Subordinates receive economic rewards based on achieving goals that have been set with their participation.

Likert argued that a **participative style** of leadership was ideal for the profit- oriented, human-concerned organisation.

5 Theories of leadership: Contingency theories

Section overview

- The nature of contingency theory
- Fiedler's contingency model
- Hersey and Blanchard: situational leadership theory
- Handy's best fit approach

5.1 The nature of contingency theory

Contingency theory of leadership is based on the view that the most effective leadership style in a given situation will depend on the situation. In other words, the most effective leadership style is 'contingent upon' the circumstances of the situation.

Contingency theories of leadership have been developed by:

- Fiedler
- Hersey and Blanchard
- Handy.

5.2 Fiedler's contingency model

Fred Fiedler's contingency theory of leadership was developed from research he conducted in the 1960s into two leadership styles, and which style was the more effective. He began by identifying two leadership styles:

- task-orientated leadership, and
- relationship-orientated leadership.

These styles could be related to Blake's grid and 'concern for the task' and 'concern for people'.

Fiedler developed a system for deciding whether a leader was task-orientated or relationship-orientated, based on getting leaders to reply to a questionnaire about their 'least favourite co-worker'.

Having categorised the individuals in his research into one or the other categories of leader, he then tried to establish which style of leadership was more effective.

He concluded that the effectiveness of a leader depends on:

- the leader's style, and also
- the extent to which the work situation gives the leader control and influence.

The work situation depends on three factors:

- The **relationship between the leader and the subordinates**: If the leader is liked and respected, he is more likely to have the support of his subordinates.
- The **structure of the task**. If the task is clearly defined, with clear goals, methods of working and standards of performance, it is more likely that the leader will be able to exert influence.

- ❑ The **position power of the leader**. If the organisation gives power to the leader, for the purpose of getting the job done, this is likely to increase the influence of the leader.

For example, the leader may have to be authoritarian in his approach when a quick decision is needed, or when employees are used to being told what to do.

The work situation can be favourable to the leader, unfavourable to the leader, or something in between (intermediate favourableness). Fiedler defined a favourable work situation as:

- ❑ good relationship between leader and subordinates
- ❑ a highly-structured task, and
- ❑ a large amount of position power for the leader.

So which leadership style was most effective? Fiedler found that it seemed to depend on the circumstances:

- ❑ When the work situation is favourable, a task-orientated leader is more effective.
- ❑ When the work situation is unfavourable, a task-orientated leader is also more effective.
- ❑ When the work situation is somewhere between favourable and unfavourable ('intermediate'), a relationship-orientated leader is more effective.

Fiedler was therefore one of the first management theorists who argued that the effectiveness of leadership style depends on the circumstances.

He went on to argue that individual leaders are task-oriented or relationship-oriented **by nature**, and it is **impossible to change them**. An organisation should therefore assess whether a work situation is favourable, unfavourable or in between, and try to appoint a leader with the more appropriate style for the work situation.

5.3 Hersey and Blanchard: situational leadership theory

Paul Hersey and Kenneth Blanchard (1968) developed another contingency theory of leadership, which they called situational leadership theory. Like Fiedler's contingency theory, their theory states that the most appropriate leadership style depends on the work situation.

Some of the assumptions in their theory are that:

- ❑ A leader should adjust his or her leadership style to meet the requirements of the work situation. Leaders must be able to use any leadership style, and should switch from one style to another as circumstances require. (In this respect their views differ from Fiedler's. Fiedler did not believe that individuals can change their leadership style, because this is 'personal' or 'natural' to each individual. It was therefore necessary to pick an individual as leader who could bring the most suitable leadership style to the job.)
- ❑ Subordinates or team members are at different levels of personal development. Some are more mature psychologically than others and some are more mature (experienced and skilled) in the job than others. The appropriate leadership style depends on the extent to which the subordinates are mature. For the purpose of their theory, Hersey and Blanchard identified subordinates' maturity in terms of:

- competence in their job and their ability to undertake successfully the tasks they are given – job maturity
- confidence in their ability to deal with the challenges of the task
- commitment to the organisation’s goals and commitment to undertake the task – psychological maturity.

They referred to the maturity of the team members as their ‘**functioning maturity**’.

Leaders are involved in:

- ❑ **directive activity** – giving guidance and direction: this is similar to ‘concern for the task’ and can be described as ‘task behaviour’.
- ❑ **supportive activity** – giving emotional and social support to subordinates: this is similar to ‘concern for people’ and can be described as ‘relationship behaviour’.

The amount of involvement by leaders in directive activity and supportive activity can range from low to high. The appropriate level of activity required from an effective leader varies with the work situation, which in turn depends largely on the maturity of the subordinates or team members.

Hersey and Blanchard identified four leadership styles, which can be presented in the form of a 2 x 2 matrix.

		AMOUNT OF DIRECTIVE ACTIVITY (TASK FOCUS)	
		LOW	HIGH
AMOUNT OF SUPPORTIVE ACTIVITY (RELATIONSHIP FOCUS)	LOW	<p>Delegating style</p> <p>Responsibility for decision-making given to subordinates</p>	<p>Telling/directive style</p> <p>Close supervision by the leader</p>
	HIGH	<p>Supportive/participating style</p> <p>Leader shares decision-making with subordinates, and asks them for input</p>	<p>Selling style</p> <p>Leader makes the decision but explains them to subordinates and gives opportunities for asking questions</p>

The four leadership styles are explained in more detail below, together with the views of Hersey and Blanchard about which leadership style is most effective for a given work situation.

Leadership style	Characteristics	Most effective when subordinates have...
Telling	High task focus, low relationship focus. The leader defines the roles and tasks of subordinates and supervises them closely. Decisions are announced by the leader. Communication is mainly one-way, from the leader down to subordinates.	Low competence High commitment
Selling	High task focus, high relationship focus. The leader defines the roles and tasks of subordinates. He seeks ideas and suggestions from subordinates, so communication is two-way. The leader makes the decisions. Subordinates may need direction because they are inexperienced. They also need support and praise from the leader to build their self-esteem.	Some competence Some commitment
Participating	Low task focus, high relationship focus. The leader delegates some day-to-day decisions to subordinates (for example, work scheduling). The leader facilitates and participates in discussions about other decisions with subordinates. Subordinates are competent in their work, but lack the psychological confidence of motivation. Some support is necessary from the leader to boost confidence and motivation.	High competence Variable commitment
Delegating	The leader is involved in discussions about problem-solving and decision-making, but control is with the subordinates. The subordinates decide how and when the leader will be involved. The subordinates can do the work themselves with little supervision or support.	High competence High commitment

5.4 Handy's best fit approach

Charles Handy described his contingency approach to leadership styles as a best fit approach.

There are four factors that influence the effectiveness of a leader:

- the leader** himself – his personality and character, and also his leadership style
- the subordinates** – the personalities of the individuals in the group, the character of the group as a whole, their preferences for a particular leadership style
- the task** – what are the objectives of the group's tasks, what methods of working are used?

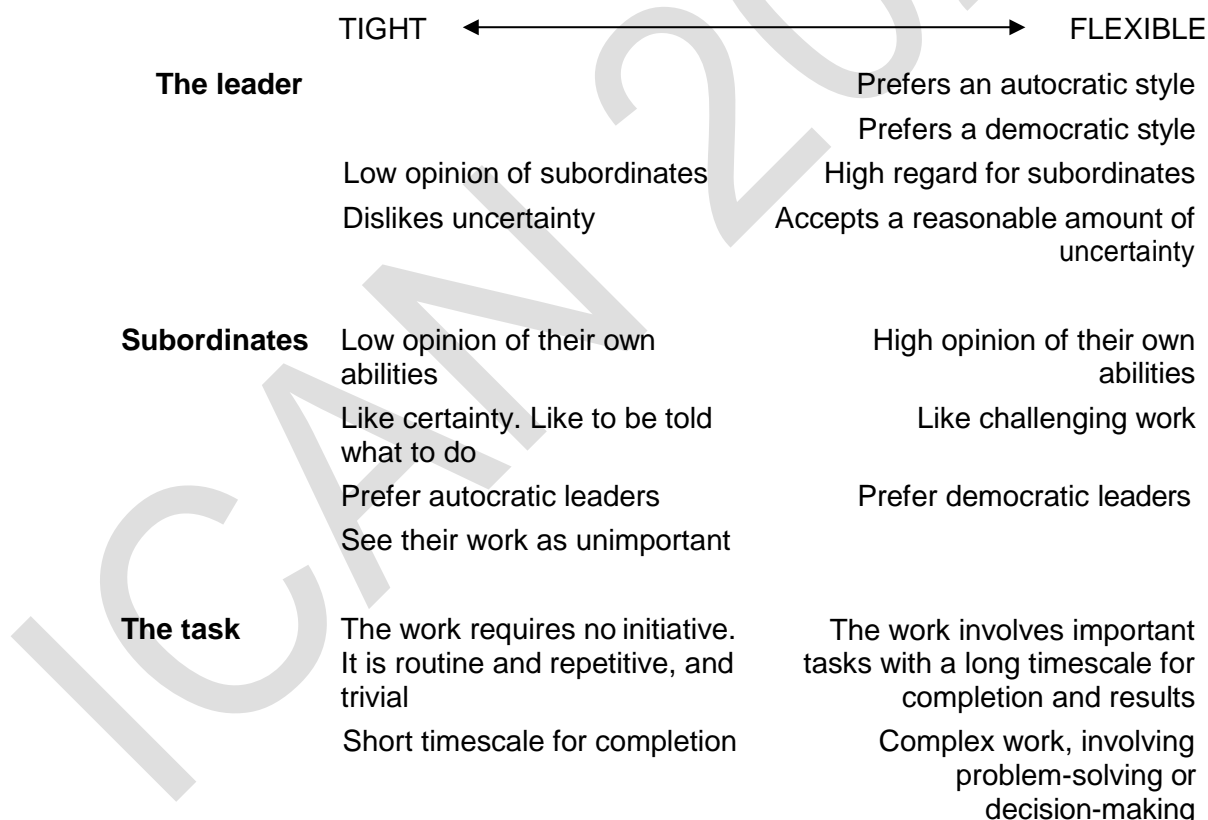
- **the environment** – this factor covers a wide range of possible issues, including the organisation structure, the culture and norms of the organisation, the technology of the organisation’s operations and the variety of tasks performed by subordinates in the group.

Leadership styles range between autocratic and democratic. A leader’s style is not necessarily one or the other. It can be somewhere in between the two extremes.

The characteristics of the subordinates in a group range between having a low opinion of themselves (and wanting to be told what to do) and having a high opinion of themselves (and so liking challenging work and freedom from supervision). Most groups are somewhere between these two extremes.

The tasks that are done by a workgroup can range between all routine and repetitive tasks at one extreme and all complex work at the other extreme. Normally, the characteristics of the work is somewhere between these two extremes.

Handy described a ‘best fit’ spectrum, in which the three factors of leader, subordinates and tasks are placed on a range or spectrum, each between two extremes. He called these two extremes ‘tight’ and ‘flexible’.



Handy suggested that in any work situation there is a best fit of leader, subordinates and task (and environment, which is not on the spectrum). The best fit occurs where all three items – leader, subordinates and task – are at the same position on the spectrum.

Whenever there is a mismatch on the spectrum of leader, subordinates and task, and change will be required to create a new best fit for the altered work situation.

6 Leadership qualities

Section overview

- What do leaders do?
- Adair's action-centred leadership
- Warren Bennis: leaders as enablers and originators
- John Kotter: what leaders really do
- Ronald Heifetz: leadership as an activity

6.1 What do leaders do?

The leadership theories described so far in this chapter have considered leadership style and which particular style of leadership is the most appropriate. Other writers on leadership have considered what leaders do, and what makes leadership different from management. Some of these theories are described in this section.

6.2 Adair's action-centred leadership

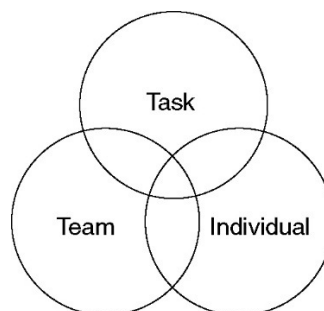
John Adair's action-centred leadership model is based on the view that effective leaders need full command of three aspects of leadership:

- achieving the task and meeting the demands of the task
- managing and maintaining the team or group
- managing individuals within the group and meeting the needs of individuals in the group.

A good leader keeps each of these three elements of leadership in balance. Adair argued that in any work situation, a leader is faced with problems and issues that will require the use of the three leadership skills. However, the particular skills that are needed to deal with any given situation will vary according to its nature. In other words, the skills required to deal with each problem will depend on the nature of the problem. An effective leader needs skills in all three areas.

Adair argued that all three aspects of leadership skills can be learned through training and development.

Sometimes a leader must show one of the leadership skills to deal with a problem, and sometimes he must show two of the skills or all three skills. The action-centred leadership model, indicating the skills required by the leader, can therefore be shown as three overlapping circles, which Adair calls the 'three circles diagram'.



The leadership skills required for each of the three areas of leadership are summarised below.

Achieving the task	Managing the team	Managing individuals
Define the task and the objectives/goals	Agree standard of performance/behaviour	Understand the team members as individuals (personality, skills, needs)
Make the plan for achieving the task	Establish the culture of the group	Assist individuals
Identify and acquire the resources needed	Maintain ethical standards and discipline	Give support to individuals
Establish responsibilities for group members	Resolve conflicts between group members	Give praise to individuals
Set standards and target performance standards	Change the balance/ membership of the group when necessary	Agree individual responsibilities and objectives
Establish reporting systems	Develop the ability of the team members to work together	Make use of the strengths and skills of the individual
Control actual performance by comparison with the targets	Build team morale. Motivate the group as a team	Reward individuals (for example with more responsibility or higher status)
Monitor performance	Develop the collective skills and maturity of the group	Train and develop individual team members
Review on completion of the task	Facilitate communications – within the group and externally Consult with the group Give the group feedback on its performance Provide group training	

The emphasis that a leader gives to each of these skills will obviously vary according to the situation, but a well-trained and effective leader is able to make use of the appropriate skills for each situation.

Note: Adair's 50:50 rule

Adair suggested a 50:50 rule that applies to his thinking about leadership. Leadership is influential, but effective leadership on its own is not sufficient.

- 50% of motivation comes from within the individual. The other 50% of motivation comes from influences outside the individual, including the influence of the leader.
- 50% of building a successful team comes from the team members and 50% comes from the leader of the team.

6.3 Warren Bennis: leaders as enablers and originators

Warren Bennis, writing from the 1980s, made a distinction between managers and leaders.

- ❑ The role of the manager is to administer and maintain systems in order. Managers focus on systems and controls. Their main concern is for the 'bottom line' (short-term profit). He referred to management as **transactional leadership**, which is '**doing things right**'.
- ❑ The function of the leader is to innovate and develop. Leaders focus on people, not systems. Their main concern is for the longer-term, not the short-term profit figure. Bennis referred to leadership as **transformational leadership**, which is '**doing the right things**'.

His comparison of managers and leaders is summarised in the table below.

Managers	Leaders
Transactional leadership	Transformational leadership
Doing things right	Doing the right things
Administer	Innovate
Maintain	Develop
Focus on systems and structures	Focus on people
Reliance on control	Inspire trust
Short-range view	Long-range perspective
Imitates	Originates
Accepts the status quo (no change)	Challenges the status quo

Bennis has argued that leaders must get involved if they are to provide leadership. Here are two quotations from his work, suggesting how leaders should provide innovation (a 'vision') and earn trust from his followers.

- ❑ 'It's not a question of giving speeches, sending out memos and hanging laminated plaques in offices. It's about living the vision, day in day out – embodying it – and empowering every other person in the organisation to implement and execute that vision in everything they do.'
- ❑ 'Leadership will have to be candid in their communications and show that they care. They've got to be seen to be trustworthy human beings. That's why I believe most communication has to be done eyeball to eyeball, rather than in newsletters or videos or via satellite broadcasts.'

Leadership at all levels

Bennis argued that leadership is needed at all levels in an organisation, and believes that everyone has the capacity and ability to provide leadership. He is **opposed** to the trait theory' that leadership is a natural talent and that there are 'born leaders'.

He has argued that the role of the leader is not to be an all-knowing problem-solver who knows the answer to every problem. Instead, a leader is someone who stimulates the group, encourages its creativity and maintains an atmosphere or culture in which the group members can find the solutions to the problems together.

6.4 John Kotter: what leaders really do

John Kotter also considered what leaders do (His most well-known book is entitled 'What Leaders Really Do'.) He has argued that leadership is largely concerned with:

- anticipating change
- dealing with change, and
- 'adopting a visionary stance' – in other words having a vision about what the organisation is trying to achieve and what it must do to get there.

More change demands more leadership, and Kotter advocated the creation of a culture of leadership within business organisations.

Like Bennis, Kotter has compared management (transactional leadership) and leadership (transformational leadership), as follows.

	Managers	Leaders
Creating the agenda	Transactional leadership Planning and budgeting (Develop a detailed plan and create a detailed map of how to achieve planning targets.)	Transformational leadership Establishing directions (Develop a vision for the organisation, and identify the direction in which it should go. Concern with strategy.)
Human relations aspects	Organise the work and fill staff in the positions (Decide which individual best fits each particular job.)	Align the people with the vision. (There is a communication problem – getting people to understand and then believe in the 'vision')
Execution of tasks	Control. Problem-solving leadership	Motivate and inspire
Outcomes	Produces a degree of predictability in outcomes	Produces change – often dramatic

6.5 Ronald Heifetz: leadership as an activity

Heifetz has argued that leadership is an activity, not a personal quality. We often confuse 'leadership' with 'authority'.

- Authority is often seen as the possession of powers based on a **formal management role** within an organisation. The manager has the right to tell subordinates what to do, because he is simply exercising his 'legitimate power'. Subordinates do what the manager tells them, to avoid dismissal, demotion or other disciplinary measures.
- However, employees may follow an individual, not because of his formal authority, but because the individual shows leadership qualities. A leader is someone who has the ability to make sense of situations that are out of the ordinary, and know how to act in these situations. Leadership of this kind gives the individual **informal authority**.

Successful leaders need this informal authority as well as the formal authority granted to them by their position.

Heifetz ('Leadership Without Easy Answers, 1994) suggested that there are two types of challenge for leaders in business. Each type of challenge needs different leadership qualities. The two types of problem are as follows:

- ❑ **Technical problems.** These are problems that have a relatively simple answer. Current knowledge can be applied to find a solution to the problem.
- ❑ **Adaptive problems.** These are problems where the answer involves a need for people to change – change their culture and outlook. People are resistant to change; therefore the solution to the problem involves getting people to learn new ways.

Technical problems can be solved by managers (transactional leaders). For adaptive problems, transformational leadership is needed. Heifetz has referred to problems requiring significant change as 'adaptive work'.

Six principles of leadership and adaptive change

Successful leadership depends on judgement, and making decisions about when to act, and how far to go each time. Change should not be introduced too quickly, but only at a pace that individuals can accept. Leaders must act within the context of 'permission to change' from the people affected and 'restraint' – not going further at any time than other people are willing to tolerate.

Heifetz suggested that there are six principles of leadership for adaptive change.

- 1 Get on the balcony A leader must have an ability to observe changes that are happening and to mobilise others to respond. It should be as if the leader is on a balcony with a clear view of all the entity's activities. The leader must then be able to mobilise the right people in the right way to do the required adaptive work.
- 2 Identify the adaptive challenge A leader has to see what response is needed to the new challenge and change. Heifetz used as a comparison an example of a band of chimpanzees that knows how to respond to a threat from a leopard, but does not have the leadership to know how to respond to a new challenge from a human with a gun.
- 3 Regulate distress Having identified the adaptive challenge, the leader must generate just the right amount of 'distress' among other people in order for everyone to see and understand the need for change. Change and progress must be introduced at the right pace – a leader must progress at the pace that other people are willing to accept. The leader must always point others in the right direction by asking them key questions.

(Heifetz even suggested that the assassination of a political leader is a failure of leadership. A political leader who tries to bring in changes too quickly might expose himself to assassination, from people who dislike the pace at which the changes are happening.)

- | | | |
|----------|--|--|
| 4 | Maintain 'disciplined attention' | The leader must get conflict out into the open and use this as a source of creativity. Constructive conflict among individuals leads eventually to collaboration and agreement. The leaders most likely to succeed are those who make followers aware of their responsibilities. |
| 5 | Give work back to the people | Leaders should not control and direct. They should provide support and allow people to find the solutions to problems through their own efforts. Change is a collaborative process. |
| 6 | Protecting voices of leadership from below | Leaders should give a voice to other people in the organisation, and should allow others (below them in the 'hierarchy') to raise contentious issues. |

7 Conflict

Section overview

- The nature of conflict at work
- Causes of conflict
- Characteristics of conflict
- Managing conflict

7.1 The nature of conflict at work

Conflict begins when one person starts to believe that someone else is preventing something that the person considers important and valuable. Two groups may be in conflict when one group believes that the other group is trying to prevent it from achieving its goals or aims. People in conflict see each other as opponents.

7.2 Causes of conflict

Conflict can occur between individuals in the same work team or work unit. More often, conflict arises between different workgroups or departments, and between people in different workgroups.

Causes of conflict may be any of the following:

- Conflict can arise when individuals are unclear about their respective areas of responsibility, so that one person believes that another is trying to take away his authority and responsibility. Conflict occurs because each individual believes that he has the responsibility for doing something, and it is not the responsibility of the other person.
- In the same way, conflict can arise when workgroups are unclear about their respective areas of responsibility. Each workgroup believes that it has the decision-making responsibility, and not the other group.
- Conflict may occur when one person or group thinks that another person or group is deliberately trying to spoil what he/it is trying to do, by being deliberately unhelpful or critical. For example, there may be conflict between the operations division and finance department of a company if the operations division management want to invest in new equipment and the finance department management will not allow them to have the money to invest.
- In some situations, conflict may occur when two workgroups are pursuing incompatible objectives. Similarly, conflict may occur between management and trade union representatives, because management act in the best interests of the organisation and its owners, and the trade union representatives try to get the best terms of employment for their members.
- On a personal level, conflict can arise when one individual thinks he can tell another person what to do, but the other person refuses to follow his instructions or recognise his authority.
- Conflict may even occur when operational managers are advised by 'specialist' advisers. The operational managers may feel that the specialists are being deliberately unhelpful in the advice they give. The specialists might feel that their advice is being wasted when it is ignored.

- ❑ Conflict may occur due to the nature of the work involved, so that for one person or group to 'succeed', another group has to 'fail'. Operational departments may have conflicts with regulators and checkers (including auditors) for this reason.
- ❑ Conflict may be 'political'. Political conflict may occur at the most senior level of the organisation, for example among the directors and senior managers of a company. One group of managers and directors may form a 'clique' that sees itself in conflict with another group, with disputes over matters such as company strategy and senior management promotions and appointments.
- ❑ Conflict might arise due to personality differences and natural ways of approaching a task. For example there may be conflict between a conservative employee who favours a measured and structured approach to implementing a new piece of technology (such as reading the instruction manual in full before trying the new system) versus a more adventurous and care-free employee who favours a 'try it, see what happens and worry later' approach.
- ❑ Non-compliance with rules, regulations and policies can be a common cause for conflict between those breaching the rules and those advocating compliance.
- ❑ Simple misunderstanding through ineffective communication can be another common cause of conflict in the workplace. For example, written communication may not easily convey body language or elicit constructive dialogue and hence may misrepresent the tone with which it was sent. The message received by the reader may also be biased by the mood of the receiver. Hence a light-hearted joke or reference may be interpreted seriously and cause offence leading to conflict.
- ❑ Conflict may arise where quotas and incentives generate competition for a scarce resource. Whilst on the one hand healthy competition can be a good motivator it can also lead to destructive and divisive behaviour such as sabotage and deliberate misinformation.

7.3 Characteristics of conflict

Conflict usually has a negative impact on the effectiveness of an organisation.

- ❑ There may be unfriendly rivalries between workgroups, departments or individuals.
- ❑ The individuals or groups in conflict are unlikely to communicate openly with each other.
- ❑ There may be inter-departmental disputes and arguments.
- ❑ Individuals or groups will be unwilling to listen to ideas from others with whom they are in conflict. There will be a refusal to co-operate.
- ❑ The opponents or rivals will constantly make accusations of wrongful treatment or improper behaviour.
- ❑ Individuals are likely to feel frustrated in their work and put the blame on the 'enemy'.
- ❑ There may be disputes over rights and responsibilities.

7.4 Managing conflict

There isn't an easy solution to the management of conflict. The most appropriate measures for dealing with the problem will vary according to circumstances.

- ❑ A manager whose subordinates are in conflict may choose to ignore it and pretend that it does not exist. This may be appropriate when the conflict is about a trivial matter and could be expected to end fairly soon.
- ❑ A manager might deal with a conflict between two subordinates or groups of subordinates by trying to impose a solution. He might ask the conflicting groups what the dispute is about, and having heard both sides of the argument, impose his own solution.
- ❑ When the main problem in a dispute appears to be one particular person, the manager may decide that a suitable solution would be to move the individual to a different position in the organisation.
- ❑ Another approach to resolving conflict amongst subordinates is to encourage them to talk through their differences and try to change their attitudes to each other. By exchanging their views and opinions, it may be possible for two groups to forget their differences – eventually – and to work in a more co-operative way.
- ❑ Similarly, a manager may try to act as a 'peacemaker', by listening to the views of each side, and trying to encourage each side to take a more rational and constructive approach to the problem that has caused the dispute. A peacemaker can listen sympathetically, but at the same time suggest some ways in which the 'other side' in the conflict may have a justifiable point of view.

Unfortunately, serious conflict is not easy to resolve quickly, and the eventual solution is found when existing personnel move on to other jobs or other management positions, or there is an organisational re-structuring.

Section overview
<ul style="list-style-type: none"> ▪ Emotional intelligence ▪ Social thinking

10 Emotional Intelligence

The term emotional intelligence which is also known as emotional quotient or EQ for short, was first coined in 1990 by researchers John Mayer and Peter Salovey, but was later popularized by psychologist Daniel Goleman (1995).

According to Goleman (1995), emotional intelligence which is also known as emotional quotient or EQ for short, is individual's ability to understand, apply, and handle his/her emotions in positive ways in order to ease stress, commune effectively, empathize with others, overcome challenges and resolve conflict.

It is a person's meta-level capability to handle emotions and use them to our benefit. The knowledge of an individual's emotional intelligence would always be a leading step taken to fully comprehend ones potential seeing that it has the capacity to predict the performance of an individual. It is also a skill that can be improved upon with training and practice.

Key Elements of Emotional Intelligence

Emotional intelligence can be typically broken down into four core competencies namely:

- Self-awareness
- Self-management or Self-regulation
- Social awareness/ Social skills
- Relationship management

Self-Awareness

Self-awareness describes an individual's ability to understand his/her strengths and weaknesses. It helps to recognize ones emotions and the effect they have on one and team's performance. Self-awareness evaluates ones performance and compares the outcome with the opinions of the boss, peers, and direct reports. In the course of this process, one will gain insights into one's behavior and discover how one is perceived in the organization.

Self-Management/ Self-Regulation

Self-management refers to the ability to manage one's emotions, mostly in traumatic circumstances and retain an optimistic viewpoint regardless of setbacks.

Social Awareness/ Social Skills

Social awareness describes the ability to recognize others people's emotions and the dynamics in play within your organization. social awareness practice empathy. They strive to understand their colleagues' feelings and perspectives, which enables them to communicate and collaborate more effectively with their peers. By communicating with compassion, you can better support your team, all while improving your individual performance.

Relationship Management

Relationship management refers to your ability to influence, coach, and

mentor others, and resolve conflict effectively. **Some prefer to avoid conflict, but it's important to properly address issues as they arise.**

Import of Emotional Intelligence

The importance of emotional intelligence could be clearly appreciated when viewed from the perspective of its capacity to:

- Coach teams, manage stress, deliver feedback, and work in partnership with others.
- Self-motivate and create positive social interactions
- Understand and handle your own emotions
- Identify and manipulate the emotions of those around you
- Prevent leaders from making decisions based on emotional biases
- Drive behavior and impact people positively
- resolve conflicts and improve relationships
- empathize with others
- Effectively overcome life's challenges
- promote a positive work environment for the whole team
- effectively motivate, inspire and earn the trust of their teams
- Perceive any potential friction or issues before they become problematic.
- Improve communication and relationships within the workplace.
- increase team productivity and staff retention

11 Social Thinking (Thinking Socially)

Social thinking is a process we all go through in our mind as we try to make sense of our own and others' thoughts, feelings, and intentions in context, whether we are co-existing, actively interacting, or figuring out what is happening from a distance like we have in the media and literature (Winner & Crooke, 2009)

Social thinking can also be described as the ability to consider your own and others thoughts, emotions, beliefs, intentions, knowledge, etc to help interpret and respond to the information in your mind and possibly through your social behavioral interactions (Winner & Crooke, 2009).

Social Thinking is a language-based teaching approach that focuses on social problem solving, cognitive flexibility and the emotions and points of view of others. Michelle Garcia Winner, a speech and language pathologist who learned about social cognition in her early career, created the term Social Thinking.

Our ability to think socially is part of social emotional learning that begins at birth and evolves across our lifetime. Social thinking is a supple teaching structure that can assist individuals become stronger social thinkers. Having good social skills simply means one is able to adapt effectively based on the situation and the people in the situation. Our social skills are part of our social problem solving

Social thinking relies of the Theory of mind for its theoretical concept. While, the Theory of mind refers to one's ability to perceive how others think, feel and how that relates to oneself.

Social Thinking shares ideals with:

Self-Regulation Theory

The self-regulation theory is a system of conscious personal management that involves the process of guiding one's own thoughts, behaviors and feelings to reach goals. The theory can be applied to impulse control, the management of short-term desires and illusion of control. Self-regulation involves a certain amount of knowledge to exert self control (Baumeister, Vohs and Tice 2007).

Executive Functioning

Executive functions are a set of intuitive procedure that is necessary for the innate control of behavior: selecting and successfully moderating behaviors that aids the attainment of chosen goals (Barkley, 2012).

Central Coherence Issues

The weak central coherence theory attempts to explain how some people diagnosed with autism can show remarkable ability in subjects like mathematics and engineering, yet have trouble with language skills and tend to live in an isolated social world. The theory is among the more prominent conceptual models that try to explain the abnormalities of autistic individuals on tasks involving local and global cognitive processes (Frith, 2008).

Perspective-Taking

Perspective-taking is the act of perceiving a situation or understanding a concept from an alternative point of view, such as that of another individual. Perspective-taking is related to other theories and concepts including theory of mind and empathy (Gerace, Day, Casey, & Mohr, 2013).

Every one benefit from exploring our own and other's social expectations however, social abilities develop and evolve over time.

Chapter review

Before moving on to the next chapter check that you can:

- Define leadership, management and supervision
- Explain the functions and roles of management
- Explain the classical theories of management including Taylor, the Gilbreths, Fayol, Urwick, Weber and Mayo
- Describe modern and other theories of management including Drucker, Kanter, Mintzberg, Ouchi, McGregor and operations research
- Summarise the trait theories of leadership including Lippitt and White, Blake and Mouton, Tannenbaum and Schmidt, Ashridge and Likert
- Explain contingency theories of leadership including Fiedler, Hersey and Blanchard and Handy
- Describe the various leadership qualities including the theories of Adair, Bennis, Kotter and Heifetz
- Explain how conflict arises and is managed in the workplace

Motivation

Contents

- 1 Theories of motivation
- 2 Reward systems and motivation
- 3 Other motivation concepts
- 4 Chapter review

INTRODUCTION

Detailed syllabus

The detailed syllabus includes the following:

C	Management and organisational behaviour	
	2	Management, individual and organisational behaviour
	g	Explain the concept of employee motivation and its relationship with productivity

Exam context

This is the second chapter on behavioural aspects of business activities. It explains the various theories about motivation and the link between motivation and productivity.

There are differing views about what motivates an individual in his or her job, and there are also differing views about whether (and how) stronger motivation leads to greater productivity/efficiency in performance. This chapter explains the most common theories of motivation and describes the various tactics and strategies that businesses adopt to motivate their staff.

By the end of this chapter students will be able to:

- Explain common theories of motivation including Maslow, Herzberg, McGregor, Vroom and McClelland;
- Explain the link between motivation and productivity;
- Describe the difference between extrinsic and intrinsic rewards and explain the link between rewards systems and motivation;
- Summarise how 'management by objectives' (MBO) works;
- Explain self-efficacy, the law of effect and reinforcement theory and equity and organisational justice.

1 THEORIES OF MOTIVATION

Section overview

- Content theories and process theories of motivation
- Maslow: the hierarchy of needs
- Herzberg and motivation-hygiene theory (two-factor theory)
- McGregor: Theory X and Theory Y
- Vroom: expectancy theory
- McClelland: motivational needs theory
- The link between motivation and productivity



Definition: Motivation

Motivation describes the reason or reasons one has for acting or behaving in a particular way. This in turn impacts the general desire or willingness of someone to do something.

In a business context, theories of motivation are concerned with identifying the factors that affect the attitudes of employees (including managers) to their work and the amount of effort that they put in to doing their work. For example, a demotivated employee may refuse to work in excess of contracted hours even if this might mean the loss of revenue or a client. However, a motivated employee might do whatever it takes to secure the revenue or client.

If managers understand the factors that motivate their employees, they might be able to take measures to improve motivation and effort.

Theories of motivation also help us to improve our understanding of our personal motivation to work and what we hope to get from our job.

1.1 Content theories and process theories of motivation

There are many different theories of motivation. It might help to make a distinction between:

- content theories of motivation, and
- process theories of motivation.

Content theories

Content theories concentrate on what motivates individuals in their work.

There is often an assumption that the same things motivate everyone. Rewards will satisfy a need and individuals will be motivated to obtain those rewards.

Examples of content theory are:

- Maslow's hierarchy of needs
- Herzberg's hygiene and motivator factors
- McClelland's motivational needs theory (although there are also elements of process theory in motivational needs theory).

Process theories

Process theories of motivation concentrate on the process by which individuals are motivated, and the strength of that motivation. In other words, the key question is: 'how are people motivated?'

It is argued that individuals are motivated differently, and the strength of their motivation depends on a variety of factors, such as:

- needs
- personality
- perceptions about whether more effort will result in achieving goals
- the rewards
- expectations about whether the rewards for achieving the goals will actually meet the individual's needs.

Rewards and perceptions of rewards are usually a key factor in process theory.

Examples of process theory include:

- Vroom's expectancy model
- Handy's motivational calculus.

1.2 Maslow: the hierarchy of needs

In the 1950s, US psychologist Abraham Maslow developed a theory of the motivation of individuals at work. He argued that individuals have seven in-built needs, and his theory is concerned with the motivating power of each of these needs.

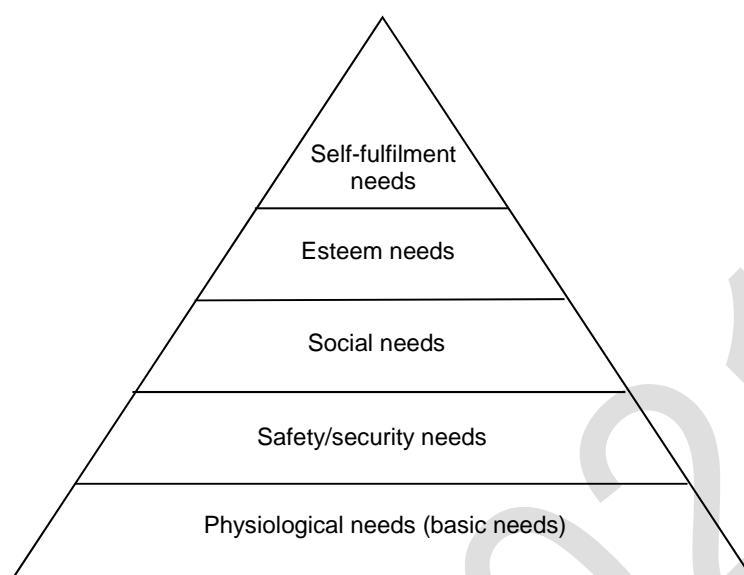
Two needs are needs of a 'higher order' that must be met before the other five needs can be satisfied. These higher order needs are:

- a need for freedom of inquiry and expression: social conditions must allow free speech and encourage justice, honesty and fairness
- a need for knowledge and understanding: a need to explore and experiment.

The other five needs can be arranged in a hierarchy of five levels. The need at a lower level is dominant until it has been satisfied. When the need at one level has been satisfied – and only then – the need at the next level becomes dominant.

- A need that has been satisfied no longer motivates the individual.
- An individual is motivated by the need at a level in the hierarchy that has not yet been satisfied.
- The highest level of need – self-actualisation – can never be fully satisfied.

The hierarchy of needs (the five levels of need) is usually drawn as a pyramid.



Physiological needs (basic needs)

These are the needs for food, shelter, clothing and everything else that we need to stay alive. These needs can be satisfied by money.

Safety needs or security needs

Safety needs are the needs for security in work. Individuals want to feel safe against the risks of unemployment, and they want protection against the consequences of illness or having to retire. People also want fair treatment at work. These needs can be satisfied by:

- employment legislation and
- the employer's arrangements for a pension scheme for its employees and for the treatment of its employees who are affected by illness or injury.

Social needs

Social needs are the needs to interact with other people, and to be part of a group. At work, social needs can be met by working with other people. However, the way in which work is organised has an important effect on whether the social needs of employees are fully met.

Esteem needs (or ego needs)

Esteem needs are the needs for the esteem of other people, and to feel good about one's own value or importance. Esteem needs can be met by promotion and by the status of the job. However, promotion only offers short-term esteem. In the longer term, individuals get esteem from their work by having some say in how their work is organised.

Self-fulfilment needs (self-actualisation needs)

These are the needs to achieve something worthwhile in life. This need is never fully satisfied. An individual at this level in the hierarchy needs continuing success and achievements.

The significance of Maslow's ideas

The significance of Maslow's ideas is that it suggests an approach that management should take to improving the motivation of employees. Management must make sure that lower-level needs are satisfied before they try to motivate employees with initiatives aimed at the satisfaction of higher-level needs.

For example:

- Pay is extremely important, because it satisfies basic needs. Employees must be paid enough to satisfy their basic physiological needs (whatever these are perceived to be).
- Unless employees feel secure in their job, there is no point in trying to increase motivation through job design that improves social interaction.
- Making individuals feel part of a group must come before satisfying needs for esteem and status.

Limitations of the hierarchy of needs

The hierarchy of needs is a simple and logical idea about human motivation, but it has significant weaknesses and limitations. The main problem is its assumption that needs are the same for all people and can be satisfied for everyone in the same way.

- Individuals have different needs, and they are not necessarily in the hierarchical order suggested by Maslow.
- Many individuals may seek to satisfy several different needs at the same time.
- The same need may cause different reactions and responses from different individuals.
- There is an underlying assumption that the objectives of the organisation will be achieved if individuals receive rewards of higher status (promotion) or self-fulfilment. Maslow does not show any link between self-fulfilment and improved organisational performance.
- Maslow's model is vague about the nature of self-actualisation or self-fulfilment needs. More modern theories of motivation go into much more detail about the nature of high-level needs and their satisfaction.
- It is a 'content theory' of motivation. It does not explain the strength of motivation, nor the effect on motivation of people's perceptions.
- The theory also fails to recognise that self-actualisation is not always possible. The environment in which the organisation operates may not be suitable for self-fulfilment – for example the nature of the product or service of the organisation, its technology or environment might mean that organisations should not (and cannot) offer their employees the satisfaction of self-actualisation needs. An example might be working on the factory floor. It is difficult to achieve self-actualisation working in a low-level job in a factory environment

1.3 Herzberg and motivation-hygiene theory (two-factor theory)

In the 1950s, Frederick Herzberg carried out some research into the factors that motivate individuals in their work, by interviewing 200 engineers and accountants. He developed a two-factor theory of motivation, which he set out in his book *The Motivation to Work* (1959).

Herzberg identified two groups or categories of factors: those causing dissatisfaction with work and those causing satisfaction. He called these:

- ❑ **hygiene factors** (= the factors causing dissatisfaction) and
- ❑ **motivator factors** (= the factors causing satisfaction).

The most significant hygiene and motivator factors were as follows:

Factors causing dissatisfaction	Factors causing satisfaction
Hygiene factors	Motivator factors
Company policy	Achievement
Supervision	Recognition
Relationship with the boss	The work itself
Working conditions	Responsibility
Salary	Advancement
Relationship with colleagues	Growth

It might be supposed that factors causing dissatisfaction and factors causing satisfaction are opposites. However, Herzberg argued that this is not the case.

- ❑ The opposite of dissatisfaction is not satisfaction: it is not being dissatisfied.
- ❑ The opposite of satisfaction is not dissatisfaction: it is not being satisfied.

The conclusion from Herzberg's analysis is that management need to deal with two different categories of factors affecting the concerns of employees in their work.

- ❑ Management need to make sure that hygiene factors are given proper attention. If employees are content with their hygiene factors, they will not be dissatisfied. For example, employees need to feel that they are being paid well enough in order to prevent them from being dissatisfied. However, satisfying the hygiene factors only prevents dissatisfaction, it does not create satisfaction.
- ❑ In order to motivate individuals, the motivator factors need to be satisfied. Creating motivation therefore means providing conditions at work that will make individuals feel a sense of achievement and recognition. According to Herzberg, a key factor in creating motivation is **job enrichment** – making the work itself more interesting and fulfilling.

1.4 McGregor: Theory X and Theory Y

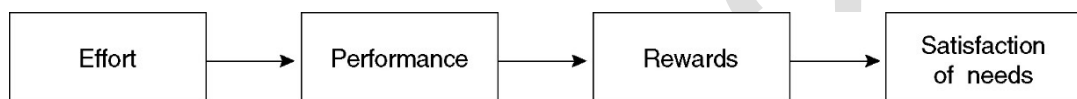
See previous chapter for details of McGregor and how the Theory X and Y management styles link to motivation.

1.5 Vroom: expectancy theory

Victor Vroom published his ideas on expectancy theory in 1964. Expectancy theory is a theory for predicting the strength of an individual's motivation to put in effort at work.

Vroom argued that our behaviour is the result of conscious choices that we make between different alternatives. We each have our own personal goals and needs for satisfying those goals. Some of these needs may be satisfied through work. We can be motivated to work if we believe that:

- there is a positive correlation between the efforts we make and the performance that is the result of our efforts – in other words, the more effort we put in, the better the performance will be, and
- good performance will result in a desirable reward, and
- the reward will satisfy an important need.



Rewards may be a mixture of:

- extrinsic rewards** – pay, bonuses, and so on
- intrinsic rewards** – promotion, sense of achievement, sense of recognition, and so on.

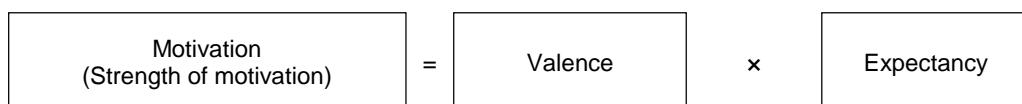
The motivation to obtain rewards is an important aspect of the theories of writers such as Vroom, Handy and McClelland, and it is important to understand that 'rewards' can consist of both extrinsic and intrinsic rewards.

Vroom also argued that there are two or three specific factors that determine the strength of an individual's motivation;

- Valence.** Valence is the strength of the individual's need for rewards.
- Expectancy.** Expectancy is the strength of the individual's belief that by putting in more effort, he will improve his performance.
- Instrumentality.** Instrumentality is the belief of an individual that by achieving a certain performance target, rewards will be obtained.

In a simplified version of the expectancy model, expectancy is defined as the belief of the individual that by putting in more effort, he or she will get the desired rewards. In this simplified model, expectancy is therefore a combination of expectancy and instrumentality.

Vroom's expectancy model for measuring the strength of an individual's motivation is:



Implications of expectancy theory

Expectancy theory has several implications for management.

- ❑ Motivation depends partly on **valence**, which is the strength of an individual's desire for particular rewards. Managers should therefore try to find out what their employees do want.
- ❑ Motivation also depends on **expectancy**. Some individuals do not believe that they are able to achieve better performance by trying harder. They may lack self-confidence, or lack training. (Alternatively, they may not be in a position to affect performance, in which case motivation will be very low, and possibly nil.) Management must consider ways of trying to increase the expectancy of their employees, for example by providing training and development, giving them the resources they need to do the job, or by providing supervision and guidance.
- ❑ Instrumentality may also affect motivation. Managers must keep the promises that they have given of rewards for performance – and try to make sure that employees believe that the managers will keep their promises.

1.6 McClelland: motivational needs theory

David McClelland (1917 – 1998) put forward a motivational needs theory, which he developed into a needs-based motivational model.

He argued that there are three needs that are found in all employees. Everyone displays all three needs, but one of the three needs is often dominant in affecting the individual's attitudes and behaviour. The three needs are:

- ❑ a need for achievement ('n-ach')
- ❑ a need for authority and power ('n-pow')
- ❑ a need for affiliation ('n-affil').

He identified the characteristics of individuals who are motivated mainly by the needs for achievement, power and affiliation, as follows:

- ❑ **N-ach person.** This person seeks achievement. Targets for achievement should be **realistic** but **challenging** goals. The person also seeks advancement in the job, and has a need for:
 - feedback: this is information about his achievements and progress towards the goals – the individual needs to know whether or not the goals are being met
 - a sense of accomplishment from achieving the goals.
- ❑ **N-pow person.** This person needs to be influential and effective, and to make an impact. He has a strong need to lead, and for his ideas to be accepted rather than the ideas of others. He needs status and prestige.
- ❑ **N-affil person.** This person needs friendly relationships and is motivated by interaction with other people. He needs to be liked and held in high regard. He makes a good 'team player'.

McClelland argued that n-ach people make the best leaders. However, they can demand too much from their employees, because they often assume that everyone else is motivated by the same need for achievement that they have.

- ❑ N-affil individuals are usually poor leaders. This is because their need to be liked will often affect their objectivity and prevent them at times from making unpopular but necessary decisions.
- ❑ N-pow individuals are also poor leaders. They are often determined individuals, with a strong work ethic and a commitment to their organisation and its goals. However, they often lack 'people skills' (skills at dealing with other people) and also lack flexibility.

Achievement-motivated individuals are usually the ones who make things happen and get results.

- ❑ They set goals that they can influence (so the goals are achievable): this is a characteristic of successful businessmen and entrepreneurs.
- ❑ They consider achievement more important than financial rewards.
- ❑ Achieving a goal or successfully completing a task gives them more satisfaction than praise or thanks from others.
- ❑ Security and status are not prime motivators for them in their work.
- ❑ They are constantly looking for ways to do things better.
- ❑ Crucially, however, they need feedback about their performance. They must be told about their actual performance and what they have achieved.
- ❑ For achievers, pay is a form of feedback about their performance. High pay and bonuses are a measurement of their success in achieving goals.

1.7 The link between motivation and productivity

It has been argued that if an individual is motivated by his or her work, enjoys doing it, and gets a feeling of satisfaction or self-actualisation from doing the work, then the individual is likely to be more productive.

Research appears to support this argument, and it is therefore reasonable to suppose that a motivated individual will want to perform better, and is likely to do so.

It is worth remembering, however, that productivity is a measure of the speed or quantity of work produced. A motivated individual may not work faster, although arguably he or she might do so. It is perhaps more likely that motivated individuals will be more effective in what they do, because their satisfaction comes from enjoyment in doing their job well.

2 REWARD SYSTEMS AND MOTIVATION

Section overview

- Extrinsic and intrinsic rewards
- What managers can do to motivate staff
- The reward system and motivation
- Constructive feedback and motivation

2.1 Extrinsic and intrinsic rewards

For an individual, rewards from doing a job can be both extrinsic and intrinsic.

Extrinsic rewards are rewards that are outside the control of the individual. Another person, often the individual's boss, has the power to provide extrinsic rewards. The main examples of extrinsic rewards are:

- basic pay (and the size of a pay increase)
- cash bonuses and incentive payments
- when the employer is a company, rewards in the form of share options or a gift of some shares
- pension benefits
- free medical insurance (and other forms of insurance, such as disability insurance, or even life assurance)
- the award of a company car, or a company helicopter or jet
- subsidised loans (these are loans from the company at an interest rate that is lower than the normal market rate).

Intrinsic rewards are rewards that are within the control of the individual himself. They include:

- a sense of achievement in doing the work
- a sense of recognition for doing the work
- enjoying the status that the job provides
- pride in doing the work
- personal satisfaction from doing the work
- a sense of responsibility that the individual enjoys.

According to theorists such as Vroom and Handy, the strength of the motivation of an individual depends partly on how strongly the individual wants these rewards – and how big are the expected rewards.

2.2 What managers can do to motivate staff

There are differing views on how individuals are motivated. Consequently, there are differing views about what management can do to improve the motivation of their employees.

- There is a view that management must **get the 'basics right' first**: they must offer a fair pay structure for staff and fair employment policies – to

meet the physiological needs and security needs of their employees (Maslow) or to prevent dissatisfaction from employees (Herzberg).

- Herzberg argued that management should take some measures to prevent dissatisfaction, but that a completely different approach is also needed in order to create motivation. Herzberg believed that **job enrichment** was a key to better motivation.
- Adams argued that the **rewards system** should be seen to be fair: however, rewards can be intrinsic rewards as well as extrinsic rewards such as higher pay.
- McGregor and Argyris argued in favour of a **participative style of management**, and getting employees involved in problem-solving and decision-making. They argued that this management style gets more out of employees, and this improves the performance of the organisation.
- McClelland argued that the best leaders were individuals with a **need for achievement**. Management should therefore try to identify and develop high achievers.
- One of the factors affecting the strength of motivation is the belief that the individual's efforts will lead to better performance. Managers should therefore try to increase the strength of this expectancy. Vroom argued that managers should give encouragement and advice to their employees, give them the resources they need to accomplish their tasks and, where necessary, give them suitable training.
- It can also be argued that managers can motivate staff by providing inspiring **leadership**.

The ability of managers to motivate their employees may also be affected by the differing needs of different employees. Whereas some content theorists (Herzberg) argued that all individuals were motivated by the same needs, there are differing views that:

- different people have different needs (for example, McClelland, Vroom)
- these needs can change over time (for example, Maslow).

It seems clear, however, that:

- managers can influence the motivation of their employees
- needs as well as rewards are an important factor in motivation, therefore
- managers must try to understand what the needs of their employees are, and what rewards – intrinsic as well as extrinsic – will help to satisfy those needs.

2.3 The reward system and motivation

The reward system refers to the system of 'extrinsic' rewards that an organisation can give to its employees. The most significant extrinsic rewards are usually:

- pay (remuneration), and
- promotion or advancement.

Elements of pay include basic pay, bonuses, commissions, premium pay for working overtime, pension rights and so on.

It is generally agreed that individuals need to be kept satisfied about their pay, in order to avoid feelings of dissatisfaction or inequality and unfairness. Dissatisfaction about pay will affect the attitudes and behaviour of individuals in their work.

It is not certain, however, whether offering pay incentives will increase the motivation of employees. (It is also not certain that extra motivation will lead to better performance.)

- ❑ McClelland would have argued that pay rewards might be seen as a measure of recognition and goal accomplishment by high achievers. Rewards in the form of higher pay or bonuses may therefore be an important motivator.
- ❑ It may also be argued that getting paid more for better performance (for example receiving a cash bonus) is important for many individuals, because the money can be used to fulfil some important needs.
- ❑ Process theories of motivation often place strong emphasis on financial rewards, because money can be used to buy satisfaction of many needs.
- ❑ There is also a view that group reward systems are able to improve the collective motivation of teams.

However, as explained already, there is also a view that in many organisations, pay systems do not provide motivation, and employees can be motivated by other things, such as participation in decision-making or an 'enriched' job.

Performance-related pay for individuals

Even so, many organisations in practice do have systems for rewarding individuals for the achievement of certain levels of performance or performance targets.

Performance-related pay may be cash bonuses or other forms of incentive.

- ❑ **Cash bonuses** are payments in cash that are related to meeting short-term targets, such as meeting budget targets such as achieving or exceeding a profit target. Sales representatives may be paid a sales commission based on the value of sales they have won during a period of time. Performance targets do not have to be financial targets: cash bonuses might be paid to an individual who achieves a specific non-financial target, such as completing a particular task on time or before a specified date.
- ❑ **Incentives** for the achievement of longer term goals are often paid to senior managers, often in the form of **company shares or share options**.

If companies use a system of performance-related pay, they presumably believe that the pay incentives are successful in motivating employees. If they did not think that this was the case, there would be no point in offering the incentives!

It is also important to remember that rewards are not always given in the form of pay. Promotion and recognition may be equally important to an individual. However, there is a limit to the number of individuals who can be rewarded with promotion, especially in small business entities.

Performance-related pay for groups

Cash bonuses might be paid to groups of workers, such as all the employees in a department, section or project team. For group bonuses to be effective as a motivator, however, it is important that individuals should identify themselves with the group and should believe that the efforts of the group as a whole are capable of earning a bonus.

A problem with group bonuses, however, is to decide how the total bonus for the group as a whole should be divided between the individual group members. If the basis for sharing the bonus is seen as unfair, a bonus payment might create resentment and arguments rather than act as a motivator.

Company-wide bonuses

Sometimes a company pays a bonus to all its employees, particularly if it has had a highly profitable year. For example in 2007, UK stores group Marks and Spencer announced strong profits growth for the previous year and a £91 million bonus to be shared by all its employees as a reward. Such a bonus might help to persuade employees to remain with the company, but it is doubtful whether it can be effective in motivating individual employees to do their work more efficiently or effectively.

Bonuses and performance

For a cash bonus scheme to be effective, the payment of a bonus should be clearly linked to the performance of an individual (for individual bonuses) or a group (for group bonuses). A clear link can only be established when the following conditions apply:

- The performance of the individual or group can be measured.
- The individual or group can affect the measured performance through efficient or effective working. As stated in some of the earlier descriptions of motivation theory, there should be a connection between effort (motivation) and outcome.

2.4 Constructive feedback and motivation

Process theories of motivation emphasise the importance of:

- the link between putting in more effort and improving performance (or reaching targets), and
- the link between reaching targets and obtaining rewards.

Individuals need to know how they are performing, and whether they are on course for achieving their goals.

If they are not on target for achieving their goals, they need to be given advice and guidance from their boss.

The process of providing information to individuals about their performance is an example of **feedback**. Feedback should be constructive and helpful, rather than critical, to maintain the motivation of the individual. If individuals are criticised in a negative way for failing to reach their goals, their motivation will disappear.

A system for providing constructive feedback about performance (but not the only system) is a system of **job appraisal**.

3 OTHER MOTIVATION CONCEPTS

Section overview

- Management by objectives (MBO)
- Self-efficacy
- Law of effect and reinforcement theory
- Equity and organisational justice

3.1 Management by objectives (MBO)

Introduction

Management by objectives (MBO) is an approach that seeks to align employees' objectives with the organisation's goals. The system was developed by Peter Drucker in the 1950's and has proved popular ever since.

Benefits of MBO

- MBO ensures that team members are clear about their work and how it benefits the whole organisation.
- This enables employees and managers to distinguish between tasks that are necessary and those that do not contribute to the organisation's objectives.
- MBO helps managers control teams and provides a robust reference point for team briefings, goal setting, performance appraisal, delegation and feedback.
- Provides a sense of purpose for individuals

Disadvantages of MBO

- MBO is often challenging and lengthy to implement needing what can be perceived as an unnecessarily expensive underlying goal tracking system.
- Implementing MBO requires commitment across the whole organisation. Significant employee resistance can occur.

The MBO process

MBO involves six steps:

- The organizational objectives should be expressed concisely in easily-understood mission and vision statements.
- The organizational objectives must be cascaded down to employees. This involves setting goals and objectives for every business unit, department, team and employee – i.e. cascading down from level to level within the organization. Goals should be SMART.
- Goal setting should be a participative process with team members understanding how their personal goals and values fit with the organization's objectives.
- Monitor the progress of individuals and teams against their achievement of goals.
- MBO is designed to drive performance at all levels of the organisation. Whilst the overall approach, participative nature and monitoring components of the goal setting process are all important, it is as equally

important to adopt a comprehensive evaluation and reward system. The system should allow managers to strategically compensate employees for work they do and demonstrate that the achievement of objectives will be rewarded.

- Repeat the above cycle.

3.2 Self-efficacy



Definition: Self-efficacy

Self-efficacy is the measure of the belief in one's own ability to succeed in situations – to complete tasks and reach goals.

Self-efficacy in action

By determining the beliefs a person holds regarding their power and ability to affect situations, self-efficacy strongly influences both the power a person has to face challenges competently and the choices a person is most likely to make.

For example, when confronted with a challenge does an employee naturally believe they can succeed or will their default reaction be that they are convinced they will fail?

People with strong self-efficacy are those who believe they are capable of performing well which means they are more likely to view challenges as something to be mastered rather than avoided.

Human functions

Levels of self-efficacy impact human functions in a number of ways:

- Motivation** – people with high self-efficacy are more likely to make the effort to complete a task and persist with those efforts than people with low self-efficacy. However, this can also manifest as high self-efficacy people being over-confident, less thorough and less well-prepared compared to someone with low self-efficacy.
- Behaviour choice** – high self-efficacy generally leads to tasks being undertaken whereas low self-efficacy generally leads to tasks being avoided. High self-efficacy beyond one's ability level to complete a task can lead to poor execution of the task, whereas self-efficacy significantly below ability levels can lead to under-achievement and stifle growth. The optimal level of self-efficacy is considered to be slightly above ability.
- Thought patterns and responses**
 - High self-efficacy people will attribute failure to external factors, whereas low self-efficacy people will blame themselves.
 - Barriers and obstacles will stimulate high self-efficacy employees whereas they will tend to discourage low self-efficacy employees.
 - Employees with high self-efficacy tend to take a broader overview of a task and embrace 'big-picture' thinking whereas low self-efficacy employees will limit their thinking and focus on achieving rather than exceeding.
 - Low self-efficacy employees tend to think that tasks are harder than they actually are. This then can result in poor planning and increased stress levels.

- ❑ **Academic productivity** – It has been argued that students with high self-efficacy demonstrate better academic performance than those with low self-efficacy. This is because they are more likely to proactively take control of their learning experience, participate in class and enjoy hands-on learning experiences.

3.3 Law of effect and reinforcement theory



Definition: Law of effect

The law of effect is the belief that a favourable after-effect strengthens the action that produced it. The converse is also true.

This means that responses closely followed by satisfaction will become firmly attached to the situation and therefore more likely to reoccur when the situation is repeated.

However, if the situation is followed by discomfort, the connections to the situation will become weaker and the behaviour of response is less likely to occur when the situation is repeated.

Law of effect

The law of effect was first published in 1905 and evolved from scientists investigating the link between stimulus (S) and response (R). They concluded that once the stimulus and response are associated, the response is likely to occur without the stimulus necessarily being present.

They noted that responses that produce a satisfying or pleasant state of affairs in a particular situation are more likely to occur again in a similar situation.

Conversely, responses that produce a discomforting, annoying or unpleasant effect are less likely to occur again in a similar situation.

The original experiments involved a cat learning to press a lever to exit a box. A more up-to-date example frequently quoted is drug addiction whereby someone who receives a pleasant sensation from trying a drug for the first time is likely to repeat the behaviour.

Reinforcement theory



Definition: Reinforcement theory

Reinforcement theory states that people seek out and remember information that provides cognitive support for their pre-existing attitudes and beliefs.

The main assumption that guides reinforcement theory is that people generally do not like to be wrong. They feel uncomfortable when their beliefs are challenged and therefore seek out and remember information to help 'prove their point'.

One common example often cited is the world of politics where pre-election polls demonstrate that relatively few people remain undecided during pre-election lobbying. The majority of voters have a consistent voting pattern and seek out information in the political lobbying that justifies their beliefs and vote.

Reinforcement theory includes three primary mechanisms:

- ❑ **Selective exposure** - a change or shift in attitude can be interpreted as an admission that the original belief was inaccurate or inadequate. However, people generally do not like to be wrong. Therefore people tend to avoid information that may discredit their views in order not to have their opinions challenged.

When faced with inconsistent information the person may justify rejecting the information by attacking the source's credibility.

Selective exposure also manifests with people exposing themselves only to stimuli that are pleasurable and therefore avoid stimuli that may induce a negative reaction.

- ❑ **Selective perception** - when exposed to dissonant messages (given that in practice it is effectively impossible to avoid all such messages) people will skew their perceptions to coincide with what they desire.

To use the political example again, a voter may not agree with one of the policies of a politician that they otherwise support. Subsequently, one of three things may happen:

- The voter learns about the candidate's policy then either changes their opinion of the candidate or alters their own stance on the policy.
- The voter can accept disagreement but instead lessen the issue's personal importance.
- The voter engages in selective perception and misperceives the candidate's position in order to better align with their own stance (even though in reality they remain mis-aligned).

- ❑ **Selective retention** – this describes people only remembering items which are consistent with their own predispositions. Furthermore, the ease with which a person can recall information impacts the level and intensity of judgment related to the topic. Specifically, people who can easily recall an example related to the message are more likely to make an intense judgment about it.

This mechanism is often referred to as 'selective memory'.

Positive reinforcement

Positive reinforcement involves the addition of a reinforcing stimulus following a desired behaviour. The objective is to make it more likely that the behaviour will re-occur in future. Examples might include:

- ❑ Receiving public praise ("well done, great job") or an award for doing something well
- ❑ Receiving a bonus for achieving a sales target

Positive reinforcement is normally most effective:

- ❑ when it occurs immediately after the event
- ❑ when delivered with enthusiasm
- ❑ when it occurs frequently

Negative reinforcement

Negative reinforcement involves the removal of a stimulus following a desired behaviour. The objective is to make it more likely that the behaviour will re-occur because of the removal of the negative reinforcement in future.

Note the difference between punishment (aimed at preventing the re-occurrence of an activity) and reinforcement (aimed at increasing a behaviour).

Examples might include:

- An employee is loudly reprimanded for arriving at work late. However, if they arrive on time the reprimand does not happen. Therefore they are motivated to arrive on-time more frequently.
- The seat-belt warning alarm that sounds in cars if the seat-belt is not used. The annoying alarm then disappears when the seat-belt is engaged which encourages the seat-belt to be worn in future in order to avoid hearing the alarm.

Negative reinforcement is normally most effective:

- when it occurs immediately after the event; and
- when it occurs frequently

Reinforcement theory in business

Managers can target both positive and negative behaviours. However, it is argued that focusing on rewarding desired behaviour helps employees develop positive habits and foster less resentment than focusing on punishing negative behaviours.

Reinforcement theory can be employed in the business environment by adopting the following tactics:

- Set clear and reasonable expectations – limiting rewards to impossible or extremely difficult tasks can lead to anger and a sense of helplessness resulting in worse performance. Therefore, expectations should be clear and achievable.
- Identify strong motivators – the best way to do this is adopt a participative approach and mutually agree with the employees what an appropriate reward would be. For example, a parachute jump experience would not be a suitable reward for someone scared of heights.
- Encourage desirable behaviours – behaviour such as strong teamwork, quality production and punctuality should be reinforced in order to turn them into strong work habits over time. An effective technique is to target rewarding one behaviour at a time in order to eradicate negative behaviours in that sphere before moving onto the next negative behaviour to manage.

3.4 Equity and organisational justice

Employees on the whole care about justice. The traditional approach leads them to consider then conclude on the fairness of outcomes, procedures and interpersonal treatment as well as consider apparent injustices.

Modern perspectives on organisational justice take this classic view to the next level and examines the reasons employees care about justice (called 'content theories') and the processes that lead to both the formation of fairness perceptions, as well as individuals' reactions to perceived injustice (process theories).

In summary, organizational justice embraces the broader topic of employee perceptions of fairness in the workplace. Perceptions can be broken out into four categories:

- ❑ **Distributive justice** – this is conceptualized as the fairness associated with decision outcomes and the distribution of resources (e.g. pay or praise).
- ❑ **Procedural justice** – this relates to the fairness of the process that leads to the outcome – e.g. did the accused receive a 'fair trial'. Consider consistency, accuracy, ethics and absence of bias.
- ❑ **Interactional justice** – this refers to the interpersonal communication element of delivering news with sensitivity and respect once a decision has been made. Interactional justice is sometimes split into two streams:
 - **Interpersonal justice** – the perceptions of respect and propriety in one's treatment
 - **Informational justice** – the adequacy of the explanations given in terms of their specificity, truthfulness and timeliness.

Justice research can occur at a number of levels including:

- ❑ **Justice climate** - how shared perceptions of justice form within work groups and organizations
- ❑ **Organisational and national cultures** - how justice perceptions and reactions vary across cultural groups

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you can:

- Explain common theories of motivation including Maslow, Herzberg, McGregor, Vroom and McClelland
- Explain the link between motivation and productivity
- Describe the difference between extrinsic and intrinsic rewards and explain the link between rewards systems and motivation
- Summarise how 'management by objectives' (MBO) works
- Explain self-efficacy, the law of effect and reinforcement theory and equity and organisational justice

Teams

Contents

- 1 Individual and group behaviour in business organisations
- 2 Teams and team roles
- 3 Team formation and development
- 4 Effective and ineffective teams
- 5 Chapter review

INTRODUCTION

Detailed syllabus

The detailed syllabus includes the following:

C	Management and organisational behaviour		
	2	Management, individual and organisational behaviour	
		d	State the roles of individual and group behaviour in organisations
		f	Explain the nature and significance of team formation, development and management

Exam context

Teamwork is an important element of most modern businesses in order to achieve efficiency and effectiveness of operations. This chapter discusses the fundamentals of teams, team behaviour and their formation as well as team management techniques.

By the end of this chapter students will be able to:

- Differentiate between individual, group and team behaviour;
- Explain team formation, development and management including the theories of Belbin and Tuckman;
- Discuss characteristics of effective and ineffective teams and describe methods for improving team effectiveness.

1 INDIVIDUAL AND GROUP BEHAVIOUR IN BUSINESS ORGANISATIONS

Section overview

- Characteristics of individual behaviour at work
- Characteristics of workgroup behaviour: formal and informal groups
- Individual and team approaches to work
- The role of management in team building

This chapter looks at the role of individuals in work and the role of workgroups. You should be able to relate many of the ideas in this chapter to your own experience, either at work or in other entities, such as a business school or college.

1.1 Characteristics of individual behaviour at work

Individuals go to work for a number of reasons. The main reason is the need to earn money in order to have a good life outside work. Many individuals have a keen interest in the type of work that they are doing, and enjoy the work that they do.

Working in a business affects behaviour, but individuals behave in different ways.

- Individuals might think that when they are at work, the employer regards them as someone who is paid to do a job. They might therefore decide that they need to get on with the job they have been given, and perform the job adequately, so that they don't get into trouble from their boss.
- Some individuals have a pride in their work, and try to do their job to the best of their ability.
- Some individuals need to be told what to do by their boss; others are much happier using their initiative and getting on with their work without having to be told what to do.
- Individuals do not work in isolation, on their own. They work with colleagues, and individuals differ in the way they interact with their colleagues. Some enjoy communicating with other people, and like this aspect of their work. Other individuals do not communicate well with other people, and so might concentrate on their work and even refuse to join in conversations in the workplace.
- The behaviour of individuals can also be affected by the prospects of promotion, career advancement or higher pay.

1.2 Characteristics of workgroup behaviour: formal and informal groups

Individuals work with other people. A workgroup is a group of employees who act with a common purpose and a sense of identity. There are two types of workgroup:

- informal workgroups, and
- formal workgroups.

Informal workgroups

An informal workgroup is a group of employees that does not have a formal or an official identity. It is a group of individuals who get on well with each other and interact socially. They might have lunch together regularly, or might talk about

personal interests and family matters over a cup of tea or coffee. Some informal groups might meet together outside work, on a social basis.

Informal workgroups often develop a collective attitude to their work. This attitude might be positive, or it could be hostile to management.

Informal workgroups can also be important because of the way they communicate with each other. Sometimes, news of an event or a new development at work gets around much more quickly through informal communications (e-mail messages to colleagues and phone calls) – ‘through the grapevine’ – than it does by more formal communication channels.

Formal workgroups

Formal workgroups are created in order to organise work. The employer establishes workgroups to perform specific roles or functions. Each workgroup has a number of jobs to be performed, and employees are appointed to fill the job vacancies. When one employee leaves his job, another person is appointed in his place, and the formal workgroup continues unchanged.

Employees work together in their workgroups, each performing their own job within the group. The workgroup has a formal leader (a manager or supervisor), and will develop its own characteristics and ‘culture’.

The purpose of a formal workgroup

The purpose of a formal workgroup is to:

- combine the efforts of several employees, working together,
- to achieve a common goal.

Teams are established because individuals working on their own would be unable to achieve the same output or end results.

Comparison of formal and informal workgroups

The differences between a formal workgroup and an informal workgroup are set out below.

Formal workgroups	Informal workgroups
Members of the formal work team are appointed by management.	An informal workgroup comes together through the social interaction of its members.
Membership of a formal workgroup is ‘permanent’. Employees continue to work in the group until they leave their job or until they are moved to other work by the employer.	Membership of an informal work team depends on the social interactions between members. New members may join the group at any time, and existing members may leave.
A formal workgroup has a clear set of work tasks, with specific objectives. These are set by management.	An informal workgroup is not organised by management and does not have a specific objective or tasks.
The workgroup has a formal existence.	The informal group does not exist in a formal or clearly-defined sense.
Workgroup members have formal roles and job titles.	Informal workgroup members do not have set roles or titles.

Formal workgroups

A formal workgroup has a formal decision-making structure. Decisions are commonly taken by the group leader.

Management assesses the performance of a formal workgroup by its performance (efficiency and effectiveness in carrying out its tasks)

Formal workgroups work together through established procedures and systems.

Informal workgroups

Informal workgroups might not make any decisions that affect their work. However, if they do, the group members will reach a collective agreement.

An informal workgroup is not assessed. However, its collective attitude to management can range from supportive at one extreme to hostile at the other. Employee attitudes to management can be determined by the shared attitudes of informal groups.

Informal workgroups can be much more efficient (than formal methods) in communicating information.

1.3 Individual and team approaches to work

A function of a manager is to get the best performance possible from the employees who work for him (or her). There are two approaches to achieving effective performance.

- ❑ The **individual approach**. This approach is based on the view that work should be properly organised, and employees should be appointed to carry out specific job functions. If each individual performs his job effectively, the entire workgroup will perform effectively. The effectiveness of the workgroup is the total sum of the effectiveness of each group member.
- ❑ The **team approach**. This approach is based on the view that a workgroup will be more effective if its members work together as a team. Effectiveness comes from the ways in which the group members work with each other, as well as from the way that individuals perform their own job. A task of management should therefore be to develop an effective team, not just effective individuals.

A useful way of comparing these two approaches might be to think about a football team or any other type of sports team. The effectiveness of the team depends to a large extent on the individual talents and skills of the team members, and their ability to perform the function for which they are in the team, such as goalkeeper or goal scorer. However, the team will not be successful unless its members can also play well together.

- ❑ When team members do not work well together, the effectiveness of the team as a whole is less than the effectiveness of each team member taken individually.
- ❑ When team members work well together, the collective effectiveness of the team as a whole can be much greater than the effectiveness of each team member taken individually.

The effectiveness of individuals is important. However, the effectiveness of teams could be even more important.

1.4 The role of management in team building

A role of management is to provide leadership to teams and workgroups, so that the team is successful. More specifically, in addition to the more general tasks of a manager, team management involves:

- Bringing together a suitable group of individuals to form the team
- Allowing and encouraging the team to develop
- Assessing the performance of the team and, where appropriate, rewarding the team as a group for the performance it has achieved.

2 TEAMS AND TEAM ROLES

Section overview

- The differences between a workgroup and a team
- A successful work team
- Team roles: the ideas of Belbin

2.1 The differences between a workgroup and a team

For the purpose of your examination, you should make a distinction between a workgroup and a team. A team is a workgroup, but not all workgroups operate like a team.

A team is a workgroup in which the team members work effectively together, and:

- all the team members identify with the team and see themselves as part of a team, and
- the team reaches decisions by agreement and consensus.**

Decisions taken by a team have the support of the entire team, which means that a team cannot exist in a group where decisions are taken by the group leader (manager or supervisor) and imposed on the group, whether the group members agree with the decision or not.

- Since teams take decisions by consensus, it is impossible for large workgroups to act as teams. In a work environment, teams are often quite small.
- For a similar reason, it is difficult to build a team when the workgroup members are spread across different geographical locations. Team members need to meet and communicate on a regular basis.

Project teams

The word 'team' may be used to mean a project team. A project team has the following characteristics:

- A project team is created to perform a specific task, and is then disbanded. The team is often made up of individuals from different functional areas of the organisation (the team is 'multi-disciplinary').
- Other workgroups are more permanent, and are established to fulfil specific roles. They may be organised by function (for example workgroups in production, in marketing, in accounting, and so on).

2.2 A successful work team

A successful work team has several characteristics. Some of the characteristics of a successful team apply to effective workgroups in general. Others relate more specifically to teams.

- The team should have a clear purpose.
- Its area of authority should be clearly defined. The team members should know what they can do, and what they do not have the authority to do.
- The team should have effective leadership. One of the tasks of the team leader is to create an effective team: team leadership skills are therefore essential.

- ❑ If the team is a project team that is required to complete a specific task, there should be a clear timescale for completion of the task.
- ❑ The team should be given the resources that it needs (equipment, materials, money) to complete its tasks successfully.
- ❑ The team members should have the necessary skills or experience to complete their task successfully. Every individual does not need all the necessary skills; however, collectively, the team members should have all the skills, expertise and experience required.
- ❑ The team members should have the motivation and commitment to achieving the objectives of the team.
- ❑ There should be good communications between the team members. There should be an effective and rapid exchange of all relevant information.
- ❑ Each member of the team should perform a role that adds to the effectiveness of the team. The role of team members is partly to carry out technical or operational tasks. Team roles are also concerned with adding to the effectiveness of the way in which the team functions as a unit. Team roles are described below.
- ❑ There should be strong team loyalty and good teamwork. Morale or team spirit should be high, and there should be respect for the team manager.
- ❑ The work of the team should produce benefits for the business. Providing benefits to the business is essential, because this defines 'success'.

2.3 Team roles: the ideas of Belbin

An important contribution to ideas about the management of teams was made by **Belbin**. Belbin studied the behaviour of individuals in teams and the 'team role' that each individual plays. He defined a team role as 'our tendency to behave, contribute and interrelate with others in a particular way'.

He suggested that in a successful team, the team members should have a balance of certain behavioural skills. He identified nine types of behavioural characteristics that team members should have between them. (An individual may have more than one behavioural characteristic, which means that a team can possess all nine characteristics without the need for nine team members.)

The nine team roles are grouped into three broad groups:

- ❑ **Doing/acting.** Some team members are good at getting things done. When they see what needs to be done, they do it or encourage others to do it.
- ❑ **Problem-solvers and thinkers.** Teams are often confronted with problems and difficulties that need to be resolved. Some team members need to be good at finding answers to problems.
- ❑ **Showing concern for people.** A team is a group of individuals acting together in a work environment. A successful team needs members who have skills in bringing the team together, by showing concerns for others, by helping others or through communicating well with others and showing a concern for the team as a unit.

The nine team roles are as follows.

General nature- of the role	Team role	Description
Doing/ acting	Implementer	A well-organised and predictable person. He takes basic ideas and makes them work in practice. However, he can be slow.
	Shaper	A person with energy, and full of action. He challenges other members of the team to move forward and make progress. However, he can be insensitive to the feelings of others.
	Completer/ finisher	A person who is reliable in seeing a task through to the end and getting it finished. He sorts out minor problems and makes sure that everything is working well. However, he can worry too much and may not trust other people.
Problem solving/ thinking	Plant	A person who solves difficult problems with original and creative ideas. However, he is a poor communicator and may ignore details.
	Monitor/ evaluator	A person who 'sees the big picture' . He thinks accurately and carefully about issues. However, he may lack energy and an ability to inspire other people.
	Specialist	A person who is driven by a pursuit of knowledge and information , and wants to go into detail. The 'specialist' role is a behavioural characteristic rather than functional specialism. However, he becomes an expert in some key areas and will solve problems in those areas. He may be disinterested in all other areas of the team's activities.
Concern for people and feelings	Coordinator	A respected leader who helps everyone else in the team to focus on their particular tasks. However, he may be seen as wanting to control things too much.
	Team worker	A person who cares for individuals and the team, and who is a good listener. He works hard to resolve social problems between other team members. However, he may find it hard to take difficult decisions.
	Resource-investigator	A person who explores new ideas and possibilities with enthusiasm , and discusses them with others. A good 'networker'. However, he may be over-optimistic and may lose energy after an initial period of enthusiasm.

None of these nine roles is the role of team leader. The coordinator in a team may be the team leader, but this is not essential.

A useful way of trying to learn the nine team roles identified by Belbin is to think about the consequences for a team of not having a team member capable of performing any one of the roles in the list.

Managing a team: using the ideas of Belbin

Belbin suggested that teams will work most successfully when there is a suitable balance between these nine roles amongst the team members, and when team members:

- understand their role in the team
- work to their strengths, and
- try to manage their weaknesses.

A team manager can use the ideas of Belbin when developing a team to perform a particular function or task. The manager can assess the role or roles played by each team member, and look for roles that the current team members do not fulfil. These gaps should then be filled by recruiting new members to the team, or by encouraging existing team members to fulfil the missing role (if this is possible). If necessary, some existing team members should be replaced by new members who will perform the missing roles.

Belbin's ideas can be applied in practice fairly easily. Questionnaires have been developed that enable individuals to assess which behavioural characteristic (or characteristics) they have, and which team roles they can perform well.

Management can use this assessment of individuals to ensure that teams consist of individuals who together possess all the characteristics of a successful team.

3 TEAM FORMATION AND DEVELOPMENT

Section overview

- The ideas of Tuckman on team development
- The value of Tuckman's analysis
- Balance theory of group formation

3.1 The ideas of Tuckman on team development

Bruce Tuckman (1965) provided an analysis of how small teams develop and change character over time. The appropriate form of team leadership changes as the team goes through each new stage of development.

In Tuckman's original analysis, there were four stages of team development:

- forming
- storming
- norming
- performing.

In 1977, he added a fifth stage:

- dorming (also called adjourning, de-forming and mourning).

Forming

In the initial stage of its existence, a team is forming. The team is a collection of individuals, but their individual roles and responsibilities within the team are unclear. There is a high level of dependence on the team leader for guidance and direction. The team leader must therefore direct the team members, and tell them what to do.

Storming

The second stage in team development is storming. During this stage, decisions do not come easily. There is usually conflict between team members, and the attitudes, norms and preconceptions of individuals are challenged by other team members. Team members compete with each other for status and position within the team. There may be cliques and factions, and power struggles between them. However, there is an improvement in the clarity of the purpose of the team and its goals. The role of the leader is to act as coach to the team members, and to encourage them to focus on the team's tasks rather than on relationships and emotional issues. The leader also encourages team members to find compromises to settle conflict.

Norming

During the norming stage of team development, the team develops norms of behaviour and operating. The roles of the team members become clear. The way in which decisions are taken is also established. Major decisions are taken by the team collectively, with all team members contributing to the decision-making process. Commitment to the tasks of the team and team unity is strong. The team leader can use a participative style of management, so that team members take on greater responsibility for decisions.

Performing

During the fourth stage of team development, performing, the team operates at its full potential. The team members are strategically aware and they understand why the team exists and what it is trying to achieve. The team members are also able to get on with their jobs without interference from the team leader, and do not need to be told what to do. The role of the team leader is to delegate new tasks and oversee performance. Disagreements may occur between team members, but these are resolved in a friendly and constructive way.

Dorming (adjourning)

In 1977, Tuckman added a fifth stage of team development to his earlier analysis. There are various ways of describing this phase.

- ❑ The group may break up, having achieved its purpose. The members of the team may feel a sense of loss, and the break-up of the team may be stressful for them, particularly if it is unplanned and unexpected.
- ❑ Alternatively, the team may lose its efficiency, and might lose its ability to make good decisions. Members of the team may share common views that ignore developments in their business environment and changing circumstances. Keeping the group in existence becomes the prime objective of the team members, rather than achievement of the team's work objectives. It may be necessary to break up the team.

3.2 The value of Tuckman's analysis

Not all teams go through all the stages of development and some teams progress more quickly than others to the performing stage. Others get stuck and fail to reach the performing stage.

However, Tuckman's analysis is useful for the management of small teams for the following reasons:

- ❑ Management should be aware that it takes time to develop a new team, and should be patient in allowing the team to progress to the 'performing' stage of its development.
- ❑ However, it should also be possible to identify when a team is not progressing as it should and is stuck, for example, in the norming stage of development.
- ❑ Tuckman's analysis also gives some insight into the style of management that might be best-suited to the team at each stage of its development, in order to encourage the team to develop as rapidly as possible.



Example: Research team

Three years ago a research team was established in the business school of a university. Six members were appointed to the team. The purpose of the team was to identify research projects, obtain funding for the projects from commercial sponsors, carry out the research and prepare research papers for publication. Initially, there was a lot of uncertainty about what the group should do, or how it should set about the task of obtaining funding for their work.

As the team gained experience, the team became more confident about what it was doing and what it was trying to achieve. However there were some arguments between the team members about the work that each of them should be doing. They carried out their research as a group, but some team members were better at some tasks than others. Eventually, the group began to operate much more efficiently. Each member of the group adapted to a function, and each group member understood instinctively what each of them should be doing. Decisions were taken collectively as a team, by mutual agreement and consensus.

Recently, three team members left, one to take up a job in another business school and the others retiring from the business school for family reasons. Three new team members have been appointed.

The team leader needs to recognise that the team has reached a new stage in its development. Having gone through the forming and storming stages of development, and having reached the norming stage, the change in team membership has taken it back to a new forming stage. The team will have to go through the forming and storming stages again, to become as effective as it was before the three team members left.

3.3 Balance theory of group formation

Theodore Newcomb suggested that people are attracted to others on the basis of sharing similar attitudes and values relating to subjects such as work, marriage, lifestyle, politics, religion and authority. Once formed, people then attempt to maintain balance within those relationships of the attraction, common attitudes and values.



Illustration: Balance theory

Consider the situation where your best friend dislikes someone you love. In this situation there is an imbalance as either the ones you love should also be loved by your best friend, or conversely the ones you dislike should also be disliked by your best friend.

In the above illustration the imbalance will naturally lead to a change of attitudes. You may conclude that your best friend is not your best friend after all, or you may conclude that you don't love the person as you thought you did. The resultant change in attitude will then restore balance in your relationship.

Balance theory concludes that where tensions arise between or within people they will attempt to reduce those tensions through either:

- Self-persuasion; or
- By trying to persuade others

So, if we feel 'out of balance' we are motivated to restore a position of balance.

Note that balance does not need to reflect only positive emotions – two people who share mutual dislike represents a state of balance as equally as two people who share mutual attraction. An imbalance would occur if one party liked the other when the other party disliked the first party.

Balance theory and Tuckman

Balance theory can be applied to Tuckman by considering where attitudes change and imbalances are eliminated.

The journey from 'form' to 'perform' sees differences and conflicts removed and accepted rules and roles established through negotiation and persuasion in the storming and norming phases.

By the time we reach 'perform' stage, balance has been achieved with mutual recognition of skills and roles, and interpersonal relationships with accepted modes of communication established.

4 EFFECTIVE AND INEFFECTIVE TEAMS

Section overview

- Characteristics of effective and ineffective teams
- Evaluating team performance: success in achieving objectives
- Tools and techniques for building team effectiveness
- Factors that impact group cohesion

4.1 Characteristics of effective and ineffective teams

An objective of a team manager should be to create an effective team. He needs to understand what makes an effective team, and why a team might be ineffective, so that he can assess the effectiveness of his own team.

Many writers on the theory of business management and organisation have suggested what the characteristics of effective and ineffective teams are. Some of these characteristics are shown in the table below.

Effective work teams	Ineffective work teams
<p>Success. An effective team is one that is successful at achieving its goals or objectives.</p> <p>Teams that are only partially successful are likely to be ineffective in some ways.</p>	<p>Lack of success. An ineffective team fails to achieve its objectives or goals.</p>
<p>Focus. An effective team is aware of its goals and objectives, and keeps these in mind all the time. They use their time and resources well.</p>	<p>Lack of focus. An ineffective team sometimes loses sight of its objectives. Team members might allocate their time badly.</p>
<p>Collective decision-making. An effective team reaches decisions through discussion and agreement.</p>	<p>Decision-making is dominated by one team member. In an ineffective team, one person (or perhaps a very small group) makes the decisions, by imposing his views on the rest of the team. Other team members might disagree, but do not speak out.</p>
<p>Good communication. In an effective team, the team members communicate with each other well, and keep each other well-informed. They are also truthful in communicating with each other.</p>	<p>Lack of communication. In an ineffective team, communication might be poor. Team members might not be fully truthful with each other.</p>
<p>Collaboration. In an effective team, the members will cooperate and collaborate. Each team member will do whatever is necessary to get the job done, even if this means doing work that is unfamiliar and outside their normal experience.</p>	<p>Doing your own job. In an ineffective team, the team members do not give each other support. Each team member does his own job and is unwilling to do anything that is not specified in the job description.</p>

Effective work teams

Positive conflict. Positive conflict occurs when there is disagreement, but the team members are willing to discuss their differences fully, and reach a suitable agreement about what the solution should be. Some conflicts are inevitable in teams: the way that the conflicts are resolved is important.

Mutual support. In an effective team, each team member is aware of the contributions provided by the other team members.

Team spirit. In an effective team, team members identify themselves with the team and feel a part of the team. Team spirit and team loyalty is strong.

Ineffective work teams

Failure to resolve differences. In an ineffective team, the team members fail to resolve their differences properly. Disagreements are not discussed fully. They are often resolved by an ineffective compromise that 'patches up' the differences of opinion, and the compromise might not last for long.

Lack of mutual support. In an ineffective team, the team members are not properly aware of what the other team members have achieved.

Lack of team spirit. Members of an ineffective team do not have any team spirit and simply get on with their job.

4.2 Evaluating team performance: success in achieving objectives

One of the tasks of management is to evaluate the performance of the workgroup for which they are responsible. Performance evaluation is linked to planning, coordination and control. Measuring and evaluating team performance is also necessary when there is a system of team incentives and rewards.

There are various ways of measuring and evaluating performance. Three basic approaches to performance measurement are measurements of:

- economy
- efficiency, and
- effectiveness.

Economy is measured by the success of the team or workgroup in controlling its costs. Cost control may be judged by comparing actual spending with the planned spending limit. (There is often a spending limit for each workgroup or team in the annual budget for the organisation.)

Efficiency (or productivity) measures the amount of resources used for the tasks that have been achieved. For example, the productivity of a workgroup may be measured by the output per member of the team during a period of time, or the output per labour hour. Alternatively, productivity may be measured by the sales achieved per member of the team (for example, annual sales revenue per member of the sales team).

Effectiveness measures success in achieving goals and targets. Targets may be short-term or long-term. They may also be:

- quantitative – measuring the volume of work achieved or the size of results
- qualitative – measuring output in terms of quality (percentage of rejected items, level of customer satisfaction, and so on)
- timescale for achievement – whether a particular task is completed before a target date for completion.

Team performance may also be measured in other ways, such as the level of job satisfaction amongst team members. However, it is doubtful whether a clear link exists between work satisfaction and achieving the goals of the organisation.

4.3 Tools and techniques for building team effectiveness

The effectiveness of a team can be improved through good team management. A team leader should try to build a team by appointing individuals to fulfil all the necessary roles, and he should give it time to develop.

The manager should keep the team aware of its objectives and targets. He should encourage openness in communication and a full discussion of problems and ideas. As the team develops, he should allow the team to reach its own collective decisions.

Team-building tools

There are some training tools that may be used by team leaders to encourage the development of the team. These involve various types of team activities on training courses, such as 'outward bound' activities.

The purpose of this type of team training is to enable the team members to get to know each other and go through shared experiences outside the work environment. In addition, the tasks they are given force the team members to rely on each other in order to accomplish these tasks. Team members have to work for the 'good' of the team in order to benefit themselves.

The experience of such training courses should continue after the course has ended, so that team members work better together when they return to their work.

Motivation and incentives

It might also be possible to improve team effectiveness by offering incentives for the successful achievement of team objectives and targets.

4.4 Factors that impact group cohesion



Definition: Group cohesion

Group cohesion describes the strength of the bond uniting the group. When cohesion is strong the group will remain strong and stable and continue to exist. Conversely when cohesion is weak the group may ultimately disband.

Factors that impact group cohesiveness include the following:

Factor	Explanation
Size of group	Smaller groups tend to display greater cohesion than larger groups
Heterogeneous vs. homogeneous	Homogeneous groups who share common characteristics such as race, gender and religion will typically demonstrate greater cohesion than groups who are more diverse (heterogeneous) sharing fewer common characteristics.

Factor	Explanation
Group success	This is arguably a 'self-fulfilling prophecy' – the more successful a group the greater the incentive to be part of it and hence the greater the cohesion. The less successful the lower the cohesion.
Barriers to entry and prestige	Human nature means that the more difficult it is to become a member of a group the greater the desire for outsiders to join the group. Subsequently the group becomes prestigious and more cohesive. A good example might be an elite academic institution.
Task cohesion	The greater the need for a task to be completed by a group rather than individuals (e.g. a sports team or military operation) the more cohesive the group becomes as members on the whole accept the need to work together to achieve the shared objective.
Rewards and punishment	The availability of reward for membership and/or punishment for leaving can have a bearing on the attractiveness of being part of a group and hence influence group cohesion.
Competition from external groups	A lack of competition from alternative groups can lead to erosion in cohesion as members do not feel any pressure to perform. However, with the emergence of competition, groups typically become more cohesive as their competitive instincts amplify and the desire to defeat a rival drives them on.
Location	Groups who enjoy segregation from others will tend to be more cohesive as strong interpersonal communication patterns develop and a sense of visible identity builds.
Leadership style	An effective leadership style that matches the skills and personalities of the group can have a significant impact on promoting group cohesion. An ineffective leadership style for that particular group of people is likely to have the opposite effect and erode group cohesion.
Social cohesion	Social cohesion is the degree to which group members enjoy each other's company and how much they like each other. Group cohesion will be highest when members enjoy the social side of being part of the group.

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Differentiate between individual, group and team behaviour
- Explain team formation, development and management including the theories of Belbin and Tuckman
- Discuss characteristics of effective and ineffective teams and describe methods for improving team effectiveness

Communications in business

Contents

- 1 Effective communication
- 2 Effective business messages
- 3 Email
- 4 Video conferencing
- 5 Chapter review

INTRODUCTION

Detailed syllabus

The detailed syllabus includes the following:

C	Management and organisational behaviour	
	3	Communication in business
	a	Explain the basic elements of communication.
	b	Explain verbal and non-verbal communication.
	d	Explain organisational communication:
	i	Formal and informal
	ii	Internal and external
	e	Explain methods of business communication.
	f	State the barriers to effective communication.
	g	State the different communication patterns.
	h	Explain the process and conduct at meetings.
	j	Explain the process of electronic communication.

Exam context

This chapter considers the essential management skill of communication with others, and the various patterns of communication and communication methods. This skill is also relevant to the work of professional accountants, and you may find it useful to consider your own skills in this area as you work your way through the chapter.

This chapter addresses basic theories of communication as well as considering business communication in particular. The chapter closes with sections on email and video conferencing.

By the end of this chapter students will be able to:

- Explain basic communication theory including formal and informal communication, communication models, attributes of effective communication and barriers to and methods of communication;
- Describe patterns of communication including vertical and lateral;
- Understand the components of and plan effective business messages using the objectives, audience, structure and style model;
- Describe the different media and channels typically used in business communications including oral and face-to-face, written, visual aids and non-verbal;
- Explain the conduct of a formal meeting;
- State the main features of email;
- Explain the benefits and limitations of email;
- Describe when to use different channels of communication;
- Advise the basics of email etiquette;
- Describe the main features of video conferencing;
- Explain the benefits and limitations of video conferencing.

1 EFFECTIVE COMMUNICATION

Section overview

- Formal and informal communication in the workplace
- The need for effective communication
- Communication models
- Attributes of effective communication
- Barriers to communication
- Methods of communication
- Patterns of communication: vertical and lateral communication
- Other patterns of communication

1.1 Formal and informal communication in the workplace

In work, as in all aspects of living, people must communicate. They have to give instructions, provide information, obtain information, communicate ideas, listen to the ideas of other people, announce decisions (tell other people what they intend to do), and so on.

The effectiveness of an organisation depends to a large extent on the effectiveness of communication by its managers and employees.

Information is exchanged in two ways, formally and informally.

- Formal communication is communication that is passed through official 'channels' established by the organisation. Examples of formal communication are reports and instructions by a manager to a subordinate. Formal communication passes through the formal management structure and 'chain of command'. Individuals receive and give information because of their position in the organisation.
- Informal communication is communication between individuals in an organisation that does not pass through an official channel. Instead, the information is passed by individuals in general conversation, sometimes as gossip or as rumour. Often informal communication passes as unofficial e-mails between colleagues.



Example: Mega

Mega Company dismisses its finance director on Monday. It makes a formal announcement to staff about the dismissal on Friday of the same week. However, most people had already heard about the dismissal, because the news had been 'leaked' and passed from person to person within the organisation.

In this example, the informal communication system has operated more quickly than the formal communication. If it is accurate, it is therefore more efficient. Unfortunately, informal communication may be inaccurate.

Comparison of formal and informal communication

All organisations rely on a mixture of formal and informal communication to operate effectively.

Formal information is often slow in coming. Organisations therefore often rely on informal communication for the transmission of information, when the formal system is slow and bureaucratic, or where senior managers are autocratic and do not believe in sharing information with subordinates.

Informal information usually passes between individuals very quickly. A problem with informal information is that management has no control over it. They control formal communication channels, but not informal communication. With informal information, it is sometimes a matter of chance who gets the information and who does not: some individuals might be totally ignorant of what most of their colleagues already know.

In an effective organisation, there should usually be an efficient formal communication system, so that accurate information is passed in good time to everyone who needs it. When formal communication is reliable, relevant and timely, employees will trust it.

However, even with the most efficient formal communication system, informal communication systems always exist. People talk to each other unofficially and socially: they exchange stories, rumours, gossip and so on, and they don't always communicate with each other in their 'official capacity'. Even in their work, individuals often prefer to communicate informally, in face-to-face conversations, or by telephone or e-mail, rather than by more formal methods such as memos and reports.

1.2 The need for effective communication

Effective communication at work is the exchange of information that individuals need to do their work properly. It needs to be clear (understandable), relevant, reliable and timely. Effective communication is essential so that:

- Instructions and guidelines are properly understood.
- Individuals know what they are expected to do.
- There is better co-ordination between people and groups in the organisation.
- Managers are able to plan and control operations more effectively.
- Individuals are more willing to work together in teams or groups, because they are being told what is happening and where their contribution fits in.
- Secrecy, misunderstanding and mistrust are eliminated. Open communication increases trust.
- Arguments and conflicts in the work place are reduced.

1.3 Communication models

Communication models are sometimes used to study the effectiveness of communication. A problem in organisations is often that communication is ineffective or inefficient. People do not receive the information they need, or they get the information too late. In many cases, the person receiving information or an instruction misunderstands what the sender of the message is trying to say.

Effective communication occurs when the receiver of information gets the information from the sender, and understands completely what the sender of the message intended.

Communication models can be used to look at the reasons for ineffective communication, or what is needed to make communication more effective.

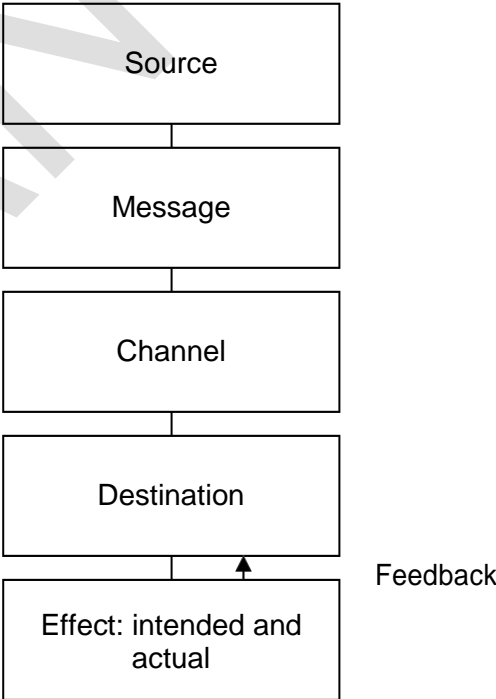
Early communication models

Early communication models were developed in the 1930s to understand the effectiveness of political propaganda. These models are simple, but still relevant.

A simple communication model considers the following elements in communicating an item of information or a decision:

- Who sends the information? This is the 'source' of the communication.
- What is the content of the information? This is the 'message'. What does the message say?
- By what method has the information been given or sent? What is the channel of communication? Has the information been given verbally, in a face-to-face discussion or by telephone? Has it been sent by e-mail or by letter? Is it in a report? Is it in a published book or journal? Television? Radio? Web site?
- Who is the information sent to? This is the 'destination' of the information.
- What effect has the communication had on the recipient? Is this the intended effect?
- Does the sender of the message expect any response to the message? If so, how clear or effective has the response been?

The basic elements in a communication system are shown in the diagram below. The effectiveness of a communication system depends on the effectiveness of each element in the system.



Feedback

In the context of a communication model, feedback involves the recipient of a message confirming with the sender of the information that he has got the message, and checking that he has understood the message correctly. The sender of the message is able to confirm that the recipient has understood it properly, or can try to correct any misunderstanding.

The value of this model is that it is possible to look at the causes for ineffective communication by looking at each element in the communication.



Example: Feedback

Manager X, sent an e-mail message to a subordinate Y, giving him some information and asking him to carry out a particular task. Subordinate Y did not do what manager X wanted.

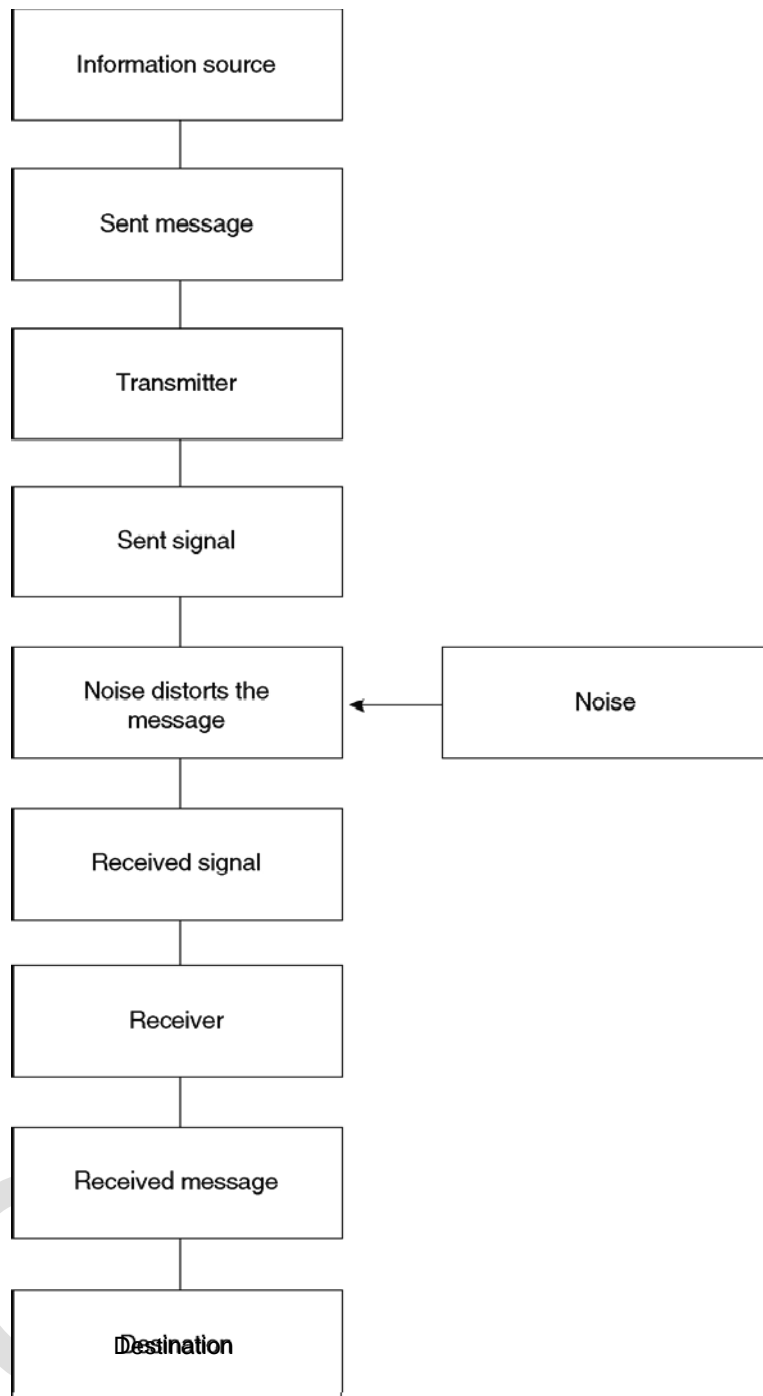
To find out why the instruction was not followed, we can look at each element in the communication link:

- Was the instruction not followed because manager X did not actually send it?
- Was the instruction not followed because subordinate Y did not read his e-mail messages, or because the e-mail system was not working?
- Was the instruction not followed because the content of the message from manager X was unclear or misleading?
- Was the instruction not followed because subordinate Y did not understand what manager X was telling him to do, even though the message was clear?
- Was the instruction not followed because subordinate Y was fed up of getting instructions from his manager that he considered a waste of time, and so he did not bother to act on the instruction?.
- Was the instruction ineffective because the sender of the message did not receive feedback, to inform him that the instruction had been carried out successfully?

Shannon and Weaver's communication model

Another communication model was developed by Shannon and Weaver in 1949. They were interested in how information seems to get lost or changed or misunderstood in transmission, and they studied telephone messages from one country to another.

Their model introduced the concept of **noise**. Noise is anything that distorts a message or makes it difficult to understand. The term comes from the noise of interference on a telephone line or in a radio message that makes the voice of the sender impossible to hear.



The obvious cause of noise is technical failure or technical problems. For example an e-mail message might fail to reach its destination for any of the following reasons:

- The server (computer) for the e-mail system is temporarily out of service.
- The message is sent to an invalid or incorrect e-mail address.
- The e-mail message is treated by the recipient's anti-'spam' software as an unwanted message, and is diverted automatically into an unwanted messages box.

Noise is also caused by a failure of the sender and the receiver of a message to communicate properly. If there are problems with communication, the problem may be a distortion in the message in transmission.

Redundancy

One cause of 'noise' may be that the person receiving a message does not understand it properly, or understands it but does not give it much attention and so forgets about it.

- A message might be unclear because the sender has failed to make the message clear enough, or has even made a mistake in the message.
- Another reason for 'noise' is that the receiver of the message does not understand the message from the sender, possibly because it is too 'technical' or complex.
- A message might be ignored simply because the receiver does not believe it, and thinks that the sender 'must have got it wrong' or is deliberately trying to tell an untruth.

One approach to getting round the problem of lack of understanding in a message is **redundancy**. Redundant information is information that is repeated. The information should be unnecessary, because if it has been given once, there should be no need to give it again. However, it may be more effective to give the message twice, three times or even more times, to make sure that the messages gets through clearly to its intended recipient.

An example of redundancy in information is advertising. A person who sees an advertisement once has got the message, but the message may not have any effect unless the person sees the advertisement many times.

The attitude of the recipient of information

Some communication models consider the effect on communication of the knowledge, attitudes and behaviour of the recipient of the information. A message might fail to prompt the intended response in any of the following situations:

- The recipient of the message wasn't paying proper attention.
- The recipient does not have the knowledge or experience to understand the message.
- The recipient has a personal dislike of the sender, or is in conflict with the sender.
- The recipient gets the message but then forgets it.

1.4 Attributes of effective communication

Effective communication depends to a large extent on the quality of the information that is communicated. The qualities of good information are described in an earlier chapter.

Other attributes of an effective communication system are as follows.

- Messages get through quickly and without difficulty when they are sent. Or information is available to individuals when they need it. 'Noise' should not disrupt the sending of messages.

- Messages should be understood, and their content and intention should be clear.
- Messages should achieve their intended purpose. The intended purpose of a communication might simply be to inform other people. However, a communication might be intended to make someone act, respond to the message or reach a decision.
- An efficient informal communication system should supplement the formal communication system.
- Every individual within the organisation should feel **confident** that he or she is receiving all the information needed to do their job.

1.5 Barriers to communication

A barrier to communication is anything that stops information from:

- getting to its intended recipient(s)
- being understood by the recipients, and
- being acted on in the way intended.

Communication models can be useful in identifying barriers to communication. However, you may be familiar with the following barriers to communication from your own experience:

- The sender of the message might think and express his ideas in a different way from the recipient. For example, people of different generations often find it difficult to communicate with each other and understand each other.
- The sender of information might use **technical words ('jargon')** that the recipient does not understand. For example, accountants might talk to non-accountants in technical terms that the non-accountant does not understand.
- The sender of the message and the recipient of the message might speak different languages.
- Personal dislike or antagonism between individuals, and a lack of trust between individuals, will make it difficult for them to communicate effectively.
- There may be **technical 'noise'**, such as a breakdown in the communication system itself.
- Information overload.** The recipient of information might be given so much information that he cannot take it all in, and so does not understand any of it.
- The sender of the message and the recipient might have different perceptions of what the information is for.
- The recipient of the information may be biased, and may interpret the message so that the information 'means' what he would like it to mean.
- The recipient of the information might misunderstand the message.
- The sender of the message might get the information wrong. The distortion of information in a message could be either intentional or accidental!
- Difficulties in communication may arise because of the **distance between the sender and the recipient.** For example, someone in Hong Kong may

have problems communicating with someone in the US because of time differences.

- The information is sent by a channel that the recipient does not like or does not use, so that the message does not get through. For example, a person might send a message to the mobile phone of someone else, who does not use the phone much and leaves it switched off or who does not check his text messages.
- The information is sent using a medium or format that the recipient finds difficult to use or understand. For example, a manager might be sent information in a written report containing nothing but words. He might prefer to receive the information in a summarised form (to reduce information overload) and in a more easily-understood form, such as in tables of figures, charts and graphs.

It should be apparent from this list of barriers to communication that the barriers may be either:

- personal barriers**, caused by interpersonal matters and the inability of the sender and/or recipient to communicate properly, or
- technical barriers**, such as faults in the transmission system, information overload, and the geographical distance between the sender and recipient.

The ability to listen effectively

Effective communication depends not only on the ability of the communicator to express the message clearly. It also depends on the person receiving the information to listen to it and try to understand it. Individuals may be effective at saying things, but poor at listening to responses.

Without an ability to listen, communication, particularly two-way communication, cannot be effective.

Effective listening requires the recipient of the message or information to:

- listen carefully to it
- avoid making unnecessary interruptions until the message has been completed
- if in doubt, say so, and ask for the message to be repeated
- check or confirm his/her understanding of the message, perhaps by repeating it to the provider of the message.

Overcoming barriers to communication

When there are significant barriers to communication, it is important to:

- identify what those barriers are, and
- consider ways of dealing with the problem.

The solution to a communication problem depends on the nature of the barrier.

1.6 Methods of communication

You will be familiar with many different methods of communication:

- face-to-face discussion
- discussion by telephone

- video conferencing
- e-mail
- web sites
- fax messages
- formal speeches or lectures
- public address systems
- notices on a notice board
- communication in electronic form, between computer systems
- communication between a computer system and individuals through keyboard, mouse and computer screen
- films, radio or television, including transmission of images by computer or phone
- in written form, such as reports, letters, notes (memoranda), journals and magazines
- in words, pictures, charts or graphs.

The choice of medium or the way of formatting the information should be suitable, so that the information is communicated effectively.

1.7 Patterns of communication: vertical and lateral communication

A pattern of communication is the direction and frequency of information. Who sends out information and how frequently? And who receives the information?

In a teaching group of six students, the pattern of communication may be described as:

- a lecturer providing information to students for 70% of the time
- students asking questions for 30% of the time
- of the six students, one asking twice as many questions as two other students, and the other three students saying nothing at all.

Within a work team, one of the tasks of the leader should be to make sure that everyone in the team communicates as they should, and that communications are not dominated by a relatively small number of individuals in the group.

Vertical communication and lateral communication

In hierarchical business organisations, information flows:

- vertically and
- laterally (horizontally).

Vertical communication is communication down the scalar chain or chain of command. A boss communicates with subordinates.

- Downward communication is information or a command given by the boss to one or more subordinates.
- Upward communication is information moving from subordinates to the boss.

When the leader is autocratic, most communication is downward.

Lateral or horizontal communication is communication between people at a similar level in the organisation's management hierarchy. It is communication between individuals in the same work group, and also between individuals in different work groups.

Purpose of vertical communication	Purpose of lateral communication
To give instructions/direction	To co-ordinate the activities of different individuals and groups
To delegate responsibilities	To develop and maintain social relationships at work
To control activities of subordinates	



Example: Pattern of communication

An organisation has four grades of manager, from level 1 (the most senior) to level 4 (the most junior). Manager A and manager W are both Level 3 managers. Manager A has a team of four level 4 managers, managers B, C, D and E. Manager W has a team of three level 4 managers, managers X, Y and Z.

The patterns of communication in these work groups may be the following.

- Manager A might be autocratic, so that most communication is vertical and one-way (downward).
- Manager W may be democratic, so that there is extensive two-way vertical communication between Manager W and his three subordinates.

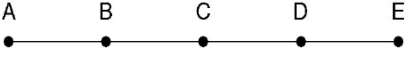
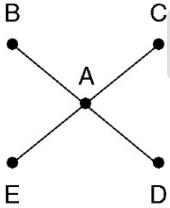
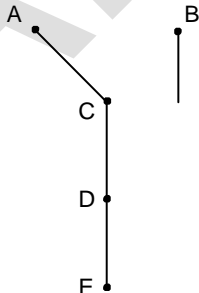
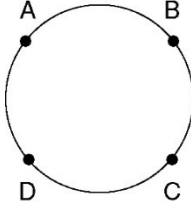
If, on the other hand, both managers have a participating style, and encourage two-way vertical communication, they would probably also allow and encourage some lateral communication.

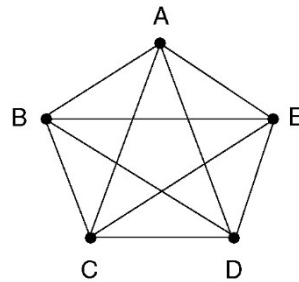
- Each manager would encourage communication between the managers in their own team – for example manager A would encourage communication between B, C, D and E.
- If the two work groups needed to co-operate in some aspects of their work, the Manager A group and the Manager W group would need to communicate with each other.
- All communication between the two management groups might be between Manager A and Manager W.
- Alternatively, whilst Manager A and Manager W might communicate regularly, they may also encourage communication and co-operation between the Level 4 managers in their groups, for example between Manager B and Manager X.

The pattern of communication in an organisation affects the way that people work together and co-operate with each other. In this example, if the two management groups work together regularly, the most effective communication pattern would be to allow and encourage horizontal (lateral) communication at the junior management level (Level 4).

1.8 Other patterns of communication

Within a work group or a management structure, other patterns of behaviour might be identified. The most efficient pattern of communication should be a pattern that achieves effective communication.

Pattern	Description
<p>Chain</p> 	<p>A communicates with B, B communicates with A and C, C communicates with B and D, D communicates with C and E, E communicates with D.</p> <p>This pattern may be found in a 'traditional' bureaucracy, with A at the top and E at the bottom of the chain of command.</p>
<p>Wheel</p> 	<p>A communicates with B, C, D and E. B, C, D and E all communicate with A only, and not with each other.</p> <p>This pattern is typical in a group led by an autocratic and authoritarian boss. A controls all communication.</p>
<p>The Y</p> 	<p>C communicates with A, B and D. A and B communicate with C only. D communicates with C and E.</p> <p>This is similar to a combination of a wheel and a chain system of communication.</p>
<p>Circle</p> 	<p>A communicates with B and D, B communicates with A and C, C communicates with B and D, D communicates with C and A.</p> <p>This is unusual in formal communication systems, but may well occur in informal communication networks.</p>

Pattern**All-channel****Description**

Everyone communicates with everyone else. This pattern is typical of a democratic work group or project team.

The chain, wheel and Y systems of communication system are found in many formal organisation structures. The speed and effectiveness of communication in each of these patterns depends on the communication abilities of particular individuals in the system.

- A chain communication structure is likely to be slow and inefficient. In the diagram above, the ability of A to get a message to E depends on the efficiency and competence of B, C and D. This is because a message must go through B then C then D before it can get from A to E.
- A wheel structure is a much quicker way to send a message, because all messages go directly to or from the person at the centre. In the diagram above, A can send a message to everyone. For B to get a message to C, it must go through A, but there are only two stages in the communication of the message.
- The speed of sending messages, and the effectiveness of communication, in a Y structure depends on the length of the chain or 'stem' of the Y pattern. In the diagram above, the chain in the stem of the Y consists of just three individuals, C, D and E. However, this chain could be much longer.
- Similarly, the speed and efficiency of a circle network depends on the number of people in the circle. When there are many people in the circle, it can be a very long time before an item of information reaches everyone.
- An all-channel system of communication is the quickest and most efficient, but it is not suitable for a formal communication structure in a formal hierarchical organisation structure.

2 EFFECTIVE BUSINESS MESSAGES

Section overview

- Introduction to business messages
- Planning a business message
- Media and channels

2.1 Introduction to business messages

Business messages are distinguishable from social communications between friends through a number of characteristics including:

- Lack of spontaneity (deliberation)
- Impersonality
- Formality
- Brevity (short)

The nature of business messages can make them seem unfriendly and aggressive to those unfamiliar with communicating in business. However there are a number of key drivers for their style:

- Authority – the formal tone demonstrates a respect of superiors and acknowledges the reporting hierarchy within an organisation
- Objectivity – the organisation must appear impartial, particularly when dealing with sensitive issues.
- Regulation – organisations often need to formally word and carefully plan communications to avoid misunderstanding as they are constrained by legal and regulatory requirements such as when contracting with customers or employees
- Effectiveness – business communications are more likely to convey the message effectively when targeted and brief rather than excessive or inappropriate
- Efficiency – succinct and focused messages avoid wasted time for both sender and receiver
- Public relations – it is important for organisations to maintain an appropriate corporate image and communicate externally in a style regarded as business-like, respectful, impersonal and consistent

2.2 Planning a business message

Many organisations, particularly larger organisations, will have a suite of standardised 'house style' template documents. However, there will still be circumstances when employees need to use significant judgment when creating truly original business communications.

Where possible it helps to plan the communication. This is easier for written messages which can be drafted and re-drafted before a final version is sent. Spoken communication lends itself less well to such careful planning although it is still possible.

The four key elements of communication planning are:

- Objectives** – what are you trying to achieve?
- Audience** – consider situations specific to the audience that may impact how they interpret the message.
- Structure** – consider the content – order, format and emphasis
- Style** – given the audience factor, what language, sentence structure and visual aids will best achieve the purpose of the message?

Objectives

The general purpose of most business communications will fall into one of the following categories:

- To build a relationship – mutual trust, respect and loyalty
- To confirm
- To request
- To persuade
- To inform



Example: A letter of complaint

Yasmeen recently purchased a food blender which unfortunately broke down after only one week. She wishes to communicate with the supplier to achieve the following objectives:

- Receive a replacement food blender
- Receive an explanation of how the fault occurred and assurance it will not reoccur
- Be compensated for the cost of returning the blender and her inconvenience

When planning the communication Yasmeen will need to factor in the following objectives:

- Inform the supplier of the faulty blender
- Persuade them that she has a legitimate claim
- Request redress

Business communications will always have at least one primary objective but may also include a number of secondary objectives. Take care not to create confusion or conflict though.

You can critically analyse a message to judge whether it is likely to achieve its objective by considering the following:

- Check that each element of your message is relevant and suitable to the audience
- Have you made all the points you need to and in a logical order?
- Is there a mechanism for checking whether your message achieves its objective?



Example: Advertising a chocolate bar

The primary objective is to persuade consumers to purchase your company's chocolate bar. However, the secondary objectives are:

- A. To convince the consumer they need a chocolate bar; and
- B. To convince the consumer that your brand is the one they should buy

Each of these objectives could be broken down into further objectives:

- A.
 - i. The consumer is hungry and lacks energy
 - ii. Buying a chocolate bar would boost energy and satisfy the hunger
- B.
 - i. Demonstrate that the advertiser has experience in judging taste – e.g. share results of a laboratory test or a consumer 'taste test'
 - ii. Associate the advertiser's chocolate bar with value for money, trend and providing energy

Audience

As the sender of a business message you want to ensure that your message is received, understood and acted upon, if necessary, having connected with the receiver's motives and expectations.

Therefore a good tactic is to investigate and anticipate the circumstances in which your message will be received and adapt your message accordingly.

Business communications will invariably be more effective if targeted at a specific person. Make sure it's the right person with authority to address the communication.

You should also consider personal factors such as:

- Relationship – are you a known and trusted colleague or is the relationship more distant and formal?
- Work environment – specialists are likely to respond better to the use of technical jargon. Also consider where in the reporting hierarchy the recipient sits.
- Education – avoid patronising a well-educated recipient
- Attitudes and interests – consider the recipient's general outlook and interests including culture and religion
- Age – remember that people's attitudes vary with age and experience

Contextual factors to consider include both physical and psychological factors:

- Physical contextual factors
 - Faults in the communication medium – e.g. broken microphone in a phone headset
 - Background noise – e.g. traffic or colleagues in an open-plan office
 - Distractions – e.g. uncomfortable seating or running meetings at lunchtime
- Psychological factors
 - Preoccupations and an already full 'to-do' list

- Pressures and stress – perhaps the recipient is dealing with family or health issues
- The need for privacy and sensitivity with confidential and potentially embarrassing messages
- Will the presence of others impact the recipient – e.g. needing to win approval or hide a weakness in a group
- Concentration and energy levels – some people are ‘slow-starters’ whereas others are at their most productive at 0700am.

Structure

Structuring a message involves deciding what you are going to say and how you say it. Key considerations include:

- Volume
 - Always remember that more information is not necessarily better information – avoid information overload
 - Only include relevant (but enough!) information
 - Incorporate an appropriate degree of accuracy. For example, a credit controller may need to refer to exact customer invoice amounts whereas the finance director may only want an analysis rounded to the nearest million.
 - For large communications (e.g. a report):
 - Include an overview (executive summary) at the start that summarises the key points and conclusions
 - Keep the main body of the communication short and to-the-point
 - Include supporting data and examples (such as director’s CVs, or detailed financial statement extracts) as an appendix
 - Split the main body of the communication into logical units
 - Use frequent headings and summaries
- Selection and grouping of material (relevance and importance)
 - The primary message for the communication will be the point that directly furthers the objective of the communication and stands alone as a point on its own
 - To help identify the primary message
 - Analyse a topic into sub-topics and then sub-topics of sub-topics
 - Classify ideas and group them into logical categories
 - The highest level grouping represents the primary message (or messages)
 - You could approach this by reflecting the ideas and sub-topics in a hierarchy or waterfall chart

- ❑ Ordering the message
 - Remember that the objective is to communicate a clear message which shows a logical progression of ideas in a balanced fashion. Consider the following:
 - If you need to attract attention then present the most important point (benefit) first
 - If the communication stream is already established with curiosity and interest present then the most persuasive approach which encourages recall is to build the message up and present the most important point at the end
 - If you need to deliver both good news and bad news always start with the good news. This places the recipient in a more amenable state of mind for receiving the bad news.
 - Other logical message ordering tactics include:
 - Chronological (time/date)
 - Importance (descending order): This has the benefit of getting the primary message out and grabbing the recipients attention
 - Importance (ascending order): This approach has the benefit of building suspense and constructing a persuasive argument through to its conclusion whilst making the most important (and memorable) point last
 - Complexity – either start with the simplest ideas first and build complexity, or alternatively start with the most familiar areas first (to build trust and confidence) before introducing new concepts
 - Causality – describe a chain of events e.g. a rise in interest rates will put a squeeze on interest payments which will result in a reduction in dividend payments which could result in a shareholder backlash and so on.

Style



Definition: Style

Communication style can be described as using the right words in the right order to achieve your message objective.

Components of style include:

- ❑ Tone – the overall effect that is created
- ❑ Vocabulary and syntax – the phrases and words actually used plus the type of sentence structure used
- ❑ Interest and personality

- ❑ Tone
 - Consciously aim for a warm and friendly yet simultaneously firm and honest tone.

- Express ideas positively rather than negatively – for example instead of saying “we are out of stock” say “we will be getting new stock in tomorrow”
 - Mood – for example, consider whether it is more appropriate to say “write the report” or rather “will you write the report, please”
 - Personal or impersonal – for example “you will receive a 3% pay rise” versus “it has been agreed by the board that employees will receive a 3% pay rise”.
 - Emphasis – a number of techniques exist such as accenting spoken words or pausing before a key point, underlining or emboldening written messages, or repeating key words.
- Vocabulary and syntax
- Appropriate vocabulary will include words that are familiar and understandable, clear and specific, factual and objective. Avoid words that could be unfamiliar, vague, ambiguous, emotional and subjective.
 - In short – KISS – ‘keep it simple, stupid’. Use single words (the shorter the better) rather than verbose descriptions. E.g. say ‘large’ instead of ‘not inconsiderable’
 - Use simple rather than complex sentences ensuring paragraphs are not too large
- Interest and personality
- Whilst maintaining the fundamentals of business communication (direct, succinct, recognise authority, impartiality, efficiency and corporate identity), incorporating elements of interest and personality can assist in conveying your message in an interesting, impactful and persuasive manner. Some of the tactics you could use include:
 - Understatement
 - Statistics
 - Questions
 - Metaphors
 - Examples
 - Facts
 - Humour (see below)
 - Curiosity
 - Analogy
 - Anecdote
- Humour
- Be careful when employing humour within a message. On the positive side it can increase attention and awareness and also gain acceptance by bringing the ‘human touch’ to an argument. On the negative side it may distract attention from the main message, may not appeal to all cultures and moods and may also undermine credibility (seriousness).

- ❑ Persuasion
 - When the objective of the business communication is to persuade then you will need to be particularly sensitive to the reactions of the recipient and consider the following:
 - Flexibility – you need to be constantly seeking and receiving feedback in order to read the signals from the recipient. This is particularly important in sales.
 - Tact – be careful with how you frame disagreement, particularly when dealing with customers who may default to the “customer is always right” premise
 - Listen – in spoken communication the trick is to listen as well as speak, in written communication it is to read as well as write.

2.3 Media and channels

Introduction

Common media and channels used for business communications include:

- ❑ Written such as monthly customer statements, annual financial statements and newsletters
- ❑ Face to face for meetings, interviews and presentations
- ❑ Oral for discussions with customers and suppliers
- ❑ Electronic such as e-mail, voice mail and pagers (e.g. for doctors or engineers)

Within the business context there are a number of key factors that will drive the most appropriate selection of media and channel:

Factor	Considerations
Time	Urgency and time available to prepare and transmit
Complexity	Use of diagrams? Combination of media?
Written record	Consider the need for an audit trail
Sensitivity	How would a letter be received compared to face to face discussion, particularly when delivering bad news
Cost	Employee time is expensive
Interaction	Is there a need for instant feedback and spontaneity?

Oral and face to face communication

The benefits of effective face to face communication include the generation of new ideas, instant feedback and exchange of views, co-operation and the rapid dissemination of information. However, for it to work people need to know the reason for the discussion, actually be able to communicate and also have the discussion effectively led.

Listening skills, presentation and body language all impact on face to face communication, particularly between unfamiliar people. Good listeners demonstrate the following:

- Retain an open mind avoiding bias and judgment
- They try to avoid distractions and are aware that attention is typically greatest at the start and end of discussions
- They are interested and make an effort.
- Have a radar for picking up the main ideas by distinguishing between supporting evidence and the key issue
- They wait before interruption
- Critical listening – i.e. assess what the other person is saying by identifying potential bias, omissions and assumptions
- They are prepared to listen and have made an active decision to focus on grasping the main concepts
- They often take notes, although be careful as this can distract from the listening

Note that listening skills are addressed at length in an earlier chapter.

The conduct of meetings

Meetings range between the more formal board meetings and annual general meetings with shareholders to much more informal team meetings, problem solving and brainstorming meetings. Delegates need to be conscious of adopting the appropriate style and tone depending on the type of meeting.

Formal business meetings may be held for a specific purpose, such as to agree a plan of action or discuss a business problem. Other business meetings are events that are held regularly and conducted in a similar way each time: board meetings and monthly budget control meetings are examples.

The matters discussed and agreed at regular formal business meetings are recorded by a secretary of the meeting, and this record is known as the minutes of the meeting.

The meeting has a leader, the chairman (or 'chair') who conducts the meeting, following a pre-set agenda. A typical meeting agenda will consist of:

- Agreeing the minutes of the previous meeting
- Discussion of matters arising from the previous meeting, if this is needed
- The agenda items: the chairman takes the meeting through each agenda item in turn. The matter is discussed and where appropriate a plan of action is agreed. One of the individuals at the meeting is made responsible for putting the plan of action into practice
- Any other business? The chairman then asks whether anyone would like to raise a matter that is not on the agenda.
- Date for the next meeting. The meeting closes with agreement on the date (and location) of the next meeting.

A feature of a well-conducted meeting is that all participants should be encouraged to contribute. It is the responsibility of the chairman to prevent any individuals from trying to dominate the meeting – or talk too much.

Committees

Many organisations also employ committees with specific responsibilities such as:

- New product committee – responsible for analysing and assessing suggestions for new products
- Remuneration committee – a sub-committee of the board of directors responsible for advising on and setting executive remuneration
- Executive committee – the board of directors or trustees responsible for governing and leading organisations

Committees benefit from the consolidation of power and authority and the ability to share responsibility for making decisions. Brainstorming should be more effective particularly when the committees bring together different abilities and skills.

Care must be taken to ensure the benefits outweigh potential disadvantages such as the time and expense of running them, the perceived delays that may exist from having consensus group decisions rather than immediate decisions made by one person, plus the potential abuse of power that can arise.

Successful committees typically demonstrate the following qualities:

- Benefits outweigh the costs
- Members collectively have the appropriate experience and skills
- Chairman is an effective leader
- The committee has well-defined areas of authority, time scale and scope which is specified in writing
- Appropriate size – not too large, not too small
- Minutes are taken and circulated promptly

Team briefings are common in the modern working environment as an aid to increasing commitment and understanding of the workforce. They are also used to communicate management decisions in the hope that this will reduce disruption and limit rumours with respect to policies, plans, progress and personnel issues. Many teams will have a weekly team meeting.

Conferences are useful as a way for bringing together a large membership spread over a wide area such as a trade union, professional body or accountancy network.

Interviews are another form of face-to-face business communication commonly employed for uses such as grievance and disciplinary interviews, staff appraisal meetings and recruitment and selection.

Having discussed the most common forms of face-to-face business communication above we can conclude that:

- the advantages of oral communication include its timeliness (swift and immediate), interaction, flexibility, generates instant feedback and combines non-verbal signals with verbal signals.
- the disadvantages can include misperceptions and lack of audit trail (memory can be untrustworthy), the need for spontaneity (less planning time), the fact that dominant personalities can prevail rather than the most logical and objective outcome and the fact it can be more difficult to control the process with large numbers of individuals.

Written communication

Organisations employ a broad range of written communication media the most common of which are explained below:

Media	Explanation
Reports	Formal communication often used to convey complex and substantial information.
Memos	<p>A brief letter used for internal purposes sent via e-mail in the modern business environment.</p> <p>Note though that in many instances memos are used instead of a telephone call when the telephone call would have been quicker, cheaper and arguably more effective. A memo could be used to simply confirm the telephone call once decisions have been made.</p>
Letters	<p>More formal than memos and therefore more frequently used for external communication where an audit trail is required.</p> <p>Letters might be sent via post or when more urgent via courier.</p>
Staff handbook / organisation manual	<p>This important document (required by law in many jurisdictions) forms part of an employee's contract of employment and is a very useful point of reference.</p> <p>Organisations must take care to keep the document up to date</p>
In-house newsletter / journal / magazine	Typically only used within larger companies this is a useful tool used to inform employees about topics ranging from company results, customer feedback and staff retirements to sports, social and philanthropic activity
Notice board	<p>Notice boards are used to communicate various types of information to a large number of people quickly and cheaply. Organisations are moving towards electronic notice boards rather than physical notice-boards.</p> <p>However, items can become rapidly out-dated thus reducing the effectiveness of the media. Furthermore it relies on the curiosity of employees to look at the notice board which may require effort and time that many members of the organisation simply do not have.</p>
Standard forms	<p>Many organisation, even the smallest, will likely use standardised forms. Examples would include invoices, purchase orders, sickness forms, holiday application, expense claims, timesheets and appraisal forms.</p> <p>Some of the key benefits are the standardisation of and subsequent familiarity with standard forms.</p>

Electronic communication

E-mails, voice-mails and video-conferencing are electronic forms of written, spoken and visual communication that bring flexibility and speed at low cost to business communications. The most common channel over which these media are communicated is the Internet which extends the scope of these media worldwide.

Visual communication

Whilst words (both spoken and written) require a reasonable amount of effort to hear, read, interpret and absorb, visual communication can achieve a much greater impact in a significantly shorter period. Visuals can be more memorable and clearer than a wall of words and blocks of text and figures.

A brief word of warning though that visual images are essentially a symbolic language and can as equally be misinterpreted by the viewer. Feedback is still an essential component of communicating using visual aids.

The various types of visual aids you are likely to encounter in business communications are described in the table below.

Visual aid	Explanation
Blackboard and whiteboard	<p>Blackboards (also called chalkboards) are gradually being replaced by modern wipe-clean whiteboards. The principle remains the same in that the presenter writes on them in real-time, then wipes them clean to re-use the writing surface.</p> <p>The process is both time-consuming and messy although remains a useful alternative to overhead projectors for annotating brainstorming and group problem-solving.</p>
Handouts	<p>Handouts describe the printed notes and diagrams that are distributed to delegates in a presentation. They may be a copy of the presentation or other supporting documentation to be reviewed at the convenience of the reader.</p>
Flipcharts	<p>Flipcharts are essentially a large pad of paper mounted on an easel frame.</p> <p>One benefit is that individual sheets can be removed and used as posters in training rooms. Furthermore it is a low-tech solution and can support multiple groups preparing presentations in a live auditorium.</p>
Overhead projectors	<p>Overhead projectors are rapidly being superseded by slides although they are still used by many organisations. Overhead projectors involve projecting pre-printed or hand-written images from a clear film onto a large screen.</p> <p>The advantage of overhead projectors compared to slides is the ease with which presenters can mark-up and annotate the film with special purpose pens. For this reason they remain popular in training rooms.</p>

Visual aid	Explanation
Slides	Slides are essentially freeze-frame photographs including text and diagrams projected onto a screen of some kind. Modern software such as Microsoft PowerPoint allows audio and video to be embedded into the slides too.
Film and video	Film and video are powerful aids that are similar to slides. They can be projected onto a large screen or output to a screen such as a computer monitor or television screen
Props and demonstrations	<p>Products (props) and demonstrations (of an operation or product) are an effective way of showing the audience how something works.</p> <p>This is useful at the design stage of product development when looking at prototype products and scaled-models for a production process as well as in the sales and marketing phase when promoting products.</p>

Take care when using visual aids to ensure they are appropriate to your message. The danger is that visual aids become a distraction rather than add value to the presentation.

Non-verbal communication



Definition: Non-verbal communication

Non-verbal communication describes the conveyance of a message without using words or symbols. It may be completely independent of any verbal message (e.g. the slamming of a door, shaking of a head or simply remaining silent) or linked to words (e.g. a particular tone of voice).

Non-verbal communications convey a message from or about the person giving them.

Whilst we all have experience of these actions (or indeed non-actions) such as putting our head in our hands, turning our back or keeping an office door open or closed, care must be taken that similar actions can mean different things around the world. For example, nodding the head generally means 'yes' whereas in India it means 'no'.

Generally we are more conscious of other people's gestures and tone of voice than we are of our own and the signals they convey to others.

Non-verbal communication may either reinforce or contradict a verbal message. For example when a manager enquires how their employee is progressing in the preparation of a particular report the words "it's going very well" may be betrayed by heavy sweating, a worried look and nervous glance at the watch.

Non-verbal communication is an effective business communication tool as it can be used to give a message when used effectively. For example:

- ❑ Creating a particular impression – smile, firm handshake, punctuality, smart dress
- ❑ Reinforcing spoken message - indicating seriousness, interest and engagement e.g. an emphatic gesture, sparkling eyes, disapproving frown
- ❑ Providing feedback – applause, fidgeting, yawn
- ❑ Establishing desired atmosphere – informal dress, respectful distance, friendly smile.

Equally with minimal effort we can learn to recognise non-verbal messages in others to help interpret people's feelings (excitement, nervousness), recognise problems (angry silence, absenteeism or poor punctuality, refusal to look someone in the eye) and read situations in order to modify our own communication and response strategy.

Common signals and their interpretation include:

- ❑ **Gestures**
 - Shrug = indifference
 - Jerk of the head to indicate direction
 - Tapping fingers = impatient
- ❑ **Personal appearance**
 - This triggers first impressions, attitudes and generalisations about people. Note that grooming and dress tend to reflect a person's personality and attitude to a greater extent than mere physical looks.
- ❑ **Posture** (positioning) and orientation (which way someone is facing)
 - Sit, stand, walk or lie down
 - How you do it:
 - Sit up straight = alertness
 - Hunched = negativity
 - Lounging = relaxation
 - People sitting/standing next to each other = cooperation
 - Standing opposite = confrontational or assertive
- ❑ **Movement and stillness**
 - Consider the pace and pattern of movement. Brisk walking conveys determination, stillness conveys calm, thoughtfulness and self-possession (although in a social gathering might convey aloofness and hostility) whilst movement without purpose conveys distraction, impatience and nervousness.
- ❑ **Facial expressions**
 - The eyes are particularly expressive – narrow, wide, closed, raised
 - Also nose, lips, mouth, jaw and skin colour

❑ **Silence and sound**

- This largely depends on the culture. Silence in western society commonly conveys embarrassment and discomfort whereas in eastern society is more likely to convey peace and thoughtfulness. It may also be a negative gesture indicating hostility, rejection or a refusal to provide feedback.

❑ **Proximity and contact**

- The term 'personal space' is generally used to describe the distance at which we feel comfortable with others. Note though how this varies with cultural norms, personal tastes and the specific relationship between two people.
- Physical contact can convey security and the assurance of affection. However, once again take care not to breach any cultural taboos with tactile gestures.

4

Digital communication

Explain:

- (a) Email systems and their application in business;
- (b) Email ethics in business communication;
- (c) Website platforms and its utilisation;
- (d) Social Media Platforms—variants and typical uses in business; and
- (e) Digital marketing — Meaning, Forms, Benefits and Risks.

15.0 Electronic communication

Electronic communication (E-communication) is the transmission of information using advanced facilities, such as computer modems, facsimile machines, voice mail, electronic mail, teleconferencing, video-cassettes, and private television network. E-communication is a communication system where information is conveyed by use of information technology devices.

The communication is mandatory in different fields for processing, controlling, making decisions and planning. The fields include finance, accounting, human relation, personal, marketing, sales, purchases and production. This type of communication can be developed by sharing data, like images, graphics, sound, pictures, maps and software.

15.1 Types of electronic communication

With the revolutionary development of information technology, the world is becoming smaller and people staying at any corner are well-capable of communicating with others, whatever the distance is, people and organisations use different modern devices of communication technology.

Below is a list of types of electronic communication:

- a. Autoresponders
- b. Blogs
- c. Bookmarking
- d. Calendars
- e. Collaborative software in the workspace
- f. Computer screen messages
- g. Data conferencing
- h. Ebooks
- i. Electronic and web chat shows
- j. Electronic bookmarking
- k. Electronic brochures
- l. Electronic content on cds and dvds
- m. Electronic flash teaser
- n. Electronic games
- o. Electronic meeting system
- p. Electronic newsletter
- q. Electronic questionnaires and surveys
- r. Electronic voteline
- s. Email
- t. Email campaigns with links to intranet
- u. Emailable audiovisuals
- v. Enterprise bookmarking
- w. Extranet
- x. Eye witness news electronic broadcasts
- y. Faxing
- z. Flash mailer

- aa. Forums
- bb. Instant messaging

- cc. Intranet
- dd. Online chat
- ee. Online consultation
- ff. Personalized urls (Purls)
- gg. Pop up electronic teasers
- hh. Radio or voice clips sent or broadcast electronically
- ii. Screensavers
- jj. Skype
- kk. Short message service (SMS) campaign
- ll. Social networks like Friendster, myspace, Twitter and Facebook
- mm. Sound clips
- nn. Special code to web page as part of bigger campaign
- oo. Synchronous conferencing
- pp. Telephone campaign with electronic aspects
- qq. Telephony
- rr. Text chat
- ss. Video
- tt. Video conferencing
- uu. Viral email competitions
- vv. Voice mail
- ww. Wall of fame on intranet
- xx. Web conferencing
- yy. Web publishing
- zz. Webcam
- aaa. Website

Few of these methods of electronic communication are discussed below:

15.1.1 Instant messaging

Instant messaging refers to short messages that are sent in real time over mobile telephones or the internet. The messages can include multimedia items, such as pictures, videos and voice recordings.

- a. Advantages of instant messaging**
 - i. Messages are cheap and sometimes free to send
 - ii. Messages are received directly after being sent
 - iii. You can see if the message has been delivered
 - iv. You can see when your message has been read
 - v. You can send a variety of messages; including text messages, pictures, videos, music and web links
 - vi. You can create group conversations in order to discuss a specific topic or plan events

- b. Disadvantages of instant messaging**
 - i. Messages are not always saved
 - ii. It is an informal method of communication and might not be suited for business-related communications
 - iii. There is a pressure to respond immediately, as people can see when you read their messages
 - iv. Can be distracting, as one message can lead to a whole conversation
 - v. Low security, as instant messaging services use a public network

When communicating by instant messaging, take note of the following:

- You may not get an immediate reply. The person you are messaging might be busy and will reply once he or she is available.
- Keep your messages short and to the point.
- Do not type your messages using uppercase as it can be interpreted as shouting.
- Be polite.
- Do not use slang words and abbreviations. This might save you time, but it can also confuse others, if they are not aware of the meaning.

15.1.2 Electronic messaging (email)

Email is one of the first and most popular forms of electronic communication. It allows the user to send and receive files and messages over the internet, and can be used on a wide variety of devices.

a. Popular email applications include:

- i. Yahoo;
- ii. Google mail (gmail); and
- iii. Hotmail.

b. Additional features of email

Email is not limited to only sending messages over the internet; it provides users with many features. Below are some of these features:

i. Calendar

Google Calendar is a time-management and scheduling calendar service developed by Google. It became available in beta release April 13, 2006, and in general release in July 2009, on the web and as mobile apps for the Android and iOS platforms.

Google Calendar allows users to create and edit events. Reminders can be enabled for events, with options available for type and time. Event locations can also be added, and other users can be invited to events. Users can enable or disable the visibility of special calendars, including Birthdays, where the app retrieves dates of birth from Google contacts and displays birthday cards on a yearly basis, holidays and a country-specific calendar that displays dates of special occasions.

ii. Contact list

Users can now get to the contact pages by clicking the application's (app's) icon in the upper right corner of the Gmail inbox. When you click the apps icon, which is a square made up of nine smaller squares, it unfolds to reveal a panel of icons for other Google programs and services, including, Google Photos, Google News and YouTube.

iii. Tasks

Gmail integrates a simple to-do list into users' accounts. Google Tasks allows you to create lists of items, set due dates, and add notes. You can also create tasks directly from Gmail messages.

iv. Archives

Rather than deleting an email and losing it for good, you can choose to archive it instead. As soon as a message is placed in the Gmail archive, it is removed from your inbox and tagged with the label All Mail. These messages remain in your Gmail account and can be retrieved easily at a later time, but in the meantime, they are not visible.

When someone replies to an archived message, it automatically returns to your inbox.

c. Email applications in business

E-mail is the modern and widely used business communication system supported by information technology. The importance and usefulness of e-mail in business communication are greater than in any other medium.

Email is one of the simplest and most cost-effective methods of corporate communication. E-mails are now regarded as legal documents.

In daily activities such as buying and selling, marketing, trading and telephoning, email is a quick way to exchange information by writing, subscribing, sharing, reporting and presenting. It is the most important way to process clients' requests.

d. Private communication in a company network

Almost all large and medium-sized companies use professional e-mail services. The email ID contains for example employee1@examplecompany.com instead of yahoo and Gmail for all employees. It is imperative to use professional e-mail to communicate with customers, suppliers, partners, and government agencies at work. This is global best practice.

When you buy a domain or hosting for your professional website, you get a free professional email account (depending on the offers). One may also buy personalised email addresses without registering for a domain.

There are several beneficial reasons for registering personalised domain.

- Communication only works on one corporate network and is generally not accessible to others. That means third party access is prohibited.
- Another advantage of professional/business email is that one does not get distracted and confused by promotional emails.
- It will increase the productivity of a company's employees. Otherwise, if they use a free email account, there is a 90% chance of being distracted while they work on the project.

This is the use of email in business communications and it is very effective when it occurs through a professional or business email account.

e. External communication / transactional mails

Businesses can use the email for external communication to customers, suppliers, and other stakeholders. Transactional mail or transactional direct mail is direct mail that is sent out by either a business or mailing houses. Examples of these external business communications include:

- i) Order receipts
- ii) Customer thank you
- iii) Invoices
- iv) Account Statements
- v) Debt or Loan Collection Letters
- vi) Renewal Letters and Cycles
- vii) Account Changes
- viii) Changes to Terms and Conditions and Customer/Business Agreements
- ix) Account and Membership Preferences
- x) Welcome Packs for New Sign Ups or Customers
- xi) Customer Service / Support
- xii) Marketing to Customers

15.1.3 Advantages of email

In the work place, communication is extremely important. Employees are now able to make use of the many advantages of email stated below.

- a. It is very easy to communicate effectively with anybody within the office or anywhere in the world regardless of where they are situated.
- b. Another advantage of having business email communication at work is that you can respond to clients quickly and easily. This means that you no longer need to spend hours on the phone, trying to get through and leaving messages with receptionists.
- c. Messages can be sent quickly, in an instant.
- d. The cost of sending an email is very low, unlike postage and other methods of communication.
- e. It is easy to use, simply type the address of the recipient, a subject line and your message and click the send button.
- f. One can copy others on correspondence. One can even blind copy (BCC) someone, if one does not want the recipient of the email to know that you are sending it to another person. A large number of people can be copied and communicated at once.
- g. One can send attachments, such as files, photos, and spreadsheets
- h. Email saves time. No need to spend valuable time going to someone else's office.
- i. Emails can be responded to when it is convenient. It is not invasive like a visitor or phone call which requires immediate attention.
- j. It speeds up the workflow process. Documents can be sent for comment and corrections made quickly.
- k. Emailing saves paper and printing costs.

15.1.4 Disadvantages of email messaging

Some of the disadvantages of email may be that your staff spends too much time on personal messages as opposed to work related stuff. This is the fundamental disadvantage to allowing email access.

However, if a positive and trusting relationship is able to be maintained between management and staff, then this could contribute to a more productive working environment, where employees can enjoy the many advantages of using email.

- a. Spam emails can be sent which can clutter one's inbox.
- b. Viruses can be sent by email.
- c. Misunderstandings can occur if messages are not constructed properly.
- d. Not everyone has internet connectivity.
- e. Confidential information can be easily forwarded and disseminated, and if done in error could easily end up in the wrong hands.

15.2 The world wide web

The online world is fast-paced and ever-changing. A business must have a solid online presence by having a well-designed website. Having a website is a prerequisite for all marketing efforts.

The world wide web or the web, is an internet-based system that enables an individual or a company to publish itself to the entire world. The web is the world's largest online shopping mall and the world's largest source of information, news and commentary. People often equate the web to the Internet, but they are two different things. The web consists of pages that can be accessed using a web browser. The internet is the network of networks, where all the information resides. Internet applications like telnet, FTP, internet gaming, internet relay

chat (IRC), and e-mail are all parts of the internet, but are not part of the world wide web.

15.2.1 Web infrastructure

The "web" is made up of "web servers," which are computers that store and disseminate "web pages" to anyone with an internet connection.

(a) **Hyperlinks and web addresses**

The salient feature of the web is the hyperlink, which connects one page to another by address, whether on the same website or on another site. The address of a website or page within the site is known as the "uniform resource locator" (URL).

(b) **The web browser**

Web pages are accessed by the user via a web browser application such as Chrome, Firefox and Safari.

(c) **HyperText Markup Language (HTML)** – the web rendering format
A web page is a text document coded with HTML tags that define how the text and graphics are displayed on screen.

(d) **Websites are made up of HTML files**

A website is a collection of Web pages (HTML files).

(e) **Web hosting** Small to medium websites are often maintained by third-party hosting companies.

(f) **HyperText Transport Protocol** – The web protocol HTML pages are transmitted to the user via the HTTP protocol.

(g) **Web Linking**

Accessing a web document requires typing in the uniform resource locator (URL) address of the home page in your Web browser. The home page contains links to other documents that can be stored on the same server or on a server anywhere in the world.

15.3 **Business uses of the internet and world wide web (WWW)**

The internet and, more particularly, the WWW are attracting businesses in their thousands, with the following appearing to be the main application areas:

15.3.1 **Publicity, marketing and advertising**

The WWW appears to be an ideal medium for businesses attempting to promote themselves and their wares. Setting up a site on the WWW, and thus gaining instant access to millions of people all over the globe, can be achieved at a small fraction of the cost using more conventional methods.

15.3.2 **Direct on-line selling**

It is already possible to visit 'virtual malls' full of 'virtual shops', browse through catalogues and examine various products in vast detail, all courtesy of the web. This has all been made possible by the multi-media capabilities that the web provides.

15.3.3 **Research and development**

Companies, especially those involved in research and development, can use the internet as an additional resource for collecting information. It is possible to post a query on a bulletin board or join a discussion group and receive advice on how to solve a problem. Alternatively, there are millions of web pages, some of which contain access to searchable databases of information relating to particular subjects.

15.3.4 Communication

Electronic mail (e-mail) is the internet service used most extensively by businesses. The use of the email has brought down communication costs for large corporations. An example is 'Digital Equipment' which has over 31,000 computers linked up to the internet and exchanges about 1.7 million e-mail messages each month with people external to the company.

15.3.5 Collaboration

When links are formed between companies, it is easy for them to communicate through the internet. One example of this is the collaboration between IBM and Bellcore which use internet links to share workstations.

15.3.6 Business benefits of having a website

Today, having a company website is as crucial as having a shop, office or telephone number. Research has found that six out of ten customers expect brands to have contents online about their businesses.

Listed below are some of the benefits of having a website:

(a) Online presence 24/7

Having a website means customers are always able to find you – anytime, anywhere. Even outside of business hours, your website continues to find and secure new customers. It offers the user convenience as they can access the information they need in the comfort of their own home;

(b) Information exchange

At its simplest, a website provides a quick and easy way of communicating information between buyers and sellers. One can list opening hours, contact information, show images of location or products, and use contact forms to facilitate enquiries from potential customers or obtain feedback from existing ones. Promotional videos can be uploaded to really engage customers and sell products and services in an effective and cost efficient way;

(c) Credibility

In today's modern world, there is an expectation for any reputable company to have some kind of online presence. Potential customers would likely not trust any business that does not have a telephone number or a physical address, and the same can be said for not having a website and email address. These are useful tools to share crucial information about one's business with customers and answer all the frequently asked questions (FAQs);

(d) Cuts costs

Apart from simply displaying information, websites are used to sell goods and provide services directly to consumers, in some cases, removing the need to use "brick-and-mortar" stores which involve large operating costs (staff wages, rent, utilities, etc). Eliminating these overheads will also allow lower prices, giving the business a real competitive edge;

(e) Market expansion

As the site is accessible to anyone all over the world, ability to break through geographical barriers has never been easier. Anyone, from any country, will be able to find the company and as such, is now a potential customer;

(f) Consumer insights

Analytical tools allow the identification of a typical customer and his behaviour. The diverse range of data available can also help a business better understand how social media channels affect a brand, and can even highlight opportunities to change the offline aspects of the business, such as branch opening times, promotions and product ranges;

(g) Advertising

Tools like Google AdWords or advertising on Facebook give the power to reach customers with much more accuracy and reliability than with traditional offline advertising methods. Online advertising via a website are a great way to help build up awareness, if it is done correctly, traffic to the website can experience an increase;

(h) Competitors online

The absence of a website gives the competition an edge over the business;

(i) Customer service online

Websites provide an easier way to handle customer services, offering answers frequently asked questions (FAQs). This reduces customer service costs and saves time; and

(j) Growth opportunity

Websites, in general, are great ways to provide places that potential investors can be referred to. It shows what the company is about, what it has achieved and what it can achieve in the future.

15.4. Social media platforms and its utilisation

15.4.1 Definition

Social media refers to websites and applications that are designed to allow people to share contents, efficiently and in real-time. By design, social media is internet-based and gives users quick electronic communication of contents. Contents include personal information, documents, videos, and photos.

Social media originated as a way to interact with friends and family but was later adopted by businesses that wanted to take advantage of a popular new communication method to reach out to customers. The power of social media is the ability to connect and share information with anyone on earth or with many people simultaneously.

15.4.2 Social media platforms

A social media platform is defined as web-based and mobile-based internet application that allows the creation, access and exchange of user-generated contents.

15.4.3 Business uses of social media platforms

The following are social media platforms useful for business:

(a) Facebook

This is arguably the largest social networking site in the world and one of the most widely used.

Apart from the ability to network with friends and relatives, you can also access different Facebook apps to sell online and you can even market or promote your business, brand and products by using paid Facebook ads;

(b) WhatsApp

Apart from social networking, WhatsApp provides an opportunity for businesses, especially small businesses and e-commerce stores to market their products. It launched a variant app called WhatsApp Business designed for business owners looking to capitalise on the apps popularity and usage. It is a proven platform for growing small businesses;

(c) Instagram

Instagram was launched as a unique social networking platform that was completely based on sharing photos and videos. Instagram can be used for visual-based businesses, like art, food, retail, and beauty products. This means the platform is useful for generating leads due to its wide reach;

(d) Twitter

Twitter is an excellent platform to build awareness for a brand. Twitter utilises the hashtag, which organizes conversations around a word or phrase. By searching hashtags, you can learn what people are talking about so you can craft your tweets to take part in popular conversations.

Since Twitter is often used to provide real time updates to an audience, many brands combine Twitter with offline engagement, such as events;

(e) YouTube

YouTube is one of the biggest search engine platforms. Many of these searches are for “How To” videos. YouTube is useful in the service industry, in the form of lifestyle and educational videos;

(f) Skype

It allows you to connect with people through voice calls, video calls (using a webcam) and text messaging. Group conference calls can be conducted on this platform. Skype-to-Skype calls are free and can be used to communicate with anyone, located in any part of the world, over the internet.

(g) LinkedIn

LinkedIn is easily one of the most popular professional social networking sites or apps and is available in over 20 languages. It is used across the globe by professionals and serves as an ideal platform to connect with different businesses, locate and hire candidates, etc. People use LinkedIn to search for jobs and to network professionally. As a result, the platform is useful for B2B lead generation, general networking, as well as recruiting employees.

(h) Telegram

This instant messaging network is similar to WhatsApp and is available across platforms in more than eight languages. However, Telegram has always focused more on the privacy and security of the messages you send over the internet by using its platform. So, it empowers you to send messages that are encrypted and self-destructive. This encryption feature has only just been made available for WhatsApp, whereas Telegram has always provided it.

15.5 Digital marketing

Digital marketing encompasses all marketing efforts that use electronic devices or the internet. Businesses leverage digital channels, such as search engines, social media, email, and websites to connect with current and prospective customers.

15.5.1 Digital marketing assets

Digital marketing asset is any marketing tool used online. Common digital marketing assets and strategies businesses use to reach people online include:

- a. Website;

- b. Branded assets (logos, icons, acronyms, etc);
- c. Video contents (video ads, product demos, etc);
- d. Images (infographics, product shots, company photos, etc);
- e. Written contents (blog posts, eBooks, product descriptions, testimonials, etc);
- f. Online products or tools (SaaS, calculators, interactive contents, etc);
- g. Reviews; and
- h. Social media pages.

15.5.2 Types of digital marketing

Digital marketing has become a vital component in organizations' overall marketing strategy. It allows companies to tailor messages to a specific audience, making it possible to market directly to people who are likely to be interested in their products. Digital marketing encompasses a wide variety of marketing tactics and technologies used to reach consumers online. Below is a list of the most popular types of digital marketing:

- (a) Search engine optimization (SEO);
- (b) Content marketing;

The channels that can play a part in content marketing strategy include:

- i. Blog posts;
 - ii. Ebooks and whitepapers;
 - iii. Infographics; and
 - iv. Social media marketing.
- (c) Pay per click (PPC);
 - (d) Affiliate marketing;
 - (e) Native advertising;
 - (f) Marketing automation;
 - (g) Email marketing;
 - (h) Online PR;
 - (i) Inbound marketing; and
 - (j) Sponsored content.

15.6 Benefits of digital marketing

Below are some of the benefits of digital marketing:

- (a) Prospects most likely to purchase the product or service are directly targeted. Digital marketing allows the identification and targeting of a highly-specific audience, and send that audience personalised, high-converting marketing messages. Digital marketing enables the conduct of the research necessary to identify the peculiarities of the target customer and refine the marketing strategy;
- (b) Digital marketing is more cost-effective than traditional marketing methods
Digital marketing enables the identification of appropriate channels/media that reach the target market effectively. This saves cost and time.
- (c) Digital marketing gives marketing edge
Digital marketing provides competitive advantage, which a company can exploit to improve its market share in the industry. However, this may attract the attention of the market leaders which will employ strategies to counteract this move.

(d) Digital marketing is measurable

Digital marketing can give you a comprehensive, online, real time, start-to-finish view of all the metrics that might matter to the company, including impressions, market shares, views, clicks, and time on page. This is one of the biggest benefits of digital marketing.

15.7 Electronic communication best practices

Netiquette, that is, proper conduct on the internet is essential to save the organisation embarrassment and give users a pleasant experience.

Guidelines when communicating on the internet

(a) Texting (messaging):

- i. Keep texts short;
- ii. Sign a text with your name; and
- iii. Spell out all words and do not use “texting lingo” or shorthand.

(b) Email:

- i. Use a descriptive subject line;
- ii. Be courteous;
- iii. Reply promptly – but allow time to get over an initial reaction to an angry email;
- iv. Remember attachments to an email may contain metadata that can disclose unwanted information to the recipient; and
- v. Ensure the integrity of the web links on email messages, as email may contain links to phishing or rogue web sites.

(c) Social media:

- i. The internet is not private, hence the need to be careful on what is shared;
- ii. Change your passwords frequently;
- iii. Log off after visiting the page;
- iv. Delete your browsing history, saved passwords and cookies regularly;
- v. Do not disparage anyone via social media;
- vi. Be aware of the acceptable behaviour on that website before sending messages; and
- vii. Educate yourself about a site before joining.

15.8 Benefits of electronic communication

Electronic communication plays an important role in modern business and society. One cannot think of managing modern businesses without electronic communication. It allows the amalgamation of several media, such as data, graphics, video, and sound, into one message. Devices such as cell phones with mobile communication technology and portable laptops could be deployed.

Benefits of electronic communication include:

(a) Facilitates quick transmission of information

The greatest advantage of electronic communication is the quick transmission of information.

(b) Enhances communication of large volume of information

Large volume of information can be sent with the help of electronic devices.

(c) Enables wide coverage

Information can be transmitted to receivers in different geographical locations in real time.

(d) Reduces communication cost

Electronic communication not only saves time but also money.

(e) Facilitates instant business decision

With the help of electronic communication, managers can take instant or quick decisions.

(f) Eases preservation of information

Electronic devices can store huge volume of information that can be used in the time of need.

In summary, electronic communication is convenient and online real time. Electronic communication is the essence of modern technologies.

15.9 Disadvantages of electronic communication

The disadvantages of electronic communication include:

(a) Information and data overload

Many small and medium organizations are overwhelmed with the abundance of data and information available for use. This suffusion of information, delivered at lightening speed makes it difficult for business owners to absorb.

(b) The cost of development

Electronic communication requires huge investment for infrastructural development. Frequent change in technology also demands further investment.

(c) Undelivered information

Information may not be delivered due to system error or fault with the technology. Hence, the required service may be delayed or not even delivered.

(d) Dependence on developed countries

Developing countries depend on developed countries for new technology infrastructure which cost they cannot afford, hence they depend on developed countries for housing and sharing global network.

(e) Over-dependence on technology

Many organisations are deskilling in areas of technical competence due to over-dependence on technology. Whenever technology fails, organisations find it difficult to cope as core skills required to run the organisations have been lost to technology.

(f) Loss of vital information

Most vital information are electronically stored, hence, when there is technology failure or cyber attack, these information may be lost irretrievably, except where the organisation has a good back up arrangement.

(g) Loss of confidentiality

The deployment of technology in the dissemination of information accentuates the risk of loss of confidentiality of these information.

(h) Rapid changes in technology

Rapid changes in technology create disruptions to the extent that most organizations in the developing economies find it difficult to cope with the pace of changes to the technology and infrastructure.

15 CHAPTER REVIEW

Chapter review

At the end of this chapter, readers should be able to:

- Explain basic communication theory including formal and informal communication, communication models, attributes of effective communication and barriers to and methods of communication;
- Explain patterns of communication including vertical and lateral;
- Understand the components of and plan effective business messages using the objectives, audience, structure and style model;
- Explain the different media and channels typically used in business communications including oral and face-to-face, written, visual aids and non-verbal;
- Explain the conduct of a formal meeting;
- State the main features of email;
- Explain the benefits and limitations of email;
- Explain when to use different channels of communication;
- State the basics of email etiquette;
- Explain the main features of video conferencing; and
- Explain the benefits and limitations of video conferencing.

Business reports

Contents

- 1 Introduction to business reports
- 2 Preparing the content
- 3 Writing the report
- 4 Business plans
- 5 Proposals
- 6 Other short reports
- 7 Chapter review

Introduction

Detailed syllabus

The detailed syllabus includes the following:

C	Management and organisational behaviour	
	3	Communication in business
	i	Explain the basic elements of report writing.

Exam context

The overall objective of this part of the syllabus is to ensure that candidates can communicate effectively while performing their professional responsibilities. This chapter deals specifically with report writing and other forms of formal written communication.

Professional accountants working in both practice and industry need to communicate with clients and other stakeholders on an almost daily basis. This section introduces students to formal business report writing and explains an approach for developing reports.

By the end of this chapter students will be able to:

- Explain what business reports are, what they are used for and what is involved in writing them;
- Prepare the contents of a short business report including:
 - Describing the features of effective reports
 - Understanding how to plan your time for writing a report
 - How to generate ideas and collect information
 - How to structure the underlying information
- Draft simple business reports, including:
 - Describing the common sections of a short business report and typical layout
 - Using appropriate language and content
 - Understanding the process for drafting the final report.

1 Introduction to business reports

Section overview

- What is a report?
- Types of business report
- What is involved in writing a report?

1.1 What is a report?



Definition: Report

An account given of a particular matter, especially in the form of an official document, after thorough investigation or consideration by an appointed person



Definition: Business report

A Business Report is a written communication of factual information on a specific subject presented in an orderly and formal manner.

Examples of the objectives of business reports in large businesses might include:

- Presenting an analysis to management on a specific issue or incident or on the on-going state of affairs of the business
- Providing evidence of regulatory compliance to regulatory authorities, shareholders, creditors, employees or some other stakeholder
- Providing product or service information to stakeholders such as customers and employees
- Summarise and formally present information and opinions that originates from external professionals in a comprehensive form – for example an audit report

So in summary, a business report is a communication of information or advice from one party to another who has requested the report for a specific purpose.

Objectives of a report

The primary objective of a report is to provide a basis for decision and action. Therefore just as you have seen when applying the fundamentals of business communication to letters, memos and minutes, the reader is the most important component of the report.

The secondary objective of a report which must be achieved in order that the primary objective is achieved is normally one of the following:

- To inform
- To record
- To recommend

Each report ultimately aids decision-making because it is simpler to make a decision if all the information is available in an easily understood form presented in a logical order.

You must once again adopt the 'big you, little me' approach with report writing. Essentially it is the reader's report, not yours. However, make sure you maintain a balance with sincerity as you must appear genuine in your report.

Components of a report

The key components of a business report are:

- Reader (top priority!)
- Writer
- Objective
- Subject
- Structure

With respect to whether you should write a letter or report the general guidance is that a document of one or two pages should be in the format of a letter. Documents greater than two pages should be presented as a report and accompanied by a brief covering letter.

Delivering reports

A written business report may be delivered in a number of ways. For example:

- Hold a meeting to discuss the issues then write a report
- Send a written report then follow it up with a meeting to discuss the report
- Deliver the report in the form of a presentation

Irrespective of the method of delivery the approach and structure remains the same and forms the basis of the rest of this chapter.

Routine and special reports

Reports fall into one of two categories based on how frequently they are prepared:

- Routine reports**
 - Routine reports contain information communicated on a regular basis for example a project progress report, or a monthly set of management accounts
 - These often follow a pre-defined layout with standard headings and are therefore typically easier to collate than special reports
- Special reports**
 - Special reports target a specific problem or specific facts, for example a due diligence report, a fraud investigation report, an audit report to management
 - Special reports are prepared once for each individual task
 - These provide much more flexibility due to their individuality. However, that in itself generally makes them more difficult to write due to their potentially free form.

1.2 Types of business report

There is literally no limit to the types and styles of reports that could be produced, given every business is dynamic and has different needs.

The following table lists some of the most common reports found in business.

Type of report	Reference
Business plan	See section 4
Request for proposal (RFP)	See section 5
Proposal	See section 5
Project progress report	See section 6
Performance appraisal report	See section 6
Feasibility report	See section 6
Sales and marketing report	See section 6
Annual report of the Chairman	See section 6
Operating report	See section 6

1.3 What is involved in writing a report?

Writing a report is an involved process. It requires information to be collected and research performed. Data needs collating, organising and then using to argue logically and reach conclusions or recommendations. Note that conclusions and recommendations must only be based on the facts and arguments included in the report.

The key stages in writing a report are:

1. Preparation

- Clarify the objective
- Plan the timings
- Generate ideas
- Research and collect information

2. Organise the information

- Information collected during the preparation phase needs filtering to isolate relevant information and reject non-relevant information
- Group the information into logical groupings and order

3. Plan the layout

- Create a skeleton plan with headings and sub-headings
- Identify where you will need diagrams, tables and illustrations

4. Write a first (rough) draft

- Complete the writing of the sections
- Where possible write simply, clearly and concisely. However, at this stage it is more important to focus on getting the information in and flowing logically

5. Editorial, revision and writing a final draft

- Review the report from the perspective of the reader to ensure it:
 - delivers 'big you, little me'
 - achieves the original objective of writing the report
- Re-draft to ensure the language and tone are appropriate

6. Checking the final draft

- Proof-read
- Final approval before distribution

2 Preparing the content

Section overview

- Features of effective reports
- Planning your time
- Generating ideas and collecting information
- Structuring the information

2.1 Features of effective reports

Where to start?

The task of writing a report can be daunting leaving the author with a helpless feeling of where to start. This need not be the case if you follow the guidance in this study manual.

The key components of a report, including:

- Reader (top priority!)
- Writer
- Objective
- Subject
- Structure

You should start by considering the questions below which all need answering in order to effectively manage the report writing process:

- What is the report meant to be about?
- Where will you find the necessary information?
- Who is going to read the report?
- How long should the report be?
- How long will it take to write?
- When will you have time to think about it and write it?

Features of effective reports

Your objective is to write a credible report that is sincere and achieves its objectives. The following characteristics help distinguish an effective report:

- Fit for purpose
- Decisive
- Easy to read and follow
- Correct in fact and language
- Concise
- Persuasive
- Action-based
- Clear

- Get to the point

So in summary, an effective report says everything it needs to without using unnecessary words.

Features of bad reports

The following list summarises characteristics of a bad report:

- Does not serve its purpose
- Leaves the reader's questions unanswered
- Hard work, boring and irritating to read
- Still needs basic editing
- Unconcise
- Leaves the reader unconvinced or in disagreement
- Over-uses the passive voice
- Is muddled and illogical
- Is story-like rather than business-like
- Indecisive

Note that arguably the most important steps occur right at the start of the process:

- defining the objective
- identifying the reader

When a client commissions a report, for example a due-diligence report, an assurance report or a fraud investigation report, they must be specific about their needs and the deadline. If there is ambiguity at the initial report commissioning stage then the client is likely to reject the report as not meeting their expectations, however good the report might be!

2.2 Planning your time

Writing a report is effectively a mini project. As with any good project management you should formulate a plan and maintain a checklist to monitor progress.

Remember to factor in breaks in your work so that you can re-focus on tasks with a clear mind and fresh perspective. Breaks are particularly important in the closing stages when attention to detail and accuracy are of paramount importance.

The following illustrative checklist can be used to help monitor the preparation of your report.

Phase	Task	When?	Completed
Preparation	<input type="checkbox"/> Identify reader	xxx	
	• Identify purpose	xxx	
	• Identify material sources	xxx	

Phase	Task	When?	Completed
Writing	<input type="checkbox"/> Skeleton structure	xxx	
	• Language & tone	xxx	
	• Logical layout	xxx	
	• Prepare rough draft	xxx	
	• Revision 1	xxx	
	• Revision 2 etc.	xxx	
Completion	<input type="checkbox"/> Proofing and editing	xxx	
	• Final check	xxx	
	• Approval	xxx	
	• Printing	xxx	
	• Sending	xxx	

2.3 Generating ideas and collecting information

Generating ideas

Always bear in mind the objective of the report. This should help streamline the ideas generation and information gathering process and keep you focused on relevant information only.

Make notes of your initial ideas before you forget them. The process of making notes will normally prompt other related thoughts creating a snowball effect.

The below toolkit will also help generate ideas:

Method	Explanation
Questions from the reader	<p>Imagine you are the reader. What are all the questions, objections or worries you might have.</p> <p>Generate answers to these and use those answers to help guide you in constructing the report.</p>
Your questions	<p>Answer the following with respect to the report title:</p> <ul style="list-style-type: none"> • What? (Events, actions or things) • Why? (reasons, conclusions, opinions) • When? • How? (methods or processes) • Where? • Who?
Brainstorming	<p>Record every idea you can think of without worrying too much about relevance or order. Think and write fast – quantity is the key at this stage. You can check facts and figures later – the brainstorm is simply to generate ideas that can be evaluated later.</p>

Method	Explanation
Sequential notes and lists	Similar to brainstorming but more ordered.
Mind-mapping and patterned note-making	Write the report subject in the centre of a blank piece of paper. Then record ideas as you think of them branching out from the central theme. Circle and join concepts to show links and organise thoughts.

Some people prefer to use paper and pen (or pencil) whilst others prefer to use a computer. Either is fine - simply use the method (or methods) that are most effective for you.

Research

There are many sources that can be used for researching the report. These include:

- Primary sources (i.e. generating original information)
 - Colleagues - particularly those with relevant experience
 - Brainstorm meetings
 - Performing an audit, review or investigation
 - Observation
 - Unstructured interviews
- Secondary sources (i.e. researching existing information)
 - The Internet - with increasingly easy access and free search engines such as Google and Bing a great place to start your research is often online.
 - Other reports, handbooks or reference books – for example an IFRS manual, or a company's most recent published annual report. Note that many of these can also be found easily online
 - Experts and specialists
 - Government or trade reports
 - Technical journals
 - Market research agencies
 - Data from another department
 - Customer database
 - Accounting data

2.4 Structuring the information

Screening

Having generated lots of ideas and thoughts you now need to start organising the information into a structure that will support the actual writing of the report.

To help in screening the information collected, continually remind yourself of the fundamental questions:

- What is the objective of the report?
- Who is the reader?
- Does the reader really need this?

The structure of a report describes the pattern in which the information is organised. The structure is critical because the reader will use it to get an overview of the content of the report. In many cases readers will not look at all the detail in a report but rather read the headings and dip into just those areas where they need further clarification.

Grouping

Research has shown that most people can only remember a maximum of seven items in their short term memory at any one time. This is why it is important that you can identify themes and trends in all the information you have collected.

The illustration below demonstrates how this could be applied to grouping the line items in a simple Statement of Financial Position.



Illustration: Identifying logical groups for a report

A brainstorm has identified the following line items from a simple Statement of Financial Position:

- Bank loan
- Ordinary share capital
- Inventory
- Tangible non-current assets
- Revaluation reserve
- Trade payables
- Trade receivables
- Overdraft
- Retained earnings
- Intangible assets
- Cash at bank

The above items would be much better structured into sub-groups as follows:

- Assets
 - Non-current assets
 - Tangible non-current assets
 - Intangible assets

- Current assets
 - Inventory
 - Trade receivables
 - Cash at bank
- ☐ Equity and liabilities
 - Equity
 - Ordinary share capital
 - Revaluation reserve
 - Retained earnings
 - Liabilities
 - Bank loan
 - Trade payables
 - Overdraft

The grouping has reduced the number of 'headline' categories from the original nine down to just two, each of which contains two further sub-categories. This provides four mid-level categories each of which contains a logical collection of the original nine items.

The illustration shows how it is possible to organise information into a series of logical giant pyramids. These pyramids provide a mechanism that you can use to communicate your ideas to the reader. Essentially you need them to understand the pyramid groupings as you have done.

Bottom-up and top -down

In communicating your thinking you will need to ensure your reader understands the links between the groups and how the information flows. Remember that the reader will not have experienced the same research and grouping thought process that you have and will therefore not be as familiar with the report content as you.

Never assume the reader knows the links – your report must explain them to clearly build the full picture. The way to do this is:

- ☐ Construct a pyramid of thoughts where each level from the bottom upwards summarises the groups below
- ☐ When you present the information to the reader (i.e. write the report) you present it in a top-downwards fashion starting with the key point then explaining each sub-level of back-up.

Let us continue the previous illustration to demonstrate this.



Illustration: Bottom-up and top-down

Continuing the previous illustration...

Bottom-up

- Tangible non-current assets and intangible assets combine to make non-current assets
- Inventory, trade receivables and cash at bank combine to make current assets
- Non-current assets and current assets combine to make assets

Top-down

- Assets comprise of non-current assets and current assets
- Non-current assets comprise of tangible non-current assets and intangible assets
- Current assets comprise inventory, trade receivables and cash at bank

Ordering the groups

Having formulated the groups you need to identify an appropriate ordering for presentation in the report. This could be based on one of the following:

- Ranking – either descending or ascending in terms of importance
- Spatial – order the groups as you would visualise them being created into a diagram or chart
- Chronological – order the groups in order of time in which they occur – e.g. steps in a process
- Argument – the order builds the argument with logical flow between the various groups culminating in the conclusion or recommendation

Reasoning

If your report presents a reasoned argument then an appropriate layout would be:

- Facts – state the evidence and information first
- Argument – describe the way in which the facts were constructed and linked
- Conclusion – the result we arrive at by applying the argument to the facts

The argument will only appear reasonable to the reader if it is supported by sufficient appropriate facts. It is critical that the conclusion follows on from the argument. All too often readers complain that the conclusions are not drawn from the argument. This gives the impression that the writer concluded first then tried to find facts to support the conclusion.

3 Writing the report

Section overview

- Layout
- Business language for reports
- Drafting the final report

3.1 Layout

Top-down or bottom-up ordering

You could use either the top-down or bottom-up approach to ordering your report:

- Top-down**
 - Present your conclusions first
 - Then present the reasons for the conclusion
 - Finally include the facts underlying your reasoning
- Bottom-up**
 - State the material facts
 - Demonstrate the reasons for the facts then summarise them
 - Finally include a conclusion based on the facts you have just summarised

In practice the method preferred by managers and clients is by far the top-down approach. This is because time is of such a premium in the business environment that people rarely have time to look at all the detail – they want immediate answers.

Therefore, senior people tend to pay most attention to the introduction, summary and conclusions rather than the body of the report. That is not to say that the body is redundant, far from it. However, in practice readers will only selectively read the sections of the body where they need more information about something they read in the summary.

The usual approach is therefore to present the end of the story at the beginning. In practice this means summarising the conclusions and recommendations in an 'executive summary' at the start of the document (top-down). However, it is also important to include an introduction right at the start of the report that sets the context of the subject of the report.

3.2 Business language for reports

Whilst longer than memos and letters, business reports still need to be kept simple, understandable and easy to read. Therefore the same principles of effective business communication apply.

In the case of business reports there are five key issues to address:

- Relevance**
 - Only include information that is important to the reader – i.e. 'need to have' rather than 'nice to have'

- ❑ Impact
 - Your report should have an impact on the reader. It should be written constructively and clearly whether the objective is to provide information, record something or provide advice.
- ❑ Cost effectiveness
 - Reports are not judged by length but rather by effectiveness. The reader should feel that their time spent reading the report was an effective use of their time. Therefore the focus should always be on quality, not quantity.
- ❑ Clarity
 - Follow the usual rules of effective clear business writing, including:
 - Use short words, sentences and paragraphs omitting unnecessary words
 - Write concisely
 - Be definite and give facts
 - Avoid jargon and clichés
 - Use active rather than passive sentences
 - Use the right tone
- ❑ Timeliness
 - The report must be available to the reader when they need it. The most perfectly written report is of little value if not available when required by the reader

3.3 Drafting the final report

First draft

There are a number of philosophies around the order in which you should actually write the first draft of the report such as:

- ❑ Write the easiest sections first to give yourself confidence
- ❑ Write the most difficult sections first to relieve pressure
- ❑ Write the sections in the order they appear in the report

There are no set rules – experience will lead you to the method that works best for you. However, the golden rule is to write the executive summary last. This will ensure that the recommendations and conclusions actually do flow from the report.

When writing the first draft, do not worry too much about grammar, punctuation or style – these can be added later. The objective is to get somewhere close to what the final report is going to look like.

Editing

Colleagues are more likely to see a report from the reader's perspective. Therefore if possible ask a colleague to review your report from a structural, logic and flow perspective.

A useful editor's checklist will include:

Consideration	Things to look for
Look at the draft as a whole	<ul style="list-style-type: none"> • Appropriate layout? • Well presented?
Title, introduction and conclusion	<ul style="list-style-type: none"> • Are they consistent? • Do they emphasise the correct points?
Text	<ul style="list-style-type: none"> <input type="checkbox"/> Short words, sentences and paragraphs, leaving out unnecessary words? • Definite and supported by facts? • No jargon and clichés? • Appropriate tone?
Read the text out aloud	<ul style="list-style-type: none"> <input type="checkbox"/> Does it flow? • Are any words, phrases or points repeated unnecessarily? • Does all the information pass the 'need to have rather than nice to have' test?

Proof reading

Unfortunately whilst the perfect report will indeed give an excellent impression, a report with a single spelling mistake gives the reader an overly negative impression about your standards. Therefore it is critical to check the report for spelling, grammar and other language or layout mistakes.

4 Business plans

Section overview

- Basic structure of a business plan
- In detail - components of a business plan

4.1 Basic structure of a business plan



Illustration: Basic structure of a typical business plan

A typical business plan will adopt the following layout:

- Title page
- Table of contents
- Introduction
- Executive summary
- Body of the report
 - Business description
 - Business environment analysis
 - Industry background
 - Competitor analysis
 - Market analysis
 - Operating plans
 - Management summary
 - Financial plan
- Conclusions and recommendations
- Appendices
 - Detailed financial information
 - CVs of key management

4.2 In detail – components of a business plan

Title page

The title page is there to attract the reader to the report and assist them in finding the report at a later date. You would typically include:

- Title (and any sub-titles) – this should distinguish the report and ensure it is easily identifiable from others
- Author (internal reports only)
- Your organisation's name (external reports only)
- Any reference numbers
- Degree of confidentiality
- Date

You might also include some kind of unobtrusive artwork such as logos (your organisation and the client) plus a simple graphic that relates to the report subject.

Table of contents

A table of contents is a list of all the sections that are included in the report (in the same order in which they appear) plus relevant page numbers.

Introduction

The introduction prepares the reader for the report itself by reminding them of what they already know i.e. why the report has been written and the question that the report answers.

The introduction should address the following:

- Make the subject of the report clear
- State the purpose of the report
- Briefly explain the methods used to get the information

Executive summary

The benefit of including an executive summary is that for senior people with little time it is the one section they will read. Therefore a succinct, clear and well written executive summary should always reach the reader.

The executive summary should include:

- What the report is about
- What the problems are
- The conclusions you arrived at
- What you recommend

The skill in writing an executive summary is to give the overall picture without including too much detail. One useful by-product of writing the executive summary is that by going through the writing process you will be able to check that the report itself is logical.

Body of the report

The body of the report should be split into sections with logical headings and sub-headings. These will likely reflect the groupings and sub-groupings you created during the planning and structuring phase.

The headings are essentially 'signposts' that allow the reader to navigate to the relevant detail in a logical fashion to further investigate something they have read in the executive summary. Typical components would include:

- Business description, which briefly explains:
 - Overall mission and objectives
 - History and ownership
 - Products and services
- Business environment analysis
 - Industry background

- PEST analysis: A PEST analysis describes the political (P), economic (E), social (S) and technological (T) factors that impact the business. For example:
 - **Political:** A change in government policy may lead to a reduction in grants available
 - **Economic:** High interest rates make it expensive to borrow money from a bank to fund expansion
 - **Social:** An ageing population increases the demand for pharmaceuticals and old-age-related healthcare
 - **Technological:** The evolution from traditional hand-held mobile phones with buttons to smart-phones with touch-sensitive screens

SWOT analysis: A SWOT analysis describes a business's strengths (S), weaknesses (W), opportunities (O) and threats (T). For example:

- **Strength:** the business employs a highly skilled and dedicated workforce
 - **Weakness:** the factory is full of old machinery that frequently breaks down
 - **Opportunity:** there is huge demand for the businesses products overseas so they could start exporting their products
 - **Threat:** A large new competitor could open an outlet in the same town where the business is currently the only supplier.
- Competitor analysis
 - Who are the main competitors?
 - Market analysis
 - Size, segmentation, growth/decline
 - ☐ Operating plans
 - Marketing plan
 - Operations plan
 - ☐ Management summary
 - Who the key management personnel are and their backgrounds
 - Organisation chart (summary only – can include more detail as an appendix)
 - ☐ Financial plan
 - Summary financial information – income statement, balance sheet and cash flow statement

Conclusions and recommendations

The conclusions and recommendations must follow logically from the rest of the report. When writing the conclusions and recommendations section, consider the following:

- Do the conclusions and recommendations follow logically from the rest of the report?
 - Draw out the main point(s) of the report and present a considered judgement of them
 - Only draw conclusions that are justified by the evidence and facts contained in the body of the report
 - Make recommendations based only on your discussion and conclusions
 - Never introduce a new line of argument or material in the conclusions and recommendations section
- Check the conclusions and recommendations against the original objective of the report
- Make sure you have answered the reader's key question
- Finish with the final impression you want to make

Appendices

The appendices should include detailed information that the reader can essentially do without in order to make sense of the main body of the report. For example: calculations, examples, questionnaires and CVs. They are effectively the bottom level of the logical pyramids you constructed during the structuring phase.

In summary, appendices should be:

- Included only if absolutely necessary
- Non-essential for understanding the main arguments
- Referred to somewhere in the body of the text i.e. there must be a link.
- Mentioned as the final item in the table of contents

An alternative approach is to exclude appendices but invite the reader to contact the author should they wish to see a copy of the detail. However, as a minimum most business plans would include the following two appendices:

- Detailed financial information – more detail than in the financial plan in the main body
- CVs of key management – certainly board members but also include for other key management personnel

5 Proposals

Section overview

- Request for proposal (RFP)
- The proposal

5.1 Request for proposal (RFP)

An RFP is a formal document that describes a project, or need for service, and invites prospective bidders to propose solutions.

An RFP should contain the following:

- (i) Description of the work to be performed (in sufficient detail)
- (ii) Method of formal submission of the proposal e.g. in a prescribed form to be delivered by hand or by registered post
- (iii) Milestones and deadlines of the proposal process
- (iv) Terms relating to payments, such as advances, stage (interim) payments and any other special terms and conditions.



Illustration: RFP for a new statutory auditor

Summary

XYZ company is accepting proposals for the appointment of a new statutory auditor with effect from 1 July 20XX. The appointment will last for an initial period of three years.

The purpose of this RFP is to provide a fair evaluation for all candidates and to provide the candidates with the evaluation criteria against which they will be judged.

Proposal guidelines and requirements

This is an open and competitive process.

Proposals should be submitted by 17:00pm Tuesday 8th June 20XX. Proposals received after 17:00pm Tuesday 8th June 20XX will not be considered and will be returned unopened.

The proposal must contain the signature of a duly authorized partner of the firm submitting the proposal.

The fee quoted should be inclusive. If the fee excludes certain expenses or charges, a detailed list of excluded items with a complete explanation of the nature of those items must be provided.

Sealed proposals must be submitted by hand to [address]. Proposals must include both the financial and operational components.

Purpose, description and objectives

Following the announcement of the retirement of the existing statutory auditor XYZ company seeks the appointment of a new statutory auditor.

Budget

XYZ company expects to pay a fair market rate fee for a high quality audit that adds significant value to the organisation's financial and operational management. There is likely to be scope for the winning bidder to provide a number of non-audit services throughout the term of the appointment.

The fee will be payable in three stages as follows:

Stage 1 [describe]

Stage 2 [describe]

Stage 3 [describe]

Background of our organization

Mission

Products and services overview

Geographies covered

Qualifications

The winning bidder must be able to provide appropriately qualified resources and demonstrate experience in similar audit engagements.

Evaluation criteria

The winning bidder will offer a competitive fee whilst delivering a quality and efficient service. They must also be able to complete the audit by [date] annually to enable XYZ company to report to its members in accordance with its articles of association.

XYZ company will consider each bidder's experience within the sector and with similarly sized clients. XYZ company will also consider the range of complementary non-audit services that each bidder might be able to provide in the future.

5.2 The proposal

A proposal is either written in response to an RFP, or alternatively used as to promote an idea to a relevant stakeholder.

The essential qualities and contents of a well-prepared proposal include:

- (i) purpose of the proposal is stated clearly
- (ii) problem or need for the proposal is understood and defined clearly
- (iii) suggested solution offered in the proposal is workable and in the best interests of the recipient
- (iv) proposal is honest, factual and objective.
- (v) benefits to be derived from the proposal outweigh the costs.
- (vi) proposal contains a time schedule including the milestones and any checklists of the projects
- (vii) contains a list of the costs and resources involved in completion of the project

A typical proposal might include the following sections:



Components of a proposal

- Reference or authorisation for the Proposal – e.g. specific reference back to the RFP
- Table of Contents
- Summary
- Purpose or Objective
- Problem or Need
- Background
- Benefits of the proposal
- Description of the solution
- Methodology of Handling the proposal
- Qualifications of personnel
- Time Schedule
- Cost
- Glossary
- Appendices
- Reference List
- Name of primary contact person

6 Other short reports

Section overview

- Project progress report
- Performance appraisal report
- Feasibility report
- Sales and marketing report
- Chairman's annual report
- Operations report

6.1 Project progress report

It outlines the progress of the tasks in a project, including work completed, work remaining, costs incurred, remaining cost to complete the project and schedule of original and anticipated time for completion of the project.



Illustration: Project progress report

Project progress report - New computer system roll-out

Project reference:	FR24CS-3d
Description:	Install new desktop computers for all traders and sales personnel
Budget - cost	₦60m
Budget - man days	4,800
Start date	1.3.20XX
End date	31.12.20XX
Sponsor	Winston Jones
Milestone 2 update	
Progress update:	Abuja complete. Now delivering Lagos which is 20% complete.
Work remaining:	Lagos plus small number of remote staff
Costs incurred:	₦24m
Costs to complete:	₦38m (Forecast overrun ₦2m due to software bug (now fixed))
Man days to date:	2,020
Days to complete	2,950

6.2 Performance appraisal report

It documents the quality of an employee's work performance for a particular period with identification of the individual's strengths and weaknesses, training and development needs and career planning.

Some appraisal reports may include recommendations of salary increments/promotions although the two themes can be kept separate.



Illustration: Performance appraisal report

Annual	
Name	Hasan Chutani
Manager	Amir Sethwi
Division	International sales Equities
Overall grade	3: meets
<i>(1= significantly below expectation, 5= significantly above)</i>	
Core skills	Grade
Client service	4
Interpersonal skills	4
Creativity	3
Teamwork	3
Punctuality	2
Decision making	3
Adaptability	3
Objective	Appraisal
1. Increase sales by 10%	9% achieved. Well done. 6 introduced.
2. Introduce 5 new clients	Great!
3. Attend advanced sales skills	
Objectives for next 12 months	
1. Increase sales by 15%	
2. Introduce 5 new clients	
3. Attend advanced negotiations course	
Career planning	
Medium-term objective is to achieve manager grade and start managing his own team.	

6.3 Feasibility report

A feasibility report examines the viability of the proposed undertaking from its technical, commercial and economic standpoints.

A feasibility report presents the benefits that the proposal or idea will yield with details of its initial capital costs, implementation schedule, recurring operating costs and returns over the useful life of the undertaking



Illustration: Feasibility report

Feasibility report - Replace manual system with automated scanners

Technical feasibility

Highly feasible - technology has been in existence for three years with the latest release (version 2.3) having excelled in both technical and user testing.

Commercial feasibility

Project now considered a 'must do' as three out of five main competitors have already implemented automated scanning systems.

Economic feasibility

Set-up costs ₦3,500,000

Payback period 2.3 years

Lead-time 3 months

Operating costs Annual maintenance contract ₦

96,000 Useful life Replace in 7 years

6.4 Sales and marketing report

A sales and marketing report provides data of actual sales of various products classified by their quantities, territories, sales teams and distributors for a specific period.

The report displays the variance between sales achieved versus the budget. The report might also include recommendations for pursuing specific marketing policies.



Illustration: Sales and marketing report

Supermarket sales report - April 20XX

Product category	Budget	Actual	Variance		Manager comments
	\$	\$	\$	%	
Meat/poultry	10,000	11,384	1,384	14%	Three major promotions
Grains and cereals	4,000	4,532	532	13%	Three major promotions
Dairy products	8,000	7,899	(101)	-1%	
Confectionary	3,000	3,403	403	13%	Major TV campaigning by manufacturers
Beverages	5,000	4,580	(420)	-8%	Government tax increases
Seafood	1,000	402	(598)	-60%	Highly publicised health scare

6.5 Chairman's annual report

The Chairman's annual report presents a summarised description of the historical financial performance of the organisation, its achievements and problems experienced during the period under review.

The report provides information about future expectations and plans to obtain the desired results.

The report also informs the stakeholders, primarily existing and prospective shareholders, creditors and analysts of the achievements and future expectations of the organisation including both profit and cash flow.



Illustration: Chairman's annual report

Chairman's annual report

Financial performance

Underlying profit for the year is up 8% at \$202m. Total income is up 7% driven by strong equities trading offset by weaker than expected bond performance.

Financial strength: we have maintained buffers well in excess of the regulatory minimum and are confident this will continue in the foreseeable future.

Our customers

Results of the annual customer satisfaction survey reveal a 98% satisfied or above grading. This exceeds our target of 95% which will remain in place for next year.

Our employees

The company remains an employer of choice within the local financial services sector. We continue to attract high quality candidates into our graduate stream and have promoted 16 staff to managing director grade this year.

We continue to lead the industry in offering flexible working and support for working parents.

Having met our 3-year diversity target of 35% employees being female we have revised the target up to 40% within the next two years.

Strategy

During the current volatile market conditions our objective remains to run a diversified portfolio with activity in the equities, fixed income and investment banking sectors. This will ensure we manage risk whilst offering reasonable exposure to the upside in the current markets.

Signed: Chairman

6.6 Operations report

An operations report summarises the operational activity for a particular time period.

The report might include information on sales and purchases, employee information and inventory.

Operating reports are used by management to obtain a quick summary of how the company is performing. For example management of an airline might be interested about revenues and employee numbers and also flight statistics, occupancy rates and punctuality.

Management use operating reports to identify areas that are performing well and areas that need improvement.



Illustration: Operating report

Airline operating report May		
Financial	Accounting profit	1.3
	Opening cash	2
		0.5
Customer	Complaint rate	4%
	Repeat flyers	63%
	Average	4.8/
Operation	Capacity utilisation	78%
	Average turnaround time	48
Employee	Absenteeism	5.30
	Training days	%
	New	463

7 Chapter review

Chapter review

At the end of this last chapter, readers should be able to:

- Explain what business reports are, what they are used for and what is involved in writing them;
- Prepare the contents of a short business report including:
 - Explaining the features of effective reports;
 - Understanding how to plan your time for writing a report;
 - How to generate ideas and collect information; and
 - How to structure the underlying information;
- Draft simple business reports, including:
 - Explaining the common sections of a short business report and typical layout;
 - Using appropriate language and content; and
 - Understanding the process for drafting the final report.

Peel & Treitel (2010). The law of contract (12th ed.). London: Sweet & Maxwell.

Foundation Level
Business, Management and Finance**17****Soft skills for accountants****Contents**

- 17.1 Emotional intelligence
- 17.2 Social thinking
- 17.3 Chapter review

17.1 Emotional intelligence**17.1.1 Introduction**

Emotional intelligence (EI) was first coined in a paper written by Michael Beldoch¹ in 1964. The term 'emotional quotient (EQ) was used in an article by Keith Beasley² in 1987. In 1989, Stanley Greenspan³ proposed the trait model, thereafter, Peter Salovey and John Mayer⁴ independently put forward ability model of emotional intelligence. However, the term emotional intelligence was made popular by Daniel Goleman⁵ in his book, "*Emotional Intelligence – Why it can matter more than IQ*". He also presented the mixed model of emotional intelligence.

Goleman described emotional intelligence as a person's ability to manage his feelings so that those feelings are expressed appropriately and effectively. According to Goleman, emotional intelligence is the largest single predictor of success in the workplace. It is the measure of an individual's abilities to recognise and manage their emotions, and the emotions of other people, both individually and in groups.

17.1.2 Importance of emotional intelligence

Emotional Intelligence has been proven to be important to an organisation in the following ways:

- (a) Increases productivity in workplace;
- (b) Helps to reduce stress;
- (c) Moderates the impact of conflict-related situation;
- (d) Promotes relationships and understanding;
- (e) Fosters stability and continuity; and
- (f) Heightens self of awareness.

17.1.3 Components of emotional intelligence

According to Goleman emotional intelligence has five components. These are:

(a)Self-awareness: This is recognising and understanding our own moods and motivations and their effect on others, which involves the ability to monitor our own emotional state and identify our own emotions. This trait shows confidence, sense of humour (can laugh at self), awareness of your impression on others (can read the reactions of others to know how you are perceived). Self-awareness encompasses emotional awareness, accurate self-assessment and self-confidence;

(b)Self-regulation: Emotional intelligence helps us to be able to regulate and manage our emotions in an appropriate way. This is not the same thing with hiding our true feelings and locking our emotions. It is the ability to wait to express our emotion at the right time, place, and avenue.

Self-regulation includes:

- i. Self-control: This is the ability to recognise and control our emotions appropriately rather than masking or hiding our emotions;
- ii. Trustworthiness: This is the ability to maintain our integrity, which means ensuring that what we do is consistent with our personal values. People who are trustworthy always act ethically;
- iii. Conscientiousness: This is taking responsibility for our own personal performance, and making sure that it matches up to our ability and our values;
- iv. Adaptability: This is the ability to change and adapt ourselves to the changing environment; and
- v. Innovation: This is deliberate application of information, imagination and initiative in deriving greater or different values from resources, and includes all processes by which new ideas are generated and converted into useful products.

(c) Motivation: This is defined as actions or strategies that will elicit a desired behaviour or response by a stakeholder (Alison Doyle).

Motivational process involves:

- i. Assessing the preferences and personality characteristics of the individual or group to be motivated;
- ii. Defining motivational strategies appropriate for that target;
- iii. Conveying expectations for performance to or achieving desired outcomes from the object of the motivation;
- iv. Communicating benefits, rewards, or sanctions, if expectations are (or are not) met.
- v. Providing feedback regarding progress or lack of progress towards desired outcomes;
- vi. Addressing problems or obstacles that are limiting success;
- vii. Providing rewards for desired outcomes; and
- viii. Issuing warnings prior to enacting sanctions.

(d) Empathy: This is the awareness of the feelings and emotions of other people.

Goleman identified five key elements of empathy, as follows:

- i. Understanding others;
- ii. Developing others;
- iii. Having a service orientation;
- iv. Leveraging diversity; and
- v. Political awareness.

(e) Social skills: These are the skills used to communicate and interact with each other, both verbally and nonverbally, through gestures, body language and our personal appearance:

- i. Self-awareness;
- ii. Self-regulation;
- iii. Motivation;

- iv. Empathy; and
- v. Social skill.

17.1.4 Models of Emotional Intelligence

There are three models of emotional intelligence. These are:

- i. Ability;
- ii. Mixed; and
- iii. Trait.

Different instruments have been developed to assess the different constructs of these models.

(a) Ability model

Definitions

Peter Salovey and John Mayer defined emotional intelligence as "the ability to monitor one's own and other people's emotions, to discriminate between different emotions and label them appropriately, and to use emotional information to guide thinking and behaviour".

This definition proposed four emotional abilities:

- i. Perceiving;
- ii. Using;
- iii. Understanding; and
- iv. Managing.

The model also states that these abilities are distinct, but, related.

Emotional intelligence also reflects abilities to join intelligence, empathy and emotions to enhance thought and understanding of interpersonal dynamics.

This model addresses how emotion affects thought and understanding. It views emotions as useful sources of information by which individuals understand and navigate their social environment. The model proposes that individuals vary in their ability to process information of an emotional nature and in their ability to relate emotional processing to a wider cognition. This ability is seen to manifest itself in certain adaptive behaviours.

We shall now discuss the four abilities identified in the ability model:

- Perceiving emotions – This is the ability to perceive and interpret emotions in faces, pictures, voices, and cultural artifacts—including the ability to identify one's own emotions. Perceiving emotions represents a basic aspect of emotional intelligence, as it makes all other processing of emotional information possible;
- Using emotions – This is the ability to harness emotions to facilitate various reasoning activities, such as thinking and problem-solving. The emotionally intelligent person can utilise his or her changing moods to best fit the task at hand;
- Understanding emotions – This is the ability to comprehend emotional language and to appreciate complicated relationships among emotions; and
- Managing emotions – This is the ability to regulate emotions in both ourselves and in others. Therefore, the emotionally intelligent person can harness emotions, even negative ones, and manage them to achieve intended goals.

The ability emotional intelligence is measured using the following test instruments:

- Mayer-Salovey-Caruso Emotional Intelligence Test (MSCEIT) which is based on a series of emotion-based problem-solving items. By testing a person's abilities on each of the four branches of emotional intelligence, it generates scores for each of the branches as well as a total score. It is structured after the ability-based IQ tests;

- Diagnostic Analysis of Non-verbal Accuracy: This test displays faces of 12 males and 12 females expressing different emotions such as happiness, fear, anger in high and low levels. Participants are required to identify these stimuli;
- Japanese and Caucasian Brief Affect Recognition Test: This test requires participants to recognise 7 emotions on the faces of Japanese and Caucasian individuals; and
- Levels of Emotional Awareness Scale: Participants are exposed to 26 social scenes and required to state the feelings displayed on a continuum of low to high.

(b) **Mixed model**

Definition

This model presented by Daniel Goleman⁴ defines emotional intelligence as a wide array of competencies and skills that drive leadership performance.

It recognises 5 main emotional constructs, as follows:

- Self-awareness – the ability to know one's emotions, strengths, weaknesses, drives, values and goals and recognise their impact on others while using gut feelings to guide decisions;
- Self-regulation – ability to control or redirect one's disruptive emotions and impulses and adapting to changing circumstances or environments;
- Social skill – managing relationships to get along with others;
- Empathy – considering other people's feelings, especially when making decisions; and
- Motivation – being aware of what motivates them.

The model

- Identifies a set of emotional competencies within each of the constructs.
- Defines emotional competencies as learned capabilities that can be developed to achieve outstanding performance, rather than innate talents.
- States that individuals are born with a general emotional intelligence that determines their potential for learning emotional competencies.

Measurement

There are 2 main measurement tools based on the mixed model. These are:

- The Emotional Competence Inventory (ECI), which was created in 1999, and the Emotional and Social Competence Inventory (ESCI), a newer version of the ECI developed in 2007, provide a behavioural measure of the emotional and social competencies; and
- The Emotional Intelligence Appraisal which was created in 2001. It may be used as a self-report or 360-degree assessment.

(c) **Trait model**

i. Definition

Trait model defines trait emotional intelligence as "a constellation of emotional self-perceptions located at the lower levels of personality".

Trait emotional intelligence refers to individuals' self-perception of their emotional abilities.

This definition identified two constructs, as follows:

- Behavioural dispositions; and
- Self-perceived abilities.

It is measured by self-report, as against the ability-based model which aims at measuring actual abilities, which have been difficult to measure scientifically. It is recommended to be taken within a personality framework. An alternative label for the same construct is trait emotional self-efficacy.

The trait emotional intelligence (EI) model is broad based and is inclusive of the mixed model discussed above. It presents emotional intelligence as a personality trait, with its implications.

ii. Measurement

There are many self-report measures of EI, including:

- The EQ-I – there are several of these emotion quotient tests. They are widely used in several jurisdictions, hence, presented in many languages.
- The TEIQue - The test has 15 subscales grouped under four factors: well-being, self-control, emotionality, and sociability. They are found reliable and follow normal distribution.

iii. The big five personality traits theory

The theory states that personality can be categorised into five factors as follows:

- Conscientiousness;
- Agreeableness;
- Neuroticism;
- Openness; and
- Extraversion.

This theory provides a basis for understanding and improving relationships with others. It helps to rationalise human behaviour. The theory may also be used to better understand oneself and thus facilitate relationships with others.

The Big Five Model, also known as the Five Factor Model, is the most widely accepted personality theory. Unlike other trait theories which factors can only take either of two values such as introvert or extrovert, the Big Five Model states that each personality trait is a spectrum. Individuals are therefore awarded scores on a continuum, based on the degree of manifestation of the traits.

17.2 General effects

A review published in the journal of *Annual Psychology*⁷ found that higher emotional intelligence is positively correlated with the following:

- (a) Better social relations for children;
- (b) Better social relations for adults;
- (c) Highly emotionally intelligent individuals are perceived more positively by others;
- (d) Better family and intimate relationships;
- (e) Better academic achievement;
- (f) Better social relations during work performance and in negotiations;
- (g) Better psychological well-being;
- (h) Allows for self-understanding, leading to self-actualisation; and
- (i) A person with a good understanding of emotional quotient, EQ, can build more meaningful connections, boost self-confidence, have a positive attitude, and face challenges enthusiastically, leading to success in life. This is referred to as the EQ edge.

17.3 Criticism of emotional intelligence

Despite its usefulness, emotional intelligence has received some severe criticisms⁶. Below are some of them:

- (a) Predictive power: Researchers challenge that emotional intelligence measures have not been subjected to enough rigorous statistical tests to establish that high emotional intelligence score correlate with effective leadership and high academic performance as postulated by proponents of emotional intelligence as a good predictor of these performances;

- (b) Correlation with personality: EI measures by self-report approach are dimensions of personality trait, hence they correlate e.g., neuroticism and extraversion;
- (c) Socially desirable responding: Socially desirable responding (SDR), or "faking good", is defined as a response pattern in which test-takers systematically represent themselves with an excessive positive bias. This bias is manifest in the tests;
- (d) Emotional intelligence as behaviour rather than intelligence: That EI is only a measure of behaviour rather than an intelligence. That it does not fit the construct of an intelligence, but a skill;
- (e) Emotional intelligence as skill rather than moral quality: That Emotional intelligence may just be a skill rather than a moral quality or personality trait;
- (f) Emotional intelligence – a measure of conformity: that by adoption of consensus, the EI may just be a measure of conformity, rather than a factor; and
- (g) Emotional intelligence – a form of knowledge: That MSCEIT tests knowledge of emotions, which may not reflect his/her response in actual situations.

17.4 Uses of emotional intelligence

Emotional intelligence has been used to explain some phenomena. These include the following:

- (a) Bullying: Bullying is an abusive social interaction between peers which can include aggression, harassment, and violence. Bullying is typically repetitive and enacted by those who are in a position of power over the victim. A growing body of research illustrates a significant relationship between bullying and emotional intelligence;
- (b) Job performance: Though there are conflicting report of correlation between EI and job performance, recent findings have shown that EI contributes to performance in emotionally demanding job situations, leading to the concept of emotional exhaustion (burn out) contributing negatively to performance;
- (c) Leadership: Although EI plays a positive role in leadership effectiveness, what actually makes a leader effective is what he/she does with his role, rather than his interpersonal skills and abilities;
- (d) Health: Recent studies have shown that people with higher emotional intelligence enjoyed better physical and mental health; and
- (e) Self-esteem and drug dependence: Researchers discovered that subjects with low emotional intelligence scores had low self-esteem and a high incidence of drug dependence.

17.5 Applications of emotional intelligence

Below are some applications of emotional intelligence:

- (a) Being considerate about feelings;
- (b) Pausing to think;
- (c) Ability to control one's thoughts;
- (d) Deriving benefit from criticism;
- (e) Being authentic;
- (f) Demonstration of empathy;
- (g) Praising others;
- (h) Giving helpful feedback;
- (i) Apologising when in error;
- (j) Ability to forgive and forget;
- (k) Ability to keep commitments;
- (l) Helping others; and
- (m) Ability to protect oneself from emotional sabotage.

According to Cooper and Sawaf (1997), in their book, Executive EQ, having high EQ has the

following advantages:

- i. A high IQ can help an individual for getting hired in a reputed organisation, but with a high EQ a person will get promoted and be sustained in an organisation;
- ii. With a high IQ, a person can master daily routine work, but with a high EQ he/she can thrive during times of changes and uncertainty; and
- iii. With a high IQ, a person can be an efficient professional but with a high EQ the same can become a great leader.

17.2 Social thinking

17.2.1 Introduction

Social thinking or social cognition or ‘thinking socially’ is a mental process people go through to make sense of their own and others’ thoughts, feelings, and intentions in context, whether co-existing, actively interacting, or figuring out what is happening from a distance (e.g., through media, literature, etc.). It commences at birth and continues all through life. Social thinking is based on the work of Michelle Garcia Winner who created the Center for Social Thinking. Social thinking is a methodology that is used to help children effectively interact with others, helping them figure out the best way to think when they are in social situations. Social thinking trains your brain to figure out what people around you might be thinking. It helps one to realize that each time one is around others, your behaviour will cause them to think a certain way about you. Social thinking teaches our brain to do and say the things that will make others feel positive thoughts about us, and make them feel good as well (ChildNEXUS, 2017).

Aristotle said that “man is a social animal”, as a result, man likes to live in a society. Studylecturenotes, (n. d.), therefore, opines that man living in a society is affected by others and he affects others. These individuals living together develop their own opinions, thinking, ideas, imagination, attitudes, aspirations and out look towards society. These ideas are moulded in a scientific and systematic manner which gives far-reaching results and become a social thought. In social thoughts, firstly an individual is thinking about the past and present social problems and secondly the body of thought is developed in a systematic manner. According to Winner (n.d.), we are social thinkers every day, whether it is at home or at work. We should be aware that people around us have thoughts and feelings. It includes sharing a space with others effectively and understanding the perspective and intentions of others. Although it is abstract, the vocabulary and lessons are concrete and talk about how the social world works. Also, fundamental to social thinking is the recognition that everyone has thoughts and feelings about one another’s social behaviour, e.g., social skills (Goleman, 2006).

17.2.2 Importance of social thinking

Rhoads (n. d.) gives three reasons why social thinking is so important, as follows:

- (a) Using appropriate social skills tend to make people feel comfortable around us which helps us better co-exist and interact with those we share space with;
- (b) Most of us want to make connections and make friends with our family, peers, boss or colleagues; and
- (c) The core concepts of social thinking help us develop insights and socially based critical thinking in the workplace. For example, anytime a person is asked to:
 - i. Work in a group;
 - ii. Solve a problem;
 - iii. Write an email;
 - iv. Express their ideas;
 - v. Answer questions;
 - vi. Understand a video clip; and
 - vii. Critically think about an issue, he is using his social thinking mind!

17.2.3 Concepts associated with social thinking

Winner and Crooke (2009) have identified the following concepts (vocabulary) in social thinking:

- (a) **Think with your eyes:** This is a statement used in lieu of saying “use good eye contact” or “look at me.” This involves “thinking with their eyes”, which means that eyes are not just for looking at another person during an interaction. The eyes are powerful tools to be used for gaining information in almost any situation. The concept of “thinking with your eyes” is also relevant in problem solving and perspective taking.
- (b) **Expected/unexpected behaviour:** Social and communicative expectations are contextually sensitive. In fact, for every situation there are a set of expected and unexpected behaviours that generate different types of thoughts. When a behaviour is expected for a situation, it encourages us to have good or okay or normal thoughts and feelings; when a behaviour is unexpected, we tend to have uncomfortable or weird thoughts and related feelings. How we think about someone over time affects our “social memory” of them. (Note: This is not the same as thinking a person is “weird.” Instead, we have a weird thought based on the behaviour within that situation.)
- (c) **Smart guess/wacky guess:** This concept has to do with “reading the situation” before deciding what actions to take based on the situation. Social inferencing is at the heart of determining what to say or do and occurs at a rapid-fire pace in everyday social communication as well as when comprehending text. The process of inferencing involves becoming aware of words and nonverbal cues to “take what you (think, know, see and hear) to make a guess.”
- (d) **Social Fake:** This is a concept is about how we feel in reality as we engage in a social interaction with others. Most of the time, we are interested in getting to know one another, even though we are not always interested by exactly what they say. We simply tolerate other’s conversational topic in order to maintain the social-emotional connection. How we make each other feel is more important than the exact words used to sustain the relationship.

Also, Winner and Crooke (2009) stated that social thinking includes constant infusion of “good social skills”? Social thinking precedes the use of good social skills, because we have to be aware of the people and the situation before we select which sets of social behaviours (social skills) to employ. While sharing space with others, we are constantly aware of people (social thinking) and then monitor and modify our behaviour accordingly to encourage people to think about us the way we want them to perceive us. Majority of times we are socially thinking in the presence of others, we are not actually interacting with these people, rather we are co-existing.

17.2.4 Social Thinking methodology

The social thinking methodology is a developmental, language-based and thinking-based (metacognitive) methodology that uses the following:

- (a) Visual frameworks;
- (b) Unique vocabulary;
- (c) Strategies; and
- (d) Activities

to foster social competence.

The methodology has assessment and treatment components for both interventionists and social learners.

The methodology includes components of other well-known and evidence-based interventions such as:

(a) Social Stories

Carol Gray's definition of social story

A Social Story accurately describes a context, skill, achievement, or concept according to 10 defining criteria. These criteria guide Story research, development, and implementation to ensure an overall patient and supportive quality, and a format, "voice", content, and learning experience that is descriptive, meaningful, and physically, socially, and emotionally safe for the people with autism.

The objective is to share information, which is often through a description of the events occurring around the subject and also state the rationale.

(b) Hidden Curriculum

Philip .W. Jackson (Life in Classrooms, 1968) coined the phrase 'Hidden Curriculum'. Hidden curriculum is a concept that describes the often unarticulated and unacknowledged things students are taught in school and that may affect their learning experience. These are often unspoken and implied lessons unrelated to the academic courses they're taking — things learned from simply *being* in school. However, autistic people have to learn things expressly.

(c) 5-point scale.

The 5-point scale is a visual system that can help to organise a person's thinking when working through difficult moments, particularly those that require social understanding.

17.2.5 Social thinking shares ideals with:

(a) Self-regulation

Control or supervision from within instead of by an external authority.

(b) Executive functioning

Executive function is **a set of mental skills that include working memory, flexible thinking, and self-control.** They are used for learning, working, and daily living.

(c) Central coherence issues

Central coherence is seeing how many component parts fit together to make a coherent whole. Central coherence difficulties could be related to attention, visual processing, or rigidity.

(d) Shifting attention

Regarding attention, a child may have difficulty shifting attention, that is, the ability to shift focus back and forth between stimuli.

(e) Perspective-taking

Perspective-taking is the act of perceiving a situation or understanding a concept from an alternative point of view, such as that of another individual.

17.2.6 Evidence-base for social thinking

Social Thinking theorises that successful social thinkers are able to consider the points of view, emotions, thoughts, beliefs, prior knowledge and intentions of others (this is often called perspective-taking). Social Thinking™ also demonstrates the link between one's social learning abilities and his or her related ability (or disability) when processing and responding to school curriculum based in the use of the social mind (e.g., reading comprehension of literature, some aspects of written expression, etc.). Winner and colleagues argue that individuals who share a diagnostic label (e.g., autism spectrum disorder) nonetheless exhibit extremely different social learning traits, or social mind profiles, and should have unique treatment trajectories, such as those based in cognitive-behavioural therapy (CBT).

Social Thinking is a language and cognitive-based methodology that focuses on the dynamic and synergistic nature of social interpretation and social communication skills, both of which require social problem solving. The methodology is developmental, utilizing aspects of behavioural and cognitive behavioural principles, as well as stakeholder input as a way to translate evidence-based concepts into conceptual frameworks, strategy-based frameworks, curricula, activities, and motivational tools.

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