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Section 1 - Finance
**USING BUDGETS**

**The Role of Budgets – “Budgetary Control”**

A budget is a **financial plan** for the future concerning the revenues and costs of a business. However, a budget is about much more than just financial numbers.

**Budgetary control** is the process by which **financial control** is exercised within an organisation.

Budgets for income/revenue and expenditure are prepared in advance and then compared with actual performance to establish any **variances**.

**Managers** are responsible for controllable costs within their budgets and are required to take remedial action if the adverse variances arise and they are considered excessive.

There are many management uses for budgets. For example, budgets are used to:

- Control income and expenditure (the traditional use)
- Establish priorities and set targets in numerical terms
- Provide direction and co-ordination, so that business objectives can be turned into practical reality
- Assign responsibilities to budget holders (managers) and allocate resources
- Communicate targets from management to employees
- Motivate staff
- Improve efficiency
- Monitor performance

Whilst there are many uses of budgets, there are a set of guiding principles for good budgetary control in a business.

In an effective budget system:

- Managerial responsibilities are clearly defined – in particular the responsibility to adhere to their budgets
- Individual budgets lay down a plan of action
- Performance is monitored against the budget
- Corrective action is taken if results differ significantly from the budget
- Departures from budgets are permitted only after approval from senior management
- Unaccounted for variances are investigated

**Variance and “management by exception”**

A key word to understand when you are looking at budgets is **“variance”**

A variance arises when there is a **difference between actual and budget figures**

Variances can be either:
• **Positive/favourable** (better than expected) or
• **Adverse/unfavourable** (worse than expected)

A **favourable variance** might mean that:

- Costs were lower than expected in the budget, or
- Revenue/profits were higher than expected

By contrast, an **adverse variance** might arise because:

- Costs were higher than expected
- Revenue/profits were lower than expected

Should variances be a matter of concern to management? After all, a budget is just an estimate of what is going to happen rather than reality. The answer is – it depends.

The significance of a variance will depend on factors such as:

- Whether it is positive or negative – adverse variances (negative) should be of more concern
- Was it foreseen?
- Was it foreseeable?
- How big was the variance - absolute size (in money terms) and relative size (in percentage terms)?
- The cause
- Whether it is a temporary problem or the result of a long term trend

**“Management by exception”** is the name given to the process of focusing on activities that require attention and ignoring those that appear to be running smoothly.

Budget control and analysis of variances facilitates management by exception since it highlights areas of business performance which are not in line with expectations.

Items of income or spending that show no or small variances require no action. Instead concentrate on items showing a large adverse variance.

**Are all adverse variances bad news?**

Here is a point that students often find hard to understand – or believe!

An adverse variance might result from something that is good that has happened in the business.

For example, a budget statement might show higher production costs than budget (adverse variance). However, these may have occurred because sales are significantly higher than budget (favourable budget).

**Remember, it is the cause and significance of a variance that matters – not whether it is favourable or adverse.**
**Variance illustrated**

Consider the following budget statement:

<table>
<thead>
<tr>
<th>Item</th>
<th>Budget</th>
<th>Actual</th>
<th>Variance</th>
<th>Favourable or Adverse</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£’000</td>
<td>£’000</td>
<td>£’000</td>
<td></td>
</tr>
<tr>
<td><strong>SALES REVENUE</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard product</td>
<td>75</td>
<td>90</td>
<td>15</td>
<td>F</td>
</tr>
<tr>
<td>Premium product</td>
<td>30</td>
<td>25</td>
<td>-5</td>
<td>A</td>
</tr>
<tr>
<td>Total sales revenue</td>
<td>105</td>
<td>115</td>
<td>10</td>
<td>F</td>
</tr>
<tr>
<td><strong>COSTS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages</td>
<td>35</td>
<td>38</td>
<td>3</td>
<td>A</td>
</tr>
<tr>
<td>Rent</td>
<td>15</td>
<td>17</td>
<td>2</td>
<td>A</td>
</tr>
<tr>
<td>Marketing</td>
<td>20</td>
<td>14</td>
<td>-6</td>
<td>F</td>
</tr>
<tr>
<td>Other overheads</td>
<td>27</td>
<td>35</td>
<td>8</td>
<td>A</td>
</tr>
<tr>
<td>Total costs</td>
<td>97</td>
<td>104</td>
<td>7</td>
<td>A</td>
</tr>
<tr>
<td>Profit</td>
<td>8</td>
<td>11</td>
<td>3</td>
<td>F</td>
</tr>
</tbody>
</table>

What do the numbers in the budget statement tell us?

Looking at the sales revenue section, you can see that actual sales of standard product were £15k higher than budget – this is a positive (favourable) variance.

Turning to the costs section, actual wages were £3k higher than budget – i.e. an adverse (negative) variance.

Overall, the profit variance was positive (favourable) – i.e. better than budget.

**Problems and limitations of using budgets**

Whilst budgets are widely used in business, you should appreciate that they have some important limitations. In particular:

- Budgets are only as good as the data being used to create them. Inaccurate or unreasonable assumptions can quickly make a budget unrealistic.
- Budgets can lead to inflexibility in decision-making.
- Budgets need to be changed as circumstances change.
- Budgeting is a time-consuming process – in large businesses, whole departments are sometimes dedicated to budget setting and control.
- Budgets can result in short term decisions to keep within the budget rather than the right long term decision which exceeds the budget.
- Managers can become too preoccupied with setting and reviewing budgets and forgetting to focus on the real issues of winning customers.

Budgets can also create some behavioural challenges in a business.
• Budgeting has behavioural implications for the motivation employees
• Budgets are de-motivating if they are imposed rather than negotiated
• Setting unrealistic targets adds to de-motivation
• Budgets contribute to departmental rivalry - battles over budget allocation
• Spending up to budget: it can result in a “use it or lose it” mentality - spend up to the budget to preserve it for next year
• Budgetary slack occurs if targets are set too low
• A “name, blame and shame” culture can develop - but managers should be answerable only for variations that were under their control

Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define the term “variance”</td>
<td>2</td>
</tr>
<tr>
<td>Explain what is meant by the term “budgetary control”</td>
<td>2</td>
</tr>
<tr>
<td>What is the difference between historical and zero-based budgeting</td>
<td>4</td>
</tr>
<tr>
<td>List three advantages of using budgets</td>
<td>4</td>
</tr>
<tr>
<td>List three disadvantages of using budgets</td>
<td>4</td>
</tr>
<tr>
<td>Outline two ways in which a favourable variance may arise</td>
<td>4</td>
</tr>
<tr>
<td>Explain how a variance is calculated</td>
<td>4</td>
</tr>
<tr>
<td>State two possible causes of a favourable sales variance</td>
<td>4</td>
</tr>
<tr>
<td>State two possible causes of an adverse cost variance</td>
<td>4</td>
</tr>
<tr>
<td>Why is it important for a business to set a budget?</td>
<td>5</td>
</tr>
<tr>
<td>Outline three problems a business faces when setting a budget</td>
<td>6</td>
</tr>
<tr>
<td>Outline three principals of effective budgetary control</td>
<td>6</td>
</tr>
<tr>
<td>Explain why it is important that management focus on large adverse variances</td>
<td>6</td>
</tr>
<tr>
<td>Explain why a favourable variance might not necessarily be good news for a business</td>
<td>6</td>
</tr>
<tr>
<td>Outline three limitations with using budgets</td>
<td>6</td>
</tr>
<tr>
<td>Explain two reasons why an adverse cost variance might not be a signal of poor management by the budget holder</td>
<td>6</td>
</tr>
<tr>
<td>Explain how an effective system of budgetary control can help business managers in their decision-making</td>
<td>8</td>
</tr>
<tr>
<td>Discuss whether the benefits of budgeting outweigh the disadvantages to a business</td>
<td>10</td>
</tr>
</tbody>
</table>
Measuring & Increasing Profit

In this section we look at:

- What is profit?
- Profit & profitability
- Return on capital
- Ways to improve profit
- The difference between profit and cash flow

Measuring Profit

Let’s start with profit. A good definition of profit is:

The reward or return for taking risks & making investments

For most businesses, making a profit is a key objective. You also need to appreciate that profit is also the most important source of cash flow & finance for a business.

However, don’t forget that there can be reasons for running a business other than the “profit motive”. For example, social enterprises exist to make a return that can be reinvested to meet society aims.

Profit can be calculated as:

Total Sales (Revenues) less Total Costs

The profit earned by a business can be measured in absolute and relative terms.

Profit in absolute terms would measure the £ value of profits earned in a specific period - e.g. £250,000 net profit made in the year.

Profit in relative terms would look at the profit earned as a proportion of sales achieved or investment made.

- E.g. £50,000 profit from £500,000 of sales is a profit margin of 10%
- E.g. £50,000 profit from an investment of £1 million = a 5% return on investment

Net Profit

Net profit is what is left after all the costs of a business have been taken from its sales revenue. Look at the following example:

<table>
<thead>
<tr>
<th>Monthly Net Profit for May 2009</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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In the profit statement above, the business has made a net profit of £50,000. The net profit is calculated by subtracting all the business costs (£150,000) from the total sales of £200,000. In the period, the business has made a net profit margin of 25%. That means that it has converted 25% of each pound of sales into profit – a good achievement.

The net profit margin tells us something about how well a business is able to convert sales into profit. It is an important measure of relative profitability. Here is how it is calculated:

\[
\text{Net profit margin} = \frac{\text{Net profit (before tax)}}{\text{Sales}} \times 100
\]

Note: net profit margin is expressed as a percentage.

What does the net profit margin tell us?

- How effectively a business turns its sales into profit
- How efficiently a business is run (in particular, is it keeping its operating costs as low as it can)
- Whether a business is able to “add value” during the production process (a high margin business must be doing something right!)

On its own, the net profit margin is useful information. However, it is even more useful if comparisons can be made between:

- Changes in net profit margin over time (e.g. month by month or comparing years)
- Net profit margins of competitors in the same market

Look at this example below:
Looking at the financial information in the table above, you can see that:

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

**Return on Capital**

Profit is the financial return that a business earns from its activities. However, it is also important to consider what has been invested in order to earn that return.

One way to look at the return on an investment is to calculate **return on capital**.

- Capital is the amount invested in a business
- Return on capital is the percentage return on that investment

The calculation formula is as follows:
Here is an example of this calculation using some business data:

<table>
<thead>
<tr>
<th>Return on Capital - 2009</th>
<th>£'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profit</td>
<td>150</td>
</tr>
<tr>
<td>Capital</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Return on Capital (150/ 2000) * 100</strong></td>
<td><strong>7.5%</strong></td>
</tr>
</tbody>
</table>

What does the return on capital tell us?

- A measure of the returns made from investing in the business
- How good the business is at converting money invested into profit
- Provides a means of comparison with other investment opportunities
- Opportunity cost – what an investor could have done by investing elsewhere

**How to Improve Profits and Return on Capital**

A business should always be looking to improve the returns that it makes. This can both in:

- Absolute terms (i.e. increase the total profit), and
- Relative terms (i.e. the profit margin or return on capital)

How can it do this? The main methods are summarised in the diagram below:

Let’s look at each option in a little more detail to see what the challenges are:
## Increase the quantity sold (higher sales volume)

<table>
<thead>
<tr>
<th>Why?</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Higher sales volumes = higher sales, assuming that the selling price is not lowered</td>
<td></td>
</tr>
<tr>
<td>• Makes better use of production capacity (i.e. fixed costs should not rise)</td>
<td></td>
</tr>
<tr>
<td>• May result in higher market share</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Will it work?</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Depends on elasticity of demand</td>
<td></td>
</tr>
<tr>
<td>• Sales value may actually fall if price has to be reduced to achieve higher sales volumes</td>
<td></td>
</tr>
<tr>
<td>• Does business have capacity to sell more?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Why it might not work</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Competitors are likely to respond</td>
<td></td>
</tr>
<tr>
<td>• Marketing efforts may fail – e.g. promotional campaign does not generate results</td>
<td></td>
</tr>
<tr>
<td>• Fixed costs might actually rise – e.g. higher marketing</td>
<td></td>
</tr>
</tbody>
</table>

## Increase the selling price (higher price per unit sold)

<table>
<thead>
<tr>
<th>Why?</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Higher selling price = higher sales (assuming quantity sold does not fall in response)</td>
<td></td>
</tr>
<tr>
<td>• Maximises value extracted from customers</td>
<td></td>
</tr>
<tr>
<td>• Customers may perceive product as higher quality</td>
<td></td>
</tr>
<tr>
<td>• No need for extra production capacity</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Will it work?</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Depends on price elasticity of demand</td>
<td></td>
</tr>
<tr>
<td>• Sales value may actually fall price rise is matched by an even bigger fall in quantity sold</td>
<td></td>
</tr>
<tr>
<td>• It will work if customers remain loyal and still perceive product to be good value</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Why it might not work</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Competitors are likely to respond (e.g. prices lower)</td>
<td></td>
</tr>
<tr>
<td>• Customers may decide to switch to competitors</td>
<td></td>
</tr>
</tbody>
</table>
### Reduce variable costs per unit

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

### Increase output

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

### Reduce fixed costs

| Why? | • A drop in fixed costs translates directly into higher profits  
• Reduces the break-even output  
• Often substantial savings to be made by cutting unnecessary overheads |
| --- | --- |
| Will it work? | • Yes, provided costs cut don’t affect quality, customer service or output  
• A business can nearly always find savings in overheads |
| Why it might not work | • Might reduce ability of business to increase sales  
• Intangible costs – e.g. lower morale after making redundancies |
As you can see, each of the above approaches has its advantages and disadvantages. A business will often try more than one of the above approaches at the same time in order to increase profit.

There are some other more complex approaches that can be taken. You don’t need to know these in detail, but here is a summary:

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

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

### The Difference between Profit and Cash Flow

This section has focused on profit. When a business makes a profit it usually results in a similar cash inflow – but not always, and not straightaway!

It is important to understand the basic reasons why net profit and net cash flow might not always be the same. Profit and cash flow are two different calculations – as shown below:

<table>
<thead>
<tr>
<th>What is Profit?</th>
<th>What is Cash Flow?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>Cash Inflows</td>
</tr>
<tr>
<td>less Variable Costs</td>
<td>less Cash outflows</td>
</tr>
<tr>
<td>less Fixed Costs</td>
<td>= Net Cash Flow</td>
</tr>
</tbody>
</table>

There are two main ways in which net cash flow differs from net profit during any accounting period:

**Timing differences**
These arise because a business may not received cash straightaway from a customer and it may also delay payment for its costs.

For example, a customer may buy goods for £50,000 but be allowed to pay for those goods in 60 days time.

**The way that fixed assets are accounted for**

Fixed assets are the assets that a business means to keep. They are treated as capital expenditure in the financial statements – that means that the cost of those assets is not treated as an operating cost. So:

- Payment for fixed asset = cash outflow
- Cost of fixed asset = treated as an asset not a cost
- Depreciation is charged as cost when the value of fixed assets is reduced

Let’s look at a few more example transactions to help make the point about how cash flow can differ from profit:

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

**Guided Revision Questions**

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define the term “net profit margin”</td>
<td>2</td>
</tr>
<tr>
<td>Define the term “return on capital”</td>
<td>2</td>
</tr>
<tr>
<td>What is the formula for calculating net profit margin?</td>
<td>2</td>
</tr>
<tr>
<td>What is the formula for calculating return on capital?</td>
<td>2</td>
</tr>
<tr>
<td>Explain why the net profit margin is expressed as a percentage</td>
<td>4</td>
</tr>
<tr>
<td>Outline two uses management might make from calculating the return on capital</td>
<td>4</td>
</tr>
<tr>
<td>Explain why a reduction in selling price might not necessarily result in an increase in sales revenue</td>
<td>4</td>
</tr>
<tr>
<td>Description</td>
<td>Marks</td>
</tr>
<tr>
<td>-----------------------------------------------------------------------------</td>
<td>-------</td>
</tr>
<tr>
<td>Describe two ways in which a business can achieve a reduction in variable costs per unit</td>
<td>4</td>
</tr>
<tr>
<td>What is the difference between net cash flow for a period and net profit?</td>
<td>4</td>
</tr>
<tr>
<td>Explain why net profit margin is a better measure of a business’ performance than gross profit margin</td>
<td>6</td>
</tr>
<tr>
<td>Outline three ways in which the net profit of a business might be different from the net cash flow</td>
<td>6</td>
</tr>
<tr>
<td>Describe why a business might experience an increase in its gross profit margin, but a fall in its net profit margin</td>
<td>6</td>
</tr>
<tr>
<td>Outline three reasons why two businesses in the same industry might have widely difference net profit margins</td>
<td>6</td>
</tr>
<tr>
<td>Discuss whether a reduction in overheads will result in an increased net profit margin</td>
<td>6</td>
</tr>
<tr>
<td>Explain why the accounting treatment of fixed assets leads to a difference between profit and cash flow</td>
<td>6</td>
</tr>
<tr>
<td>Discuss whether a business with a low net profit margin should increase its selling prices in order to improve the margin</td>
<td>8</td>
</tr>
<tr>
<td>Analyse two possible problems that might arise if a business attempted to reduce marketing costs to increase profit</td>
<td>8</td>
</tr>
</tbody>
</table>
IMPROVING CASH FLOW

Introduction

In this section we consider:

- What is a cash flow problem?
- Why do cash flow problems occur?
- How a business can improve its cash flow to avoid or address problems

You should already have been introduced to the idea of a cash flow forecast. This is a financial forecast that predicts the movement of cash into and out of a business, by category.

The most important parts of the cash flow forecast are the lines at the bottom:

- The net cash flow for the period (usually a month), and
- The closing cash balance (how much cash the business has left)

It is more than a business cliché to state that ‘cash is king’. However, as with all clichés the statement is borne in fact. None more so than this, which highlights the vital importance of cash to modern businesses. While profit, turnover and even market share are all indicators of success, if there is no cash in the bank to meet monthly bills, wage runs and loan payments then any business will ultimately fail. That’s why the cash flow forecast is so important.

Cash Flow Cycle and Working capital

Before we look at the process of cash flow management, here is a quick reminder of the main types of cash inflow and outflow in a typical business:

<table>
<thead>
<tr>
<th>Inflows</th>
<th>Outflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash sales to customers</td>
<td>Purchasing finished goods for re-sale</td>
</tr>
<tr>
<td>Receipts from customers who were allowed to buy on credit (trade debtors)</td>
<td>Purchasing raw materials and other components needed for the manufacturing of the final product</td>
</tr>
<tr>
<td>Interest on bank and other balances</td>
<td>Paying salaries and wages and other operating expenses</td>
</tr>
<tr>
<td>Proceeds from sale of fixed assets</td>
<td>Purchasing fixed assets</td>
</tr>
<tr>
<td>Investment by shareholders</td>
<td>Paying the interest on, or repayment of loans</td>
</tr>
<tr>
<td></td>
<td>Paying taxes</td>
</tr>
</tbody>
</table>

Cash flow can be described as a cycle:

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The business uses cash to acquire resources (assets such as stocks). The resources are put to work and goods and services produced. These are then sold to customers. Some customers pay in cash (great), but others ask for time to pay. Eventually they pay and these funds are used to settle any liabilities of the business (e.g. pay suppliers). And so the cycle repeats.

Hopefully, each time through the cash flow cycle, a little more money is put back into the business than flows out. But not necessarily, and if management don’t carefully monitor cash flow and take corrective action when necessary, a business may find itself sinking into trouble.

The cash needed to make the cycle above work effectively is known as **working capital**. **Working capital is the cash needed to pay for the day to day operations of the business.** In other words, working capital is needed by the business to:

- Pay suppliers and other creditors
- Pay employees
- Pay for stocks
- Allow for customers who are allowed to buy now, but pay later (so-called “trade debtors”)

What is crucially important, therefore, is that a business **actively manages working capital**. It is the timing of cash flows which can be vital to the success, or otherwise, of the business. Just because a business is making a profit does not necessarily mean that there is cash coming into and out of the business.

There are many advantages to a business that actively manages its cash flow:

- It knows where its cash is tied up, spotting potential bottlenecks and acting to reduce their impact

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It can plan ahead with more confidence. Management are in better control of the business and can make informed decisions for future development and expansion. It can reduce its dependence on the bank and save interest charges. It can identify surpluses which can be invested to earn interest.

**Cash flow problems**

A cash flow problem can be defined as:

*When a business does not have enough cash to be able to pay its liabilities*

The main causes of cash flow problems are:

- Low profits or (worse) losses
- Over-investment in capacity
- Too much stock
- Allowing customers too much credit
- Overtrading
- Unexpected changes
- Seasonal demand

Let’s look at these in a little more detail.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Why It Causes a Cash Flow Problem</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Low profits or</strong></td>
<td>The profit a business makes from trading is the most important source of cash.</td>
</tr>
<tr>
<td><strong>(worse) losses</strong></td>
<td>There is a direct link between low profits or losses and cash flow problems.</td>
</tr>
<tr>
<td><strong>Over-investment in</strong></td>
<td>This happens when a business spends too much on fixed assets.</td>
</tr>
<tr>
<td><strong>capacity</strong></td>
<td>Problem is made worse if short-term finance is used (e.g. bank overdraft).</td>
</tr>
<tr>
<td></td>
<td>Fixed assets are hard to turn back into cash in the short-run.</td>
</tr>
<tr>
<td><strong>Too much stock</strong></td>
<td>Holding too much stock ties up cash</td>
</tr>
<tr>
<td></td>
<td>+ Increased risk that stocks become obsolete</td>
</tr>
<tr>
<td></td>
<td>On the other hand...</td>
</tr>
<tr>
<td></td>
<td>There needs to be enough stock to meet demand</td>
</tr>
<tr>
<td></td>
<td>Bulk buying may mean lower purchase prices</td>
</tr>
<tr>
<td><strong>Allowing customers</strong></td>
<td>Customers who buy on credit are called “trade debtors”</td>
</tr>
<tr>
<td><strong>too much credit</strong></td>
<td>Offer credit = good way of building sales</td>
</tr>
<tr>
<td></td>
<td>On the other hand...</td>
</tr>
<tr>
<td></td>
<td>Late payment is a common problem – and slow-paying customers often put a strain on cash flow</td>
</tr>
</tbody>
</table>
Worse still, the debt may go “bad” – i.e. it is not paid at all

**Overtrading**

Occurs where a business expands too quickly, putting pressure on short-term finance

Classic example – retail chains

- Keen to open new outlets
- Have to pay rent in advance, pay for shop-fitting, pay for stocks
- Large outlay before sales begin in new store

Businesses that rely on long-term contracts are also at high risk of overtrading

**Unexpected changes**

These are items or events that are not included in the cash flow forecast – they are unforeseen. Examples include:

- Internal change (e.g. machinery breakdown, loss of key staff)
- External change (e.g. economic downturn, accidents, change in legislation that requires a business to invest in new facilities)

**Seasonal demand**

Where there are predictable changes in demand & cash flow

Production or purchasing usually in advance of seasonal peak in demand = cash outflows before inflows

This can be managed – cash flow forecast should allow for seasonal changes

---

### Handling Cash Flow Problems

The keys to the ability of a business to handle cash flow problems are:

- Have a reliable cash flow forecasting system
- Actively manage working capital
- Choose the right sources of finance for the business needs

Good cash flow forecasting is at the heart of cash flow management. The key is having good information and using it! A good cash flow forecast:

- Is updated regularly
- Makes sensible assumptions
- Allows for unexpected changes
- Is reviewed regularly by senior management

Working capital management focuses on:

- Striking the right balance between offering customers credit and ensuring that they pay on time
- Holding an appropriate level of stocks in the business
- Managing relationships with suppliers so that the maximum amount of trade credit can be obtained without damaging supplies to the business

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*Managing Debtors (credit control)*

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This isn’t easy. Credit control covers areas such as

- Policies on how much credit to give and repayment terms and conditions
- Measures to control doubtful debtors (chasing, threatening legal action etc)
- Credit checking (only allowing credit to customers who can afford to pay!
- Selling off debts to debt factors
- Cash discounts and other incentives for prompt payment
- Improved record keeping – e.g. accurate and timely invoicing

One area you should be aware of is **factoring**. This involves the selling of debtors (money owed to the business) to a third party. This generates cash and it guarantees the firm a percentage of money owed to it. The downside to factoring is that it reduces income and profit margin made on sales. The costs involved in factoring can be high!

*Managing Suppliers (trade credit)*

Suppliers are important sources of finance for a business and key part of managing cash flow. “Trade credit” refers to amounts owed to suppliers for goods supplied on credit and not yet paid for. Delaying payment means that the business retains cash longer.

However, by delaying payment, the business has to be careful not to damage its credit reputation and rating. Trade creditors are seen (wrongly) as a “free” source of capital. Some firms habitually delay payment to creditors in order to enhance their cash flow - a short sighted policy which also raises ethical issues.

*Managing Stocks (stock control)*

Stock refers to goods purchased and awaiting use or produced and awaiting sale. Stocks take the form of raw materials, work-in-progress and finished goods.

Stockholding is costly and therefore it is sound business to:

- keep smaller balances (just in time stocks)
- computerise ordering to improve efficiency
- improve stock control

This will cut down the spending on stock but may leave the business vulnerable to “stock-out” (i.e. no stocks available to meet demand – which is bad news!)

*Bank Overdraft or Bank Loan?*

One of the key issues in cash flow management is ensuring that a business has the right kind of bank finance. The essential choice is between a bank overdraft and a bank loan.

Banks are the traditional “port of call” for businesses with cash flow problems. However, the Credit Crunch has made banks much more wary of lending to troubled businesses.

Assuming that bank finance is available, which one should a business go for?

Here is a summary of the key considerations:
<table>
<thead>
<tr>
<th>Bank Overdraft</th>
<th>Bank Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td><strong>Greater certainty of funding, provided terms of loan complied with</strong></td>
</tr>
<tr>
<td>Relatively easy to arrange</td>
<td>Flexible – use as cash flow requires</td>
</tr>
<tr>
<td><strong>Flexible</strong> – use as cash flow requires</td>
<td>Lower interest rate than a bank overdraft</td>
</tr>
<tr>
<td>Interest – only paid on the amount borrowed under the facility</td>
<td>Appropriate method of financing fixed assets</td>
</tr>
<tr>
<td>Not secured on assets of business</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Disadvantages</strong></th>
<th><strong>Can be withdrawn at short notice</strong></th>
<th><strong>Requires security (collateral)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Can be withdrawn at short notice</td>
<td>Requires security (collateral)</td>
<td></td>
</tr>
<tr>
<td>Interest charge varies with changes in interest rate</td>
<td>Interest paid on full amount outstanding</td>
<td></td>
</tr>
<tr>
<td>Higher interest rate than a bank loan</td>
<td>Harder to arrange</td>
<td></td>
</tr>
</tbody>
</table>

**Sale of Assets / Sale and Leaseback**

Selling assets is another way to improve cash flow. Selling spare or surplus assets is a way to achieve a short-term boost to cash flow – assuming it can be done!

Good examples include the sale of spare land or surplus equipment.

However, note – not all businesses have spare assets

**Sale and leaseback** is a specialist method of raising cash from the sale of fixed assets. It involves selling fixed assets and then leasing them back from new owner.

Sale and leaseback tends to involve business properties (e.g. hotels, supermarkets, offices – popular when property market was booming

Note: sale and leaseback can only be done once for each fixed asset. It is a one-off method of raising cash.

**Guided Revision Questions**

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define the term “working capital”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “overtrading”?</td>
<td>2</td>
</tr>
<tr>
<td>Explain why suppliers are an important source of improved cash flow for many businesses</td>
<td>4</td>
</tr>
<tr>
<td>Explain what is meant by the phrase “cash flow problem”</td>
<td>4</td>
</tr>
<tr>
<td>Explain why a business might lose sales if it reduces the length of credit offered to customers</td>
<td>4</td>
</tr>
<tr>
<td>Explain why a supplier might be reluctant to offer a longer credit period to a</td>
<td>4</td>
</tr>
<tr>
<td>new business</td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------------------------------</td>
<td>---</td>
</tr>
<tr>
<td>Briefly explain what is meant by “factoring”</td>
<td>4</td>
</tr>
<tr>
<td>Outline three reasons why a profitable business might experience cash flow</td>
<td>6</td>
</tr>
<tr>
<td>problems</td>
<td></td>
</tr>
<tr>
<td>Explain why a business may find it difficult to turn fixed assets into cash</td>
<td>6</td>
</tr>
<tr>
<td>Outline the cash flow implications of a business increasing the amount of</td>
<td>6</td>
</tr>
<tr>
<td>stocks held</td>
<td></td>
</tr>
<tr>
<td>Outline the main differences between a bank overdraft and a bank loan</td>
<td>6</td>
</tr>
<tr>
<td>Describe how a more effective system of credit control can improve cash flow</td>
<td>8</td>
</tr>
<tr>
<td>Outline two advantages and disadvantages of using a bank overdraft as a way</td>
<td>8</td>
</tr>
<tr>
<td>of managing cash flow problems</td>
<td></td>
</tr>
<tr>
<td>Discuss the importance of improving profit as a way of increasing cash flow</td>
<td>10</td>
</tr>
<tr>
<td>Describe how a period of rapid growth by a business might create cash flow</td>
<td>10</td>
</tr>
<tr>
<td>problems</td>
<td></td>
</tr>
<tr>
<td>Discuss the importance of a business producing realistic and timely cash flow</td>
<td>10</td>
</tr>
<tr>
<td>forecasts</td>
<td></td>
</tr>
<tr>
<td>Discuss whether a business should use asset sales as a way of handling a</td>
<td>10</td>
</tr>
<tr>
<td>cash flow problem</td>
<td></td>
</tr>
</tbody>
</table>
Section 2 - People in Business
IMPROVING ORGANISATIONAL STRUCTURES

In this section, we’ll look at:

- The alternative organisational structures
- Hierarchies, spans of control, workloads, job allocations and delegation
- Organisational structures and business performance

Organisation charts

The simplest way to show how a business is organised is to look at an organisation chart. This shows the management hierarchy in a business and works from top to bottom. The organisation chart also shows:

- Span of Control
- Line management
- Chain of command

Here is an example organisational chart:

Hierarchy

The levels of hierarchy refer to the number of layers within an organisation. Traditional organisations were tall with many layers of hierarchy and were often authoritarian in nature.

The organisation chart above shows a business with four levels of hierarchy – from the Managing Director at the top, to assistants and team members at the bottom.

Below is another organisation chart, which shows a taller hierarchy.
Span of control

The **span of control** is the number of subordinates for whom a manager is directly responsible. The two diagrams below illustrate two different spans of control:
A span of control of 7 would be considered to be quite wide. Contrast this with a span of 3 below, which would be considered “narrow”

Is there an ideal span of control? The answer is generally no – a suitable span of control will depend upon a number of factors:

- The experience and personality of the manager
- The nature of the business. If being a line manager requires a great deal of close supervision, then a narrower span might be appropriate
- The skills and attitudes of the employees. Highly skilled, professional employees might flourish in a business adopting wide spans of control
- The tradition and culture of the organisation. A business with a tradition of democratic management and empowered workers may operate wider spans of control

Should spans of control be wide or narrow? Here is a summary of the relative advantages and disadvantages of each:

<table>
<thead>
<tr>
<th>Narrow</th>
<th>Wide</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allows for closer supervision of employees</td>
<td>Gives subordinates the chance for more independence</td>
</tr>
<tr>
<td>More layers in the hierarchy may be required</td>
<td>More appropriate if labour costs are significant – reduce number of managers</td>
</tr>
<tr>
<td>Helps more effective communication</td>
<td></td>
</tr>
</tbody>
</table>
Chains of Command

The chain of command describes the lines of authority within a business. In the example below, Sam is responsible for Eve, Chris and Brenda. Further down the chain, Brenda is responsible for Sharon and Dawn.

Types of Organisational Structure

There are various types of organisational structure that are used by businesses. The key types are summarised below:

Hierarchical structure

This is the traditional form of organisational structure in business. Layers of hierarchy reflect levels of seniority

One question arises is -- should the hierarchy be tall (many layers) or flat (just a few levels)?
Above is a tall hierarchy – with six levels. Here are the key points about a tall structure:

- Sometimes called a traditional or mechanistic structure
- Many layers in hierarchy & narrow spans of control
- Key features – many layers of hierarchy + narrow spans of control
- Allows tighter control (less delegation)
- More opportunities for promotion
- Takes longer for communication to pass through the layers
- More layers = more staff = higher costs

Contrast a tall structure with a flat structure below:

The key points to remember about a flat structure are:

- Few layers of hierarchy + wide spans of control
- Less direct control + more delegation
- Fewer opportunities for promotion, but staff given greater responsibility
- Vertical communication is improved
- Fewer layers = less staff = lower costs

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Matrix Structures

The matrix structure was first used in the USA and has become more popular within the UK. This type of structure combines the traditional departments seen in functional structures with project teams.

For example, a project or task team established to develop a new product might include engineers and design specialists as well as those with marketing, financial, personnel and production skills. These teams can be temporary or permanent depending on the tasks they are asked to complete. Each team member can end up with two line managers - their normal departmental manager as well as the manager of the project.

Matrix structures have advantages and disadvantages.

Advantages

- Can help to break down traditional department barriers, improving communication across the entire organisation.
- Can allow individuals to use particular skills within a variety of contexts.
- Avoid the need for several departments to meet regularly, so reducing costs and improving coordination.

Disadvantages

- Members of project teams may have divided loyalties as they report to two line managers. Equally, this scenario can put project team members under a heavy pressure of work.
- There may not be a clear line of accountability for project teams given the complex nature of matrix structures.

De-layering

Many businesses are moving towards flatter organisational structures through de-layering. De-layering involves removing one or more levels of hierarchy from the organisational structure.

Frequently, the layers removed are those containing middle managers. For example, many high-street banks no longer have a manager in each of their branches, preferring to appoint a manager to oversee a number of branches. Some schools adopt this policy too – with a director of studies looking after several schools in a local area.

De-layering can offer a number of advantages to business:

- It offers opportunities for delegation, empowerment and motivation as the number of managers is reduced and more authority is given to shop-floor workers.
- It can improve communication within the organisation as messages have to pass through fewer levels of hierarchy.
- It can remove departmental rivalry if department heads are removed as the workforce is organised in teams.

- It can reduce costs as fewer employees are required and employing middle managers can be expensive.

But disadvantages exist too, making a decision to delayer less clear cut:

- Not all organisations are suited to flatter organisational structures - mass production industries with low-skilled employees may not adapt easily.

- De-layering can have a negative impact on motivation due to job losses, especially if it is really just an excuse for redundancies.

- A period of disruption may occur as people take on new responsibilities and fulfil new roles.

- Those managers remaining will have a wider span of control which, if it is too wide, can damage communication within the business.

**Delegation**

Delegation involves the **assignment to others of the authority for particular functions, tasks, and decisions.**

The main advantages and disadvantages of delegation can be summarised as follows:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduces management stress and workload</td>
<td>Cannot / should not delegate responsibility</td>
</tr>
<tr>
<td>Allows senior management to focus on key tasks</td>
<td>Depends on quality / experience of subordinates</td>
</tr>
<tr>
<td>Subordinates are empowered and motivated</td>
<td>Harder in a smaller firm</td>
</tr>
<tr>
<td>Better decisions or use of resources (potentially)</td>
<td>May increase workload and stress of subordinates</td>
</tr>
<tr>
<td>Good method of on-the-job training</td>
<td></td>
</tr>
</tbody>
</table>

**Empowerment**

Empowerment is **giving employees the power to do their job.** The aim of empowerment is that

The concept of empowerment is closely linked to motivation and customer service. Employees need to feel that their actions count – and empowerment is about making this happen.

Empowerment is a catch-all term that covers:
Giving authority to make decisions to front-line staff (e.g. hotel receptionist, call centre assistant)

- Encouraging employee feedback
- Showing more trust in employees

**Workforce roles and workload**

What roles do employees play in a business? How much work should each employee perform, and who decides?

Here are three key terms that you need to remember:

<table>
<thead>
<tr>
<th>Workforce roles</th>
<th>Managerial and supervisory roles within the hierarchy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work loads</td>
<td>The tasks an individual employee has to complete within a period</td>
</tr>
<tr>
<td>Job allocations</td>
<td>The way in which tasks are allocated to certain jobs</td>
</tr>
</tbody>
</table>

There are a variety of titles that are given to the roles employees play. Four of the most common and important are summarised below:

| Directors | In overall charge of business  
|-----------|------------------------------|
|           | Appointed by shareholders  
|           | Responsibility for key business functions  
|           | - Marketing  
|           | - Finance  
|           | - Operations  
|           | - HRM  
|           | Close day-to-day involvement in small/medium sized businesses |

| Managers | Report to Directors  
|----------|------------------|
|          | Responsible for specific departments / activities  
|          | Oversee budgetary control  
|          | Have responsibility for their functional areas & budgets  
|          | May delegate tasks to subordinates  
|          | Managerial styles will vary |

| Team leaders | Tasked with ensuring that teams of employees work well together  
|--------------|------------------------------------------------|
|              | Associated with a matrix organisational structure  
|              | A ‘team leader:  
|              | - Allocates workload & jobs between the team members  
|              | - Manages team resources  
|              | - Focuses on quality & team motivation |

| Supervisors | Common role in a tall hierarchy  
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Responsible for allocating jobs to subordinates (at different levels of</td>
</tr>
</tbody>
</table>
Communication in Business

Communication can be defined as:

The process by which a message or information is exchanged from a sender to a receiver

Communication can be:

- **Internal**: between people in the same business
- **External**: with people outside the business

Internal communication is particularly important. It links together all the different activities involved in a business. It also aims to ensure that all employees are working towards the same goal and know exactly what they should be doing and by when.

External communication is where the business communicates with people & organisations outside of the business. This is closely linked with the idea of “stakeholders” – i.e. those who have an interest in the activities and results of the business.

Examples of external communication include:

- Press releases
- Marketing materials (e.g. adverts, brochures, direct mailings)
- Published financial information (e.g. accounts)
- Letters, emails and telephone conversations with customers and suppliers
- Reports to government and other agencies

There are many reasons why it is important for a business to achieve effective communication:

- Motivates employees – helps them feel part of business
- Easier to control and coordinate business activity – prevents different parts of business going in opposite directions
- Makes successful decision making easier – decisions are based on more complete and accurate information
- Better communication with customers will increase sales
- Improve relationships with suppliers
- Improves chances of obtaining finance – e.g. keeping bank up-to-date about how business is doing
The link between communication and motivation is particularly important. Good communication is an important part of motivating employees and the main motivational theorists recognised this:

- Mayo emphasised importance of communication in meeting employees’ social needs
- Maslow and Herzberg stressed importance of recognising employee’s achievements and self-esteem needs

Amongst the other reasons for using communication to boost motivation are:

- Ensures that everyone is working towards same company goals
- Enables employees to be involved in decision-making
- Employees can offer feedback and give suggestions
- People are motivated by having clear targets set for them
- Recognise employee achievements

Aiming to achieve effective communication is one thing – actually doing it is another. There are several barriers to communication, including:

- Too many intermediaries (e.g. too many layers in hierarchy through which message has to be passed)
- Geographical distance between a firm’s offices, production plants or outlets
- Communication overload – too much information can cause problems e.g. slow down decision making
**Guided Revision Questions**

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define the term “span of control”</td>
<td>2</td>
</tr>
<tr>
<td>Explain what is meant by the term “organisational structure”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “chain of command”?</td>
<td>2</td>
</tr>
<tr>
<td>Outline three uses of an organisation chart</td>
<td>4</td>
</tr>
<tr>
<td>Explain the relationship between an organisational hierarchy and the span of control</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between a team leader and a supervisor</td>
<td>4</td>
</tr>
<tr>
<td>Describe two possible benefits to a business of having wide spans of control</td>
<td>4</td>
</tr>
<tr>
<td>Outline three factors that affect how wide a manager’s span of control should be</td>
<td>4</td>
</tr>
<tr>
<td>Explain what is meant by “delayering”</td>
<td>4</td>
</tr>
<tr>
<td>Describe the role of a director in a business</td>
<td>4</td>
</tr>
<tr>
<td>Explain why delegation is easier for managers working in a larger rather than smaller business</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between informal and formal communication</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between a flat and a tall organisational structure</td>
<td>6</td>
</tr>
<tr>
<td>Explain why a flatter organisational structure is more likely to provide opportunities to motivate staff</td>
<td>6</td>
</tr>
<tr>
<td>Explain how empowerment can lead to greater employee motivation</td>
<td>6</td>
</tr>
<tr>
<td>Explain why a tall organisational structure may lead to a bureaucratic and inefficient business</td>
<td>6</td>
</tr>
<tr>
<td>Describe two benefits and two disadvantages of a business having a flat organisational structure</td>
<td>6</td>
</tr>
<tr>
<td>Distinguish between the role of a director and a manager</td>
<td>6</td>
</tr>
<tr>
<td>Explain why increased use of delegation might lead to better employee motivation and productivity</td>
<td>6</td>
</tr>
<tr>
<td>Describe two factors that will determine whether delegation will result in better allocation of workloads</td>
<td>6</td>
</tr>
<tr>
<td>Explain three benefits to a business of strong internal communication</td>
<td>6</td>
</tr>
<tr>
<td>Describe how delayering might result improved business performance and employee motivation</td>
<td>8</td>
</tr>
</tbody>
</table>
**MEASURING THE EFFECTIVENESS OF THE WORKFORCE**

In this section we look at:

- Methods of measuring workforce effectiveness
- Calculation and interpretation
- Measures to improve workforce effectiveness

**Labour productivity**

Labour productivity is concerned with the amount (volume) of output that is obtained from each employee. Why does this matter?

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

Achieving higher labour productivity is not a simple task. Several factors influence how productive the workforce is: e.g.

- Extent and quality of fixed assets (e.g. equipment, IT systems)
- Skills, ability and motivation of the workforce
- Methods of production organisation
- External factors (e.g. reliability of suppliers)

How can labour productivity be measured? The common formula is as follows:

\[
\text{Labour productivity} = \frac{\text{Output per period (units)}}{\text{Number of employees at work}}
\]

An example of this calculation is provided below:

Marcouse Plastics makes 5,000 widgets each month. Total monthly labour hours are 1,250. What is labour productivity (hours per unit)?

\[
\text{Labour productivity} = \frac{\text{Labour hours per month (1,250)}}{\text{Units produced per month (5,000)}} = 0.25 \text{hrs / unit}
\]
How can a business improve its labour productivity? Here are the main approaches:

- Measure performance and set targets – it is often claimed that “what gets measured, gets done!”
- Streamline production processes
- Invest in capital equipment (automation + computerisation)
- Invest in employee training
- Make the workplace conducive to productive effort

**Labour turnover**

*Employee retention* is the ability of a firm to convince its employees to remain with the business.

It is often measured by the labour turnover of a business. This is defined as the proportion of a firm’s workforce that leaves during the course of a year.

*The percentage of the workforce (employees) that leave a business within a given period (usually a year)*

The formula for calculating labour turnover is:

\[
\text{Labour turnover} = \frac{\text{Number of employees leaving during period}}{\text{Average number employed during period}} \times 100
\]

An example of using the formula is shown below:

**Surridge Porridge** is a manufacturer of breakfast cereals. In 2008 it employed an average of 80 staff. During 2008, the business recruited 12 staff to replace 15 who left.

\[
\text{Labour turnover} = \frac{\text{Number of employees leaving} (15)}{\text{Average number employed} (80)} \times 100
\]

\[
= 18.75\%
\]

It is important to remember that all businesses lose staff – for a variety of reasons:
• Retirement / Maternity / Death / Long-term Illness
• Unsuitability
• Changes in strategy (e.g. closure of locations)

In terms of this part of the course, we are more concerned with the loss of staff for reasons other than above. You might call this voluntary staff turnover – employees who leave of their own accord.

There are many reasons why a high labour turnover figure (poor employee retention) may cause problems for a firm:

• Increases recruitment costs (e.g. advertising for replacement staff; employing temporary staff whilst the job vacancies are filled)
• Reflects poor morale in workforce and so low productivity levels
• Increases training costs of new workers
• Loss of productivity while new worker settles in

However, there are some advantages of a firm experiencing labour turnover:

• It gives the chance for new people to be brought into the business who may have fresh ideas and up to date market knowledge.
• Workers with specialist knowledge or expertise can be employed rather than having to train up existing lower skilled employees.

A business can improve its employee retention by offering:

• Financial incentives (e.g. bonus, salary rise)
• Non-financial incentives (e.g. promotion, more decision making power)

A business may also have to adopt more flexible working practices in order to retain staff and fit in with the changing trend in UK employment and working patterns. For instance, there is a greater emphasis currently being placed on “flexible hours contracts” and part-time working. This is mainly to allow for the growing number of women joining the workforce who have to juggle childcare and their working lives.

Absenteeism

Absenteeism concerns employees who don’t turn up for work and who don’t have a legitimate reason. It is, therefore, largely about unauthorised absence from work.

There are various ways of calculating absenteeism – here is a popular formula:

\[
\text{Number days taken off for unauthorised absence (during period)} \times 100 \div \text{Total days worked by workforce over the period}
\]

The important point to remember about absenteeism is that is represents a significant business cost. Sickness absence alone costs UK businesses around £600 for each worker per
year (source: BusinessLink). The key for management is to understand the reasons for absent employees (genuine or not). E.g.

- Genuine sickness, bereavement, bullying, stress
- Some employees simply “playing the system”
- Predictable / traditional absenteeism – e.g. Monday / Friday, when there is a major sporting event during the day or at the end of a shift pattern

What can a business do to reduce absenteeism?

- Understand the causes
- Set targets and monitor trends
- Have a clear sickness & absence policy
- Provide rewards for good attendance
- Consider the wider issues of employee motivation

Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
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<tbody>
<tr>
<td>What is meant by the term “staff turnover”</td>
<td>2</td>
</tr>
<tr>
<td>Define the term “labour productivity”</td>
<td>2</td>
</tr>
<tr>
<td>Explain two methods of measuring labour productivity</td>
<td>4</td>
</tr>
<tr>
<td>Outline three reasons why firms lose staff in the normal course of business</td>
<td>4</td>
</tr>
<tr>
<td>List three advantages to a business of achieving high staff retention</td>
<td>4</td>
</tr>
<tr>
<td>Explain how a business could measure “labour turnover”</td>
<td>4</td>
</tr>
<tr>
<td>Outline why a hotel operator is likely to have a higher staff turnover than a long-established factory</td>
<td>6</td>
</tr>
<tr>
<td>Explain how more effective recruitment and selection processes might lead to lower staff turnover</td>
<td>6</td>
</tr>
<tr>
<td>Describe two factors that determine labour productivity in a manufacturing business</td>
<td>6</td>
</tr>
<tr>
<td>Explain how better staff training might result in improved labour productivity</td>
<td>6</td>
</tr>
<tr>
<td>Describe two problems a business faces if it experiences a significant increase in labour turnover</td>
<td>8</td>
</tr>
<tr>
<td>Explain why a high rate of absenteeism will adversely affect business performance</td>
<td>8</td>
</tr>
<tr>
<td>Discuss why measuring labour productivity is important to businesses</td>
<td>8</td>
</tr>
</tbody>
</table>
RECRUITMENT & SELECTION

In this section we consider:

- The need for workforce planning
- The recruitment and selection process
- Advantages and disadvantages of recruitment methods

Workforce Planning

For most businesses, large or small, the task of identifying what work needs doing and who should do it is a continuous challenge!

It is rare that a business of any size operates for long without having to recruit or remove employees.

For example, consider why a business might need to recruit staff:

- Business expansion due to
  - Increasing sales of existing products
  - Developing new products
  - Entering new markets
- Existing employees leave:
  - To work with competitors or other local employers
  - Due to factors such as retirement, sick leave, maternity leave
- Business needs employees with new skills
- Business is relocating – and not all of existing workforce want to move to new location

The world of work is also changing rapidly:

- Increase in part-time working
- Increased number of single-parent families
- More women seeking work
- Ageing population
- Greater emphasis on flexible working hours
- Technology allows employees to communicate more effectively whilst apart
- People rarely stay in the same job for life

Businesses need to understand and respond to these changes if they are to recruit staff of the right standard – and keep them!

So what is workforce planning?

**Workforce planning is about deciding how many and what types of workers are required**

There are several steps involved in workforce planning:

- The workforce plan establishes what vacancies exist
- Managers produce a job description and job specification for each post

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Job description
- Detailed explanation of the roles and responsibilities of the post advertised
- Most applicants will ask for this before applying for the job
- Refers to the post available rather than the person

Job specification
- Sets out the kind of qualifications, skills, experience and personal attributes a successful candidate should possess.
- A vital tool in assessing the suitability of job applicants
- Refers to the person rather than the post

The Recruitment Process
Recruitment and selection is the process of identifying the need for a job, defining the requirements of the position and the job holder, advertising the position and choosing the most appropriate person for the job.

Undertaking this process is one of the main objectives of management. Indeed, the success of any business depends to a large extent on the quality of its staff. Recruiting employees with the correct skills can add value to a business and recruiting workers at a wage or salary that the business can afford, will reduce costs. Employees should therefore be carefully selected, managed and retained, just like any other resource.

Managing job applications
For many jobs, a business will ask applicants to provide a Curriculum Vita (CV). This is a document that the applicant designs providing the details such as:

| Personal details | Name, address, date of birth, nationality |

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<table>
<thead>
<tr>
<th>Educational history</th>
<th>Including examination results, schools/universities attended, professional qualifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Previous employment history</td>
<td>Names of employers, position held, main achievements, remuneration package, reasons for leaving</td>
</tr>
<tr>
<td>Suitability and reasons for applying for the job</td>
<td>A chance for applicants to ‘sell themselves’</td>
</tr>
<tr>
<td>Names of referees</td>
<td>Often recent employer or people who know applicant well and are ideally independent</td>
</tr>
</tbody>
</table>

In some circumstances however an applicant may be asked to fill in a firm’s own application form. This is different from a CV in that the employer designs it and sends it to applicants, but it will still ask for much of the same information. It has the benefit over a CV in that a business is able to tailor it to their exact needs and ask specific questions.

Once a business has received all the applications, they need to be analysed and the most appropriate form of selection decided upon. When analysing applications, a business will normally sieve the applications into three categories.

<table>
<thead>
<tr>
<th>Those to reject</th>
<th>Candidates may be rejected because they may not meet the standards set out in the job specification such as wrong qualifications or insufficient experience or they may not have completed the application form to a satisfactory standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Those to place on a short list</td>
<td>Often comprises 3-10 of the best candidates who are asked to interview</td>
</tr>
<tr>
<td>Those to place on a long list</td>
<td>A business will not normally reject all other candidates immediately but keep some on a long list in case those on the short list drop out or do not appear suitable during interview. The business would not want to incur costs putting them through the selection process, such as interviews, unless they have to</td>
</tr>
</tbody>
</table>

### Internal versus External Recruitment

A manager can recruit in two different ways:

- **Internal recruitment** is when the business looks to fill the vacancy from within its existing workforce
- **External recruitment** is when the business looks to fill the vacancy from any suitable applicant outside the business

Of course, the option to use BOTH internal and external recruitment can be used. This is often the case for senior management appointments.

<table>
<thead>
<tr>
<th></th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal</td>
<td>Cheaper and quicker to recruit</td>
<td>Limits the number of potential applicants</td>
</tr>
<tr>
<td>Recruitment</td>
<td>Advantages</td>
<td>Disadvantages</td>
</tr>
<tr>
<td>-------------</td>
<td>------------</td>
<td>---------------</td>
</tr>
<tr>
<td></td>
<td>People already familiar with the business and how it operates</td>
<td>No new ideas can be introduced from outside</td>
</tr>
<tr>
<td></td>
<td>Provides opportunities for promotion with in the business – can be motivating</td>
<td>May cause resentment amongst candidates not appointed</td>
</tr>
<tr>
<td></td>
<td>Business already knows the strengths and weaknesses of candidates</td>
<td>Creates another vacancy which needs to be filled</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>External Recruitment</th>
<th>Outside people bring in new ideas</th>
<th>Longer process</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Larger pool of workers from which to find the best candidate</td>
<td>More expensive process due to advertising and interviews required</td>
</tr>
<tr>
<td></td>
<td>People have a wider range of experience</td>
<td>Selection process may not be effective enough to reveal the best candidate</td>
</tr>
</tbody>
</table>

The four most popular ways of recruiting externally are:

- **Job centres** – Government agencies to help the unemployed find jobs or get training
- **Job advertisements** - the most common form of external recruitment. Where a business chooses to advertise will depend on the cost of advertising and the coverage needed (i.e. how far away people will consider applying for the job)
- **Recruitment agency** - Provides employers with details of suitable candidates for a vacancy and can sometimes be referred to as ‘head-hunters’. They work for a fee and often specialise in particular employment areas e.g. nursing, financial services, teacher recruitment
- **Personal recommendation** - Often referred to as ‘word of mouth’ and can be a recommendation from a colleague at work. A full assessment of the candidate is still needed however but potentially it saves on advertising cost

When recruiting externally, the business will almost certainly have to produce a job advertisement. The objectives of the advertisement are to:

- Inform audience of potential candidates about opportunity
- Provide enough information to both inform and interest possible applicants
- Help “screen” or dissuade unsuitable applicants
- Obtain most number of suitably qualified applicants for post advertised

**Selecting the Best Candidate**

An interview is the most common form of selection and it serves a very useful purpose for both employer and job candidate:

**For the Employer:**

- Information that cannot be obtained on paper from a CV or application form
- Conversational ability - often known as people skills
- Natural enthusiasm or manner of applicant
- See how applicant reacts under pressure
Queries or extra details missing from CV or application form

For the Candidate

- Whether job or business is right for them
- What the culture of company is like
- Exact details of job

There are though other forms of selection tests that can be used in addition to an interview to help select the best applicant. The basic interview can be unreliable as applicants can perform well at interview but not have the qualities or skills needed for the job.

Other selection tests can increase the chances of choosing the best applicant and so minimise the high costs of recruiting the wrong people. Examples of these tests are aptitude tests, intelligence tests and psychometric tests (to reveal the personality of a candidate).

Managers selecting candidates for a high level post in an organisation may even send applicants to an assessment centre. In such centres candidates undergo a variety of tests, role-plays and simulations for a number of days.

Once the best candidate has been selected and agreed to take up the post, the new employee must be given an employment contract. This is an important legal document that describes the obligations of the employee and employer to each other (terms and conditions) as well as the initial remuneration package and a number of other important details.

Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
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<tbody>
<tr>
<td>Define the term “job description”</td>
<td>2</td>
</tr>
<tr>
<td>Explain what is meant by the term “workforce planning”</td>
<td>2</td>
</tr>
<tr>
<td>Outline the main stages in the recruitment process</td>
<td>4</td>
</tr>
<tr>
<td>Outline three reasons why job vacancies arise in a business</td>
<td>4</td>
</tr>
<tr>
<td>Explain the difference between a shortlist and a long list</td>
<td>4</td>
</tr>
<tr>
<td>Outline four common contents in a job description</td>
<td>4</td>
</tr>
<tr>
<td>Explain why an employer would wish to take up references from a selected candidate</td>
<td>4</td>
</tr>
<tr>
<td>Outline three piece of information that a candidate would wish to obtain during a recruitment interview</td>
<td>4</td>
</tr>
<tr>
<td>Discuss two advantages and disadvantages of using external recruitment</td>
<td>6</td>
</tr>
<tr>
<td>Explain why a business might use the services of a recruitment agency to handle the appointment of a new senior manager</td>
<td>6</td>
</tr>
<tr>
<td>Explain why assessment tests are widely used for selecting candidates for management positions</td>
<td>6</td>
</tr>
<tr>
<td>Outline the main advantages of requiring candidates to submit specific application form rather than a CV</td>
<td>6</td>
</tr>
<tr>
<td>Briefly explain the different ways in which a business might recruit externally</td>
<td>6</td>
</tr>
<tr>
<td>Explain why workforce planning is an important process for a growing business</td>
<td>6</td>
</tr>
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<td>Question</td>
<td>Score</td>
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<tr>
<td>-------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>Describe why a recruitment interview is such an important part of the selection process</td>
<td>6</td>
</tr>
<tr>
<td>Explain how external recruitment can benefit a business</td>
<td>6</td>
</tr>
<tr>
<td>Discuss whether a business should aim to use internal rather than external recruitment as the main source of filling job vacancies</td>
<td>8</td>
</tr>
<tr>
<td>Explain the importance of a job description and a person specification in the recruitment and selection process</td>
<td>8</td>
</tr>
</tbody>
</table>
TRAINING THE WORKFORCE

In this section we consider:

- What is training?
- Why a business needs training
- Main methods of training

What is Training?

Training can be defined as:

The process of increasing the knowledge and skills of the workforce to enable them to perform their jobs effectively

Training is, therefore, a process whereby an individual acquires job-related skills and knowledge.

Training costs can be significant in any business. However, many employers are prepared to incur these costs because they expect their business to benefit from employees' development and progress.

Training takes place at various points and places in a business. Commonly, training is required to:

- Support new employees (“induction training”)
- Improve productivity
- Increase marketing effectiveness
- Support higher standards of customer service and production quality
- Introduction of new technology, systems or other change
- Address changes in legislation
- Support employee progression and promotion

Effective training has the potential to provide a range of benefits for a business:

- Higher quality
- Better productivity
- Improved motivation - through greater empowerment
- More flexibility through better skills
- Less supervision required (cost saving in supervision)
- Better recruitment and employee retention
- Easier to implement change in the business

Effective training starts with a “training strategy”. The three stages of a training strategy are:

- Identify the skills and abilities needed by employees
- Draw up an action plan to show how investment in training and development will help meet business goals and objectives
- Implement the plan, monitoring progress and training effectiveness

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Given the costs involved, you might not be surprised to learn that many businesses do not invest enough in training. Some firms don’t invest anything in training! Here are the most common reasons for under-investment in training:

They fear employees will be poached by competitors (who will then benefit from the training)

- A desire to minimise short-term costs
- They cannot make a justifiable investment case
- Training takes time to have the desired effect – management are impatient!
- Sometimes the benefits of training are more intangible (e.g. morale) than tangible – so they are harder to measure

**Induction training**

*Induction training* is important as it enables a new recruit to become productive as quickly as possible. It can avoid costly mistakes by recruits not knowing the procedures or techniques of their new jobs. The length of induction training will vary from job to job and will depend on the complexity of the job, the size of the business and the level or position of the job within the business.

The following areas may be included in induction training:

- Learning about the duties of the job
- Meeting new colleagues
- Seeing the layout the premises
- Learning the values and aims of the business
- Learning about the internal workings and policies of the business

**On-the-job training**

With on the job training, employees receive training whilst remaining in the workplace.

The main methods of one-the-job training include:

- **Demonstration / instruction** - showing the trainee how to do the job
- **Coaching** - a more intensive method of training that involves a close working relationship between an experienced employee and the trainee
- **Job rotation** - where the trainee is given several jobs in succession, to gain experience of a wide range of activities (e.g. a graduate management trainee might spend periods in several different departments)
- **Projects** - employees join a project team - which gives them exposure to other parts of the business and allow them to take part in new activities. Most successful project teams are "multi-disciplinary"

The advantages and disadvantages of this form of training can be summarised as follows:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
</table>
Generally most cost-effective
Employees are actually productive
Opportunity to learn whilst doing
Training alongside real colleagues

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>A wider range of skills or qualifications can be obtained</td>
<td>More expensive – e.g. transport and accommodation</td>
</tr>
<tr>
<td>Can learn from outside specialists or experts</td>
<td>Lost working time and potential output from employee</td>
</tr>
<tr>
<td>Employees can be more confident when starting job</td>
<td>New employees may still need some induction training</td>
</tr>
<tr>
<td></td>
<td>Employees now have new skills/qualifications and may leave for better jobs</td>
</tr>
</tbody>
</table>

Off-the-job training

This occurs when employees are taken away from their place of work to be trained.

Common methods of off-the-job training include:

- Day release (employee takes time off work to attend a local college or training centre)
- Distance learning / evening classes
- Block release courses - which may involve several weeks at a local college
- Sandwich courses - where the employee spends a longer period of time at college (e.g. six months) before returning to work
- Sponsored courses in higher education
- Self-study, computer-based training

The main advantages and disadvantages of this form of training can be summarised as follows:

Training’s link to motivation

An important part of managing people is to let them know how they are performing. Various methods of performance appraisal can be used and an important output from this process should be an assessment of an employee’s training needs. Training programmes should be focused on meeting those needs.

Assuming training is effective: then:

- Employees feel more loyal to the business
• Shows that business is taking an interest in its workers
• Employees should benefit from better promotional opportunities
• Employees to achieve more at work – and perhaps gaining financially from this (depending on the remuneration structure)

Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
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<tbody>
<tr>
<td>Define the term “induction training”</td>
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<tr>
<td>Define the term “training”</td>
<td>2</td>
</tr>
<tr>
<td>Outline three likely elements to an induction training programme</td>
<td>4</td>
</tr>
<tr>
<td>Explain the purpose of an induction training course</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between on-the-job and off-the-job training</td>
<td>6</td>
</tr>
<tr>
<td>Outline three reasons why training is important to a business</td>
<td>6</td>
</tr>
<tr>
<td>Describe three methods of on-the-job training</td>
<td>6</td>
</tr>
<tr>
<td>Explain why a business should conduct “training needs analysis”</td>
<td>6</td>
</tr>
<tr>
<td>Outline two advantages and disadvantages of off-the-job training</td>
<td>6</td>
</tr>
<tr>
<td>Explain how an employee’s performance appraisal might link into a training programme</td>
<td>6</td>
</tr>
<tr>
<td>Explain why businesses often don’t provide sufficient training for employees</td>
<td>8</td>
</tr>
<tr>
<td>Describe how an effective training programme might lead to better employee motivation</td>
<td>8</td>
</tr>
<tr>
<td>Explain why a business should measure the effectiveness of its training</td>
<td>8</td>
</tr>
<tr>
<td>Analyse the role that employee training might play if a business wants to improve the standard of customer service</td>
<td>10</td>
</tr>
</tbody>
</table>
Motivating Employees in Theory

In this section we provide an overview of the theories that support motivational techniques at work.

What is motivation?

Writers disagree on the precise meaning of this term. However, in essence motivation is, about

“The will to work”

Motivation comes from the enjoyment of the work itself and/or from the desire to achieve certain goals e.g. earn more money or achieve promotion.

A well-motivated workforce can provide the following advantages:

- **Better productivity** (amount produced per employee). This can lead to lower unit costs of production and so enable a firm to sell its product at a lower price
- **Lower levels of absenteeism** as the employees are content with their working lives
- **Lower levels of staff turnover** (the number of employees leaving the business). This can lead to lower training and recruitment costs
- **Improved industrial relations** with trade unions
- Contented workers give the firm a good reputation as an employer so making it easier to recruit the best workers
- Motivated employees are likely to improve product quality or the customer service associated with a product

Main Theories of Motivation at Work

There are several different views as to what motivates workers. The most commonly held views or theories are discussed below and have been developed over the last 100 years or so. Unfortunately these theories do not all reach the same conclusions!

Taylor

Taylor put forward the idea that workers are motivated mainly by pay. His Theory of Scientific Management argued the following:

- Workers do not naturally enjoy work and so need close supervision and control
- Therefore managers should break down production into a series of small tasks
- Workers should then be given appropriate training and tools so they can work as efficiently as possible on one set task.
- Workers are then paid according to the number of items they produce in a set period of time- piece-rate pay.
- As a result workers are encouraged to work hard and maximise their productivity.

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Taylor’s methods were widely adopted as businesses saw the benefits of increased productivity levels and lower unit costs.

Taylor’s approach has close links with the concept of an **autocratic management style** (managers take all the decisions and simply give orders to those below them) and Macgregor’s Theory X approach to workers (workers are viewed as lazy and avoid responsibility).

However workers soon came to dislike Taylor’s approach as they were only given boring, repetitive tasks to carry out. Firms could also afford to lay off workers as productivity levels increased. This led to an increase in strikes and other forms of industrial action by dissatisfied workers.

**Mayo**

Mayo believed that workers are not just concerned with money but could be better motivated by having their social needs met whilst at work (something that Taylor ignored). He introduced the **Human Relations School** of thought, which focused on managers taking more of an interest in the workers, treating them as people who have worthwhile opinions and realising that workers enjoy interacting together.

Mayo concluded that workers are best motivated by:

- Better communication between managers and workers
- Greater manager involvement in employees working lives
- Working in groups or teams

His theory most closely fits in with a **paternalistic style** of management.

**Maslow**

Maslow focused on the psychological needs of employees. Maslow put forward a theory that there are five levels of human needs which employees need to have fulfilled at work.
All of the needs are structured into a hierarchy and only once a lower level of need has been fully met, would a worker be motivated by the opportunity of having the next need up in the hierarchy satisfied. For example a person who is dying of hunger will be motivated to achieve a basic wage in order to buy food before worrying about having a secure job contract or the respect of others.

A business should therefore offer different incentives to workers in order to help them fulfil each need in turn and progress up the hierarchy. Managers should also recognise that workers are not all motivated in the same way and do not all move up the hierarchy at the same pace. They may therefore have to offer a slightly different set of incentives from worker to worker.

**Herzberg**

Herzberg had close links with Maslow and believed in a **two-factor theory of motivation**. He argued that there were certain factors that a business could introduce that would directly motivate employees to work harder (**motivators**). However there were also factors that would de-motivate an employee if not present but would not in themselves actually motivate employees to work harder (**hygiene factors**).

Motivators are more concerned with the actual job itself. For instance how interesting the work is and how much opportunity it gives for extra responsibility, recognition and promotion. Hygiene factors are factors which ‘surround the job’ rather than the job itself. For example a worker will only turn up to work if a business has provided a reasonable level of pay and safe working conditions but these factors will not make him work harder at his job once he is there.

Herzberg believed that businesses should motivate employees by adopting a democratic approach to management and by improving the nature and content of the actual job through certain methods. Some of the methods managers could use to achieve this are:

- **Job enlargement** – workers being given a greater variety of tasks to perform (not necessarily more challenging) which should make the work more interesting.
- **Job enrichment** - involves workers being given a wider range of more complex and challenging tasks surrounding a complete unit of work. This should give a greater sense of achievement.
- **Empowerment** means delegating more power to employees to make their own decisions over areas of their working life.

**Summary of motivation theory**

Here is a brief summary of the main motivational theorists:

<table>
<thead>
<tr>
<th>Theorist</th>
<th>Key Conclusions</th>
</tr>
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<tbody>
<tr>
<td>Taylor</td>
<td>Workers given one repetitive task so they can learn to master it</td>
</tr>
<tr>
<td>Theory of Scientific Management</td>
<td>Managers should give orders and closely control workers</td>
</tr>
<tr>
<td></td>
<td>Workers should be paid per item they produced – piece rate</td>
</tr>
</tbody>
</table>
| **Mayo Human Relations School of thought** | Workers motivated by having social needs met  
Workers should work in teams  
Managers should have greater involvement in employee’s working life  
More two-way communication between managers and workers |
| --- | --- |
| **Maslow Hierarchy of needs** | Workers motivated by having each level of need met in order as they move up the hierarchy  
Levels of needs are: Physical, Security, Social, Self-esteem, Self-fulfilment  
Workers must have lower level of needs fully met by firm before being motivated by next level |
| **Herzberg Two factor theory** | Workers motivated to work harder by motivators e.g. more responsibility, more interesting work, more praise for good work  
Workers can become de-motivated if hygiene factors are not met e.g. pay, working conditions, relationships with colleagues |
**Motivating Employees in Practice**

In this section, we look at the main financial and non-financial methods of motivating staff.

**Non-financial methods of motivation**

Most businesses recognise the need for non-financial methods of motivation. They have realised that money may not be a great motivator and that financial incentive schemes can be difficult to operate. Working in teams may also mean that individual financial incentive schemes are of little relevance. A number of non-financial methods of motivation have been developed.

**Job enlargement**

Job enlargement involves the addition of extra, similar, tasks to a job. In job enlargement, the job itself remains essentially unchanged. However, by widening the range of tasks that need to be performed, hopefully the employee will experience less repetition and monotony that are all too common on production lines which rely upon the division of labour.

With job enlargement, the employee rarely needs to acquire new skills to carry out the additional task, and the motivational benefits of job enrichment are not usually experienced.

One important negative aspect is that job enlargement is sometimes viewed by employees as a requirement to carry out more work for the same amount of pay!

**Job rotation**

Job rotation involves the movement of employees through a range of jobs in order to increase interest and motivation.

Job rotation can improve “multi-skilling” but also involves the need for greater training.

In a sense, job rotation is similar to job enlargement. This approach widens the activities of a worker by switching him or her around a range of work.

For example, an administrative employee might spend part of the week looking after the reception area of a business, dealing with customers and enquiries. Some time might then be spent manning the company telephone switchboard and then inputting data onto a database.

Job rotation may offer the advantage of making it easier to cover for absent colleagues, but it may also reduce productivity as workers are initially unfamiliar with a new task.

**Job enrichment**

Job enrichment attempts to give employees greater responsibility by increasing the range and complexity of tasks they are called upon to complete and giving them the necessary authority. It motivates by giving employees the opportunity to use their abilities to the fullest.
Herzberg argued that job enrichment (through motivators) should be a central element in any policy of motivation. According to Herzberg, enriched jobs should contain a range of tasks and challenges at different ability levels and clear opportunities for achievement and feedback on performance. Job enrichment necessitates training.

**Teamworking and empowerment**

Empowerment involves giving people greater control over their working lives. Organising the labour force into teams with a high degree of autonomy can achieve this. This means that employees plan their own work, take their own decisions and solve their own problems. Teams are set targets to achieve and may receive rewards for doing so. Empowered teams motivate through allowing people the opportunity to meet some of the higher needs as identified by Maslow or Herzberg’s motivators.

This is a common topic for examination questions as empowered teams are a popular method of organising labour forces. It is important to appreciate the advantages and disadvantages of this approach. The advantages centre upon the positive motivational effects. This can result in higher productivity, leading to improved competitiveness and higher profits or market share. Disadvantages (which may only exist in the short term) centre upon the cost and disruption of training, and opposition from employees.

**Quality circles**

Quality circles are in widespread use to allow employees an opportunity to contribute to decision-making. These are small groups of people who meet regularly to discuss and solve production problems. The members are usually drawn from all levels and areas within the organisation. This ensures that all perspectives are considered. As well as motivating staff, such a group can provide businesses with some valuable ideas. This technique was first used at the Toyota Motor Company in Japan in the 1950s. It has been increasingly adopted in the West since the 1980s.

**Job design and redesign**

Many theorists have argued that jobs need to be designed or redesigned with the major motivational factors in mind. They should not be too highly specialised and should offer a varied range of duties. Equally, jobs need to allow people to use their initiative as well as enable them to meet their social needs by working with others.

**Financial Methods of Motivation**

Although some theorists like Herzberg believe that money is not a positive motivator (although lack of it can de-motivate), pay systems are designed to motivate employees.

The scientific / Theory X approach, in particular, argues that workers respond to financial rewards.
Getting employee pay right (often referred to as the “remuneration package”) is a crucial task for a business.

Why is pay important?

- It is an important cost for a business (in some “labour-intensive” businesses, payroll costs are over 50% of total costs)
- People feel strongly about it
- Pay is the subject of important business legislation (e.g. national minimum wage; equal opportunities)
- It helps attract reliable employees with the skills the business needs for success
- Pay also helps retain employees – rather than them leave and perhaps join a competitor
- For most employees, the remuneration package is the most important part of a job – and certainly the most visible part of any job offer

There are many methods of financial reward:

- Time-rate pay
- Piece-rate pay
- Commission
- Other performance-related pay (including bonuses)
- Shares and options
- Benefits in kind (“fringe benefits”)
- Pensions

Because pay is a complex issue, there are several ways in which businesses determine how much to pay:

- **Job evaluation / content;** this is usually the most important factor. What is involved in the job being paid? How does it compare with similar jobs?
- **Fairness** – pay needs to be perceived and be seen to match the level of work
- **Negotiated pay rates** – the rate of pay may have been determined elsewhere and the business needs to ensure that it complies with these rates.
- **Market rates** – another important influence – particularly where there is a standard pattern of supply and demand in the relevant labour market. If a business tries to pay below the “market rate” then it will probably have difficulty in recruiting and retaining suitable staff
- **Individual performance** – increasingly, businesses include an element of “performance-related” reward in their pay structures.

However, it is important to remember that pay is only **one element of motivation** and will work best where management also give attention to:

- Developing good management and supervision
- Designing jobs and organising work groups to make them as satisfying as possible
- Providing feedback to staff about their performance and training and development
- Making effective arrangements for communications and consultation

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Structuring the financial package

With so many methods of pay available, how should a business decide to structure the pay package it offers to employees, and what rate of pay should it use?

The starting point is usually to find out what the “market rate” is. Factors that help determine the market rate for a job include:

- Whether the skills that are required are widely available
- The overall level of unemployment in the employment “catchment area”
- Whether the job requires specialised (or even highly specialised) skills

There are several ways in which a business can obtain data on market rates:

- Local employment agencies & job centres
- Job adverts
- Industry associations (who often perform annual surveys of pay in an industry)

The next question is – should the business pay MORE or LESS than the market rate?

Factors to consider here include:

- Does the business need above-average employees (e.g. salesmen with an industry reputation for being strong performers)
- Does the business need trained employees or is it prepared to invest in training beginners?
- Are the skills wanted by the business needed urgently (in which case – the business would probably want to pay more)
- Do factors affecting the mobility of labour need to be addressed – e.g. are there transport problems that need to be solved (e.g. pay for a rail season ticket) or relocation allowances to be offered to encourage new employees to move home?

The third important question is how to structure the remuneration package.

- Should employees be paid on the basis of time spent working (e.g. time-rates) or the amount they produce (e.g. piece rates) or some other measure of performance?
- Should the remuneration package be a combination of approaches (e.g. some basic pay per month + a commission-related incentive)?

In deciding the answers to these questions, a business should try to construct a pay structure that is simple (to help employees understand it), logical and fair

Time-rate pay

Time rates are used when employees are paid for the amount of time they spend at work. This is the most common method of payment in the UK.

The usual form of time rate is the weekly wage or monthly salary. Usually the time rate is fixed in relation to a standard working week (e.g. 35 hours per week). The employment contract for a time-rate employee will also stipulate the amount of paid leave that the employee can take each year (e.g. 5 weeks paid holiday).
Time worked over this standard is known as **overtime**. Overtime is generally paid at a higher rate than the standard time-rate – reflecting the element of sacrifice by an employee. However, many employees who are paid a monthly salary do not get paid overtime. This is usually the case for managerial positions where it is generally accepted that the hours worked need to be sufficient to fulfil the role required.

The main advantages of time-rate pay are:

- Time rates are simple for a business to calculate and administer
- They are suitable for businesses that wish to employ staff to provide general roles (e.g. financial management, administration, maintenance) where employee productivity is not easy to measure
- It is easy to understand from an employee’s perspective
- The employee can budget personal finance with some certainty
- Makes it easier for the employer to plan and budget for employee costs (e.g. payroll costs will be a function of overall headcount rather than estimated output)

The main disadvantages of time-rate pay are:

- Does little to encourage greater productivity – there is no incentive to achieve greater output
- Time-rate payroll costs have a tendency to creep upwards (e.g. due to inflation-related pay rises and employee promotion)

**Piece-rate pay**

Piece-rate pay gives a payment for each item produced – it is therefore the easiest way for a business to ensure that employees are paid for the amount of work they do. Piece-rate pay is also sometimes referred to as a **“payment by results system”**.

Piece-rate pay encourages effort, but, it is argued, often at the expense of quality. From the employee’s perspective, there are some problems. What happens if production machinery breaks down? What happens if there is a problem with the delivery of raw materials that slows production? These factors are outside of the employee’s control – but could potentially affect their pay.

The answer to these problems is that piece-rate pay systems tend, in reality, to have two elements:

- A basic pay element – this is fixed (time-based)
- An output-related element (piece-rate). Often the piece-rate element is only triggered by the business exceeding a target output in a defined period of time

**Commission**

Commission is a payment made to employees **based on the value of sales achieved**. It can form all or (more often) part of a pay package. Commission is, therefore, a form of **“incentive pay”** (see also profit-related pay, bonuses).

Commission, like piece-rates, is a reward for the quantity or value of work achieved. In most cases, the employee is paid a flat percentage of the value of the good or service that is sold.
The rate of commission depends on the selling price and the amount of effort required in making the sale.

For example, commission rates could range from 5% where the product sells easily (e.g. household goods sold door-to-door) to 30% where the effort is substantial.

The main advantage of commission from an employee’s point-of-view is that it enables high performing sales people to earn huge amounts.

The main advantage to the employer is that the payroll cost is related to the value of business achieved rather than just the amount produced. After all, businesses exist to sell goods and services for profit – not just to make things.

However, there are several drawbacks with using commission payments:

- Sales people may cut corners to make sales (e.g. not explain the product or service in enough detail to potential customers) – i.e. customers are misled & missold
- High commission earnings enjoyed by some of the sales team may be resented elsewhere in the business – particularly if the sales actually depend on a team effort
- It is difficult to change what proves to be an over-generous commission structure without upsetting and demoralising the sales team
- Once commission payments have been made, the sales force may lose some motivation until they begin to focus on the next payment (which might be up to 12 months away)

As a result of the above disadvantages, most businesses that use commission as an incentive payment method offer a basic pay plus a moderate commission level. In this way, if sales and profits justify the change, the commission rate can always be increased slightly.

**Performance related pay**

Performance-related pay is a financial reward to employees whose work is considered to have reached a required standard, and/or above average

Performance related pay is generally used where employee performance cannot be appropriately measured in terms of output produced or sales achieved.

Whilst the detail of real performance-related schemes varies from business to business, there are several common features:

- Individual performance is reviewed regularly (usually once per year) against agreed objectives or performance standards. This is the performance appraisal
- At the end of the appraisal, employees are categorised into performance groups – which determine what the reward will be
- The method of reward will vary, but traditionally it involves a cash bonus and/or increase in wage rate or salary

Performance-related pay has grown widely in recent years – particularly in the public sector. This is part of a movement towards rewarding individual performance which reflects individual circumstances.

There are several problems with performance-related pay:

- There may be disputes about how performance is measured and whether an employee has done enough to be rewarded
Rewarding employees individually does very little to encourage teamwork

There is doubt about whether performance-related pay actually does anything to motivate employees. This may be because the performance element is usually only a small percentage of total pay.

**Fringe benefits**

Fringe benefits are financial benefits that are not paid out directly in cash (or cash equivalents such as shares).

Examples of these include:

- Company cars
- Discounted season tickets
- Health insurance
- Pensions
- Holiday and other entitlements to take time off work
- Childcare provision
- Staff uniforms
- Staff discounts

Benefits in kind have become a much more popular and widespread form of remuneration. This is partly because businesses pay less tax on providing them, but also because they cause a business less hassle and can help to differentiate the remuneration package.

**Profit sharing**

Profit sharing refers to any system whereby employees receive a proportion of business profits. Profit sharing is generally accepted as having many advantages, providing that all employees are able to participate. Key advantages include:

- Creates a direct link between pay and performance
- Creates a sense of team spirit - helps remove ‘them and us’ barrier between managers and workers if all employees involved
- May improve employee’s loyalty to company
- Employees more likely to accept changes in working practices if can see that profits will increase overall

**Guided Revision Questions**

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<th>Question</th>
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<tbody>
<tr>
<td>Define the term “fringe benefits”</td>
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<tr>
<td>What is meant by the term “motivation”?</td>
<td>2</td>
</tr>
<tr>
<td>According to Taylor, how are employees motivated?</td>
<td>4</td>
</tr>
<tr>
<td>List three objectives that remuneration systems are meant to achieve</td>
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<table>
<thead>
<tr>
<th>Question</th>
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<tbody>
<tr>
<td>Suggest an appropriate method of remuneration for (a) a salesman, and (b) a car assembly worker</td>
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<tr>
<td>Outline three fringe benefits that could be used to motivate employees working from a city centre office</td>
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<tr>
<td>Describe two potential problems with performance-related pay</td>
<td>4</td>
</tr>
<tr>
<td>Outline why a business might choose to set up teams</td>
<td>4</td>
</tr>
<tr>
<td>Explain two benefits of emphasising teamworking in a business</td>
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<tr>
<td>Explain the difference between job enrichment and job enlargement</td>
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<tr>
<td>Outline three benefits of teamworking as a method of employee motivation</td>
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<tr>
<td>Analyze two advantages and disadvantages of using a piece rate system as method of motivation</td>
<td>6</td>
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<tr>
<td>Explain who job rotation might result in improved employee motivation</td>
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</tr>
<tr>
<td>Explain why it is important for employees to feel motivated at work</td>
<td>8</td>
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<tr>
<td>Discuss how the use of fringe benefits might motivate employees</td>
<td>8</td>
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<tr>
<td>Discuss whether profit-sharing schemes are a more effective method of motivation than simply paying employees a higher basic pay</td>
<td>8</td>
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<tr>
<td>Discuss whether the payment of commission acts as a motivator for staff involved in selling direct to customers</td>
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<tr>
<td>To what extent do you believe that employee motivation is determined by financial rather than non-financial incentives?</td>
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</table>
Section 3 – Operations Management
MAking operational decisions

In this section we look at two important concepts:

- Managing the production capacity of a business
- Production efficiency

Capacity

Capacity can be defined as:

The maximum output that a business can produce in a given period with the available resources

- Capacity is usually measured in production units (e.g. 1,000 cars per month). Productive capacity can change e.g. when a machine is having maintenance, capacity is reduced
- Capacity is linked to workforce planning: e.g. by working more production shifts, capacity can be increased
- Capacity needs to take account of seasonal or unexpected changes in demand
  - E.g. Chocolate factories need capacity to make Easter Eggs in November and December before shipping them to shops after Christmas
  - E.g. Ice-cream factories in the UK needed to quickly increase capacity during a heat wave

Capacity utilisation

Utilisation can be defined as:

The percentage of total capacity that is actually being achieved in a given period

Capacity utilisation (expressed as a percentage) is calculated using this formula:

\[
\frac{\text{Actual level of output}}{\text{Maximum possible output}} \times 100
\]

Here is an example of the formula above in action:
Capacity utilisation is an important concept:

- It is often used as a measure of productive efficiency
- Average production costs tend to fall as output rises – so higher utilisation can reduce unit costs, making a business more competitive
- So firms usually aim to produce as close to full capacity (100% utilisation) as possible

Is there an ideal level of capacity utilisation? The answer is – it depends!

There are several reasons why businesses operate at less than 100% capacity utilisation:

- Lower demand:
  - General reduction in overall market demand
  - Loss of market share
  - Seasonal variation in demand
- Increase in capacity not yet matched by increased demand:
  - Possibly new technology introduced
  - Provide some “slack”
- Inefficiency (a problem = less competitive unit costs)
  - Poor maintenance, quality, employee disruption

When a business is operating at less than 100% capacity, it is said to have “spare capacity”.

Sometimes spare capacity is not the problem – a business finds itself with excess demand (i.e. it cannot produce enough to meet demand). In such circumstances, what can it do to operate at higher than 100% normal capacity? It can often:

- Increase workforce hours (e.g. extra shifts; encourage overtime; employ temporary staff)
- Sub-contract some production activities (e.g. assembly of components)
- Reduce time spent maintaining production equipment
However, there are some potential pitfalls with operating at very high capacity (i.e. around 100%):

- Negative effect on quality (possibly)
  - Production is rushed
  - Less time for quality control
- Employees suffer
  - Added workloads & stress
  - De-motivating if sustained for too long
- Loss of sales
  - Less able to meet sudden or unexpected increases in demand
  - Production equipment may require repair

**Production efficiency**

It is important that a business makes effective use of its assets. The investment in production capacity is often significant. Think about how much it costs to set up a factory; the production line with all its machinery and technology. One way to look at how efficiently a business operates is to look at “productivity”.

Productivity measures the relationship between inputs into the production process and the resultant outputs. Productivity can be measured in several ways: e.g.

- Output per worker or hour of labour
- Output per hour / day / week
- Output per machine
- Unit costs (total costs divided by total output)

The unit cost measure is particularly important. A falling ratio would indicate that efficiency was improving.

Why is achieving high productivity important?

- Most importantly, a more efficient business will produce lower cost goods than competitors. That means the business can either make a higher profit per unit sold (assuming that the product is sold for the same price as a competitor) or the business can offer customers a lower price than competitors (and still make a good profit)/
- Investing in production assets (e.g. equipment, factory buildings) is expensive – a business needs to maximise the return it makes on these assets

There are various ways in which a business can try to improve its productivity:

- Training – e.g. on-the-job training that allows an employee to improve skills required to work more productively
• Improved motivation – more motivated employees tend to produce greater output for the same effort than de-motivated ones
• More or better capital equipment (this links with the topic of automation)
• Better quality raw materials (reduces amount of time wasted on rejected products)
• Improved organisation of production – e.g. less wastage

Guided Revision Questions

<table>
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<td>What is the formula for calculating capacity utilisation?</td>
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<td>Define the term “productivity”?</td>
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<tr>
<td>Describe two circumstances in which a business might experience a short-term capacity shortage</td>
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<tr>
<td>Why is it important for a business to minimise its unit costs?</td>
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<tr>
<td>Outline four ways in which a business could improve its productivity</td>
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<tr>
<td>Explain two implications of a business operating well below its capacity</td>
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<tr>
<td>Describe three ways in which a manufacturing business could increase production capacity in the short-term</td>
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<tr>
<td>What problems might a business experience if it operates at very high capacity utilisation for a prolonged period?</td>
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QUALITY

In this section we look at:

- The meaning and importance of quality
- Quality control compared with quality assurance
- Approaches to monitoring and improving quality

What is quality?

Quality is important to businesses but can be quite hard to define.

A good definition of quality is:

“Quality is about meeting the needs and expectations of customers”

Customers want quality that is appropriate to the price that they are prepared to pay and the level of competition in the market.

Key aspects of quality for the customer include:

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

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

Some products and services are marketed as ‘basic’, having none of the extra features and benefits of more expensive alternatives. Good examples would be Easyjet and George at Asda clothing ranges. Even though it may be ‘low quality’ in terms of style or features, these products still give good value for money for their overall level of quality.

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

Why is quality important?

Quality helps determine a firm’s success in a number of ways:

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

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

**The Costs of Poor Quality**

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

- Product fails – e.g. a breakdown or unexpected wear and tear
- Product does not perform as promised (or what the customer thought was promised!)
- Product is delivered late
- Poor instructions/directions for use make using the product difficult or frustrating
- Unresponsive customer service

Poor customer service as listed above results in additional business costs:

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

You can see from the list above that poor quality is a source of competitive disadvantages. If competitors are achieving higher quality, then a business will suffer.

**Measuring quality**

Businesses can measure quality aspects such as:

- Failure or reject rates
- Level of product returns
- Customer complaints
- Customer satisfaction – usually measured by a survey
- Customer loyalty – evident from repeat purchases, or renewal rates

However, it is important to remember that:

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

Achieving high quality does not happen by accident. The production process must be properly managed to achieve quality standards.

Quality management is concerned with controlling activities with the aim of ensuring that products and services are fit for their purpose and meet the specifications.

There are two alternative approaches to managing quality

**Quality control**

A definition of quality control is:

> The process of inspecting products to ensure that they meet the required quality standards

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

**Advantages**

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

**Disadvantages**

A major problem is that individuals are not necessarily encouraged to take responsibility for the quality of their own work.

Rejected product is expensive for a firm as it has incurred the full costs of production but cannot be sold as the manufacturer does not want its name associated with substandard product. Some rejected product can be re-worked, but in many industries it has to be scrapped – either way rejects incur more costs.

A quality control approach can be highly effective at preventing defective products from reaching the customer. However, if defect levels are very high, the company’s profitability will suffer unless steps are taken to tackle the root causes of the failures.

**Quality Assurance**

A definition of quality assurance is:

> The processes that ensure production quality meets the requirements of customers

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

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

Advantages of quality assurance include:
Costs are reduced because there is less wastage and re-working of faulty products as the product is checked at every stage.

It can help improve worker motivation as workers have more ownership and recognition for their work (see Herzberg).

It can help break down ‘us and them’ barriers between workers and managers as it eliminates the feeling of being checked up on.

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

**Total Quality Management (‘TQM’)**

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

**Quality Benchmarking**

Benchmarking is a general approach to business improvement based on best practice in the industry, or in another similar industry. It can provide a useful quality improvement target for a business.

This can be a helpful approach for services as well as for products – for example a fast food business selling fish and chips could decide that it wanted to aim to equal McDonalds’ speed of meeting customer orders for takeaway food. A financial services firm might want its call centre staff to answer 95% of telephone calls within six rings, if this is the practice of the best in the industry.

In some cases, firms can use *internal benchmarking* in which best practice may be set with reference to another department, or by a similar factory in a different location.

**Quality Control v Quality Assurance?**

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

<table>
<thead>
<tr>
<th>Quality Assurance</th>
<th>Quality Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus on processes</td>
<td>Focus on outputs</td>
</tr>
<tr>
<td>Achieved by improving production processes</td>
<td>Achieved by sampling &amp; checking (inspection)</td>
</tr>
<tr>
<td>Targeted at the whole organisation</td>
<td>Targeted at production activities</td>
</tr>
<tr>
<td>Emphasises the customer</td>
<td>Emphasises required standards</td>
</tr>
<tr>
<td>Quality is built into the product</td>
<td>Defect products are inspected out</td>
</tr>
</tbody>
</table>
## Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define the term “quality”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “quality assurance”?</td>
<td>2</td>
</tr>
<tr>
<td>What is a “quality circle”?</td>
<td>2</td>
</tr>
<tr>
<td>Distinguish between quality control and quality assurance</td>
<td>4</td>
</tr>
<tr>
<td>Explain what is meant by the term “right first time”</td>
<td>4</td>
</tr>
<tr>
<td>List four examples of poor quality</td>
<td>4</td>
</tr>
<tr>
<td>Describe two costs of poor quality</td>
<td>4</td>
</tr>
<tr>
<td>Why employees resist the introduction on TQM?</td>
<td>4</td>
</tr>
<tr>
<td>Explain why it is important for a business to have the support of employees when trying to improve quality</td>
<td>6</td>
</tr>
<tr>
<td>Explain why more firms changing from a system of quality control to one of quality assurance</td>
<td>6</td>
</tr>
<tr>
<td>Explain two advantages and disadvantages of TQM (total quality management)</td>
<td>6</td>
</tr>
<tr>
<td>Explain the relationship between employee training and customer service</td>
<td>8</td>
</tr>
<tr>
<td>Discuss how an improvement in quality might enable a business to become more competitive</td>
<td>8</td>
</tr>
<tr>
<td>Examine the link between quality and customer service</td>
<td>8</td>
</tr>
</tbody>
</table>
CUSTOMER SERVICE

In this section, we’ll look at:

- Who is the customer?
- What is meant by customer service and customer satisfaction?
- Benefits of good customer service / problems of poor customer service

Who is the Customer?

A customer is anyone who receives a product – either a good or a service – from an organisation. In most situations the customer will have to pay to obtain the product, but this is not always the case. For example, students are increasingly referred to as the ‘customers’ of the schools and colleges that they attend, but the majority of students do not pay directly for the educational service they receive.

Internal customers are members of staff or outside suppliers that contribute towards the service provided to external customers. They include:

- Colleagues
- Managers/supervisors
- Staff in other functional departments

Good customer service to internal customers will help to establish good working relationships between colleagues, managers and staff teams. These relationships are important if the business is to function effectively. For example, working in a pleasant environment where staff are supportive of each other can keep staff turnover and absenteeism costs to a minimum.

External customers, on the other hand, are the people who we more usually associate with the term ‘customer’, i.e. the people that actually buy or use an organisation’s products and services.

A key point to remember is that there are many occasions in which a business comes into contact with external customers. It is not just about the moment a transaction takes place. Points of customer contact take place:

- When a customer is enquiring about the product
- Taking a customer order or payment
- Delivering a product
- When handling a complaint or problem
- When making repairs or doing maintenance
- Providing after-sales care

What is Customer Service?

Broadly speaking, customer service can be defined as:

The way a business looks after its customers

Customer service has to be a team effort and not just the responsibility of employees who deal with the public directly.
Providing good customer service is a vital part of managing a business. Most customers have the option to go elsewhere if the quality of customer service is lacking. On the other hand, good customer service is a source of competitive advantage.

Good customer service leads to **customer satisfaction**. Satisfied customers are more loyal and profitable. Dissatisfied customers take their money elsewhere – and tell their friends about the poor service they have received.

**What is Customer Satisfaction?**

The following ideas are usually considered to be fundamental in achieving customer satisfaction:

- **The product or service** must meet customer needs & wants – i.e. it must be of good quality
- **Sales and promotional activities** need to create a positive experience for the customer. For example, the attitudes of employees who make contact with customers should be positive and professional
- **After-sales service** should also be positive and appropriate (e.g. user training, help lines, servicing). Customers often need reassurance after they have bought something that they have made the right choice, or help in using a product properly.

Customer expectations of good customer service also play a part in customer satisfaction. These expectations typically include factors such as:

- Safety and security
- Clear and accurate information
- Legal rights to be upheld
- Impartiality and objectivity
- Complaint, enquiry and suggestion procedures
- Special needs catered for (e.g. disability access)
- Ethical delivery

**Benefits of Good Customer Service**

The potential benefits to the firm from providing a consistently high level of customer service include:

- **Increased sales** – more likely to try out other products/services too
- **Customer loyalty** – more likely to be a source of repeat business and to recommend the business to friends and family
- **Enhanced public image** – helps build a brand and provides protection if there is a slip-up in customer service
- **More effective workforce** – satisfied customers help create a positive working environment
It should be evident from the points made above that the benefits of good customer service are interrelated, i.e.

- Satisfied customers will lead to more sales from their own repeat business and from the new customers generated by their recommendations
- A positive public image will generate more sales by attracting new customers
- Staff who deliver good customer service receive their customers’ appreciation and are further motivated to offer good customer service and so on

**Improving Customer Service**

Businesses need to regularly monitor the quality of service provided in order to assess and evaluate the degree to which they are meeting (and, hopefully, exceeding) the needs and expectations of their customers.

A common method used by many businesses to do this is known as **benchmarking**. This involves comparing the standards achieved by the business against known industry levels for key service criteria.

Another important method of assessing service quality is to look at **customer feedback**. It is important for businesses to obtain as much feedback as possible from customers. It is worth remembering that feedback can be **positive** as well as **negative**, and it is just as useful to know what the business is getting right as it is to know what it is doing wrong!

There are several ways that a business can encourage customers to provide feedback:

- Make it easy to complain: e.g. free phone number; complaint forms
- Customer service feedback forms
- Train staff to listen carefully / look for problems
- Reward customer feedback with incentives (e.g. discounts, special offers, entry into prize draws)
- Thank customers when they submit complaints

Don’t forget too that customer feedback can be:

<table>
<thead>
<tr>
<th>Positive</th>
<th>Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information from satisfied customers&lt;br&gt;Confirms business is doing something right / well&lt;br&gt;Encourages &amp; motivates staff</td>
<td>Information from unhappy customers&lt;br&gt;Vital indicator about what may need to be done to gain and keep hold of customers&lt;br&gt;Often obtained from customer complaints&lt;br&gt;It is often said that the worst customer is an unhappy customer who doesn’t tell you about it</td>
</tr>
</tbody>
</table>

Gathering data on customer service is not an end in itself. This data must now be analysed and conclusions must be drawn and presented to the relevant parties, i.e., all the people involved in delivering customer service. Clearly, senior managers who have ultimate responsibility for devising corporate strategy need accurate and up-to-date information in order to make effective decisions but staff who deal with customers directly may also benefit from knowing what they are getting right as well as what they are getting wrong!
# Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
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<tbody>
<tr>
<td>Define the term “customer service”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “customer feedback”</td>
<td>2</td>
</tr>
<tr>
<td>Outline four methods by which a business can obtain feedback from its customers</td>
<td>4</td>
</tr>
<tr>
<td>Describe three ways in which a business could encourage customers to evaluate the customer service they receive</td>
<td>4</td>
</tr>
<tr>
<td>Outline two advantages and disadvantages of a business receiving customer complaints</td>
<td>4</td>
</tr>
<tr>
<td>Explain the role of a “mystery shopper” in helping a business monitor the quality of its customer service</td>
<td>6</td>
</tr>
<tr>
<td>Examine how customer service can be improved through investment in training</td>
<td>6</td>
</tr>
<tr>
<td>Analyses three benefits to a business of good customer service</td>
<td>8</td>
</tr>
<tr>
<td>Discuss why it is often claimed that small businesses provide the highest standard of customer service</td>
<td>8</td>
</tr>
<tr>
<td>Explain the relationship between product quality and customer service standards</td>
<td>8</td>
</tr>
</tbody>
</table>
WORKING WITH SUPPLIERS

In this section we look at:

- What is a supplier?
- Factors to consider in choosing a supplier
- Working effectively with suppliers to improve business performance

What is a Supplier?

A supplier can be defined as:

A person, business or other organisation that provides a product or service to another business

So a supplier could include all of the following:

- The landlord of the office space leased to the business
- The local franchise that provides design and printing services to a business
- The supplier of raw materials and components to a business
- Hotels, train operating companies and other providers of services to the employees of business whilst they are at work

You could also argue that employees are a supplier to a business, although this is not strictly true and we’ll leave them out of the subsequent description of how a business can work effectively with suppliers.

However, consider the case of a consultant or adviser to a business – the accountant, lawyer or recruitment agency etc. These too are people providing a service, and they qualify as suppliers using our definition.

Suppliers are an important part of business operation, for several reasons:

- For a business to meet the needs and wants of customers, it needs an effective “supply chain”
- Suppliers determine many of the costs of a business (e.g. raw materials, distribution)
- Suppliers are closely linked to product quality (e.g. poor quality materials are likely to lead to greater wastage and production defects)
- Suppliers can be an important source of finance to a business (trade credit)
- For businesses that use lean production techniques (such as just-in-time) effective relationships with key suppliers are essential

Finding Suppliers

Where can a business find suppliers for its needs? The main sources of information are summarised below:

<table>
<thead>
<tr>
<th>Source</th>
<th>Why</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Word of mouth</strong></td>
<td>Often the best – a recommendation from another business (not necessarily in the same market). Note: a recommendation can be positive or negative!</td>
</tr>
<tr>
<td>-------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Trade associations</strong></td>
<td>Most industries have a trade body that provides directories of businesses operating in the market. Sometimes they have an “approved supplier” list</td>
</tr>
<tr>
<td><strong>Exhibitions</strong></td>
<td>Traditionally popular way of meeting several potential suppliers at the same time in the same place</td>
</tr>
<tr>
<td><strong>Trade press + trade websites</strong></td>
<td>Websites, newspapers and magazines dedicated to a particular market or industry</td>
</tr>
<tr>
<td><strong>Directories</strong></td>
<td>E.g. Yellow Pages. A good source of suggestions for “commodity suppliers” but not particularly reliable for “strategic suppliers”</td>
</tr>
<tr>
<td><strong>Direct marketing + advertising</strong></td>
<td>Introductions from the promotional marketing activities of suppliers. Often aimed at generating an introduction from a sales representative</td>
</tr>
</tbody>
</table>

**Strategic versus Commodity Suppliers**

You can make a useful distinction between a “strategic supplier” and a “normal supplier”. A strategic supplier provides goods or services that are essential to the business - such as high-value raw materials.

Normal suppliers provide low-value supplies such as office stationery.

It should go without saying that a business should spend much more time selecting and managing strategic suppliers.

Some examples of strategic and commodity suppliers are given below:

<table>
<thead>
<tr>
<th>Example Business</th>
<th>Strategic Suppliers</th>
<th>Commodity Suppliers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car manufacturer</td>
<td>Car components</td>
<td>Office stationery</td>
</tr>
<tr>
<td></td>
<td>Energy</td>
<td>Magazines (advertising)</td>
</tr>
<tr>
<td>National chain of fast food sandwiches</td>
<td>Local fresh produce</td>
<td>Shop cleaning</td>
</tr>
<tr>
<td></td>
<td>Product distribution</td>
<td>Refuse collection</td>
</tr>
<tr>
<td>UK-wide car hire company</td>
<td>Vehicle suppliers</td>
<td>Office water coolers</td>
</tr>
<tr>
<td></td>
<td>IT systems</td>
<td>Head office photocopiers</td>
</tr>
</tbody>
</table>

Relationships with strategic suppliers are often formalised in terms of a supply contract.

A supply contract sets out how a business and its supplier will work together. The key contents of a contract would normally include:
• What is to be provided (the product or service) – precise description required, including quality standards to be met
• When – delivery timetable (including milestones where appropriate)
• How much – pricing & payment terms
• Source of supply – any restrictions on materials to be used (e.g. ethically sourced)
• Disputes – procedure for disputes and how they will be resolved
• Termination – how & when a supply contract will be terminated

How Many Suppliers?

Another factor to consider is the **number of suppliers** that a business has for each category of purchasing. Should a business look to spread its spending over a few or many suppliers? There are arguments for both approaches

<table>
<thead>
<tr>
<th>Few Suppliers</th>
<th>Many Suppliers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Easier to control suppliers</td>
<td>Important to have a choice to foster competition</td>
</tr>
<tr>
<td>Custom is more important to suppliers</td>
<td>Suppliers less likely to become complacent</td>
</tr>
<tr>
<td>Possible deals based on volumes bought that provide a cost advantage</td>
<td></td>
</tr>
<tr>
<td>Stronger relationship built – useful when a supplier is asked to help with problems</td>
<td></td>
</tr>
</tbody>
</table>

Choosing a Supplier

At the start-up phase, supplier selection is often quite informal and based on word-of-mouth recommendation or by responding to promotional materials. A start-up business may initially have relatively low operating costs and will deal with a small, manageable number of suppliers. However, as the size of the business and the amount spent with supplier grows, then the choice of supplier becomes much more important.

Choosing the right supplier involves much more than scanning a series of price lists. The choice will depend on a wide range of factors such as:

• Value for money (not necessarily the same thing as price)
• Quality
• Reliability
• Service

How a business weighs up the importance of these different factors depends on its priorities and strategy.
The best, long-term relationships are built with suppliers who offer products or services that match - or exceed - the needs of the business rather than simply sell what they are trying to get the business to buy.

For example, if a business wants to reduce the delivery lead-time on customer order, suppliers that offer faster delivery might rate higher than those that compete on price alone.

A manufacturing business that builds its reputation on high product quality will want to ensure that the raw materials or components included in the production process are also of high quality. Again, supplier price will be less of an issue than quality & reliability etc.

To summarise, the main things a business should look for in choosing a supplier are:

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

**How Important is Supplier Price?**

Many business textbooks like to emphasise importance of non-price factors (e.g. reliability, quality, location) when choosing suppliers. However, in the real rather than textbook business world, it is important to appreciate that suppliers need to offer a competitive price (i.e. offer value for money).

Think of the cost structure of a business – essentially it has two parts:

1. Labour costs (the cost of employing people)
2. Other operating costs – e.g. raw materials, overheads etc. These costs are all as a result of contracting with suppliers. Keeping the supplier price down is a great way of keeping business costs down.

Supplier prices can be pushed lower by:

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

By developing effective relationships with suppliers, a business can improve several aspects of its performance:

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

Importantly, supplier relationships can also help a business with cash flow management:

- Trade credit = where a business buys goods and services from a supplier and pays for them later (e.g. 60 days)
- Extending trade creditors terms is a way of improving cash flow (delays cash outflows)
- However, extending trade credit too far risks damaging supplier relationships

Guided Revision Questions

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<thead>
<tr>
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<tbody>
<tr>
<td>Define the term “supplier”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “supply chain”</td>
<td>2</td>
</tr>
<tr>
<td>List four examples of suppliers to a food factory</td>
<td>4</td>
</tr>
<tr>
<td>Outline four factors that determine whether a supplier is effective for a business</td>
<td>4</td>
</tr>
<tr>
<td>Identify four sources of information a business could use to identify and select a supplier</td>
<td>4</td>
</tr>
<tr>
<td>Describe why suppliers are important to a business</td>
<td>6</td>
</tr>
<tr>
<td>Assess the importance of price as a factor when it comes to choosing a supplier</td>
<td>8</td>
</tr>
<tr>
<td>Describe three ways in which a business could work with its suppliers to improve the net profit margin</td>
<td>8</td>
</tr>
<tr>
<td>How could a business improve its cash flow by working more effectively with suppliers?</td>
<td>8</td>
</tr>
</tbody>
</table>
USING TECHNOLOGY IN OPERATIONS

In this section we look at:

- The main types of technology used in business operations
- How technology supports the effective management of operations
- The link to productivity & quality

Most business use one or more kinds of technology in their day-to-day operations. Your studies need to focus on the applications of technology beyond simple software applications like word processing and spreadsheets or presentations. So technology in operations is more about topics such as:

- Robots
- Stock control / sales order fulfilment programs
- Automation
- Design software systems
- Communications

Technology in Manufacturing

Developments in technology have revolutionised manufacturing processes over a long period. Here are some examples of more recent use of technology to innovate the production process.

Robotics

The use of robots in operations has come a long way, but even today, most robots are used in manufacturing operations. The use of robots can be divided into three categories:

| Material handling | Material-handling applications include material transfer and machine loading and unloading. These require the robot to move materials or work parts from one location to another. Many of these tasks are relatively simple, requiring robots to pick up parts from one conveyor and place them on another. |
| Processing operations | For processing operations, the robot manipulates a tool to perform a process on the work part. Examples of such applications include spot welding, continuous arc welding, and spray painting. |
| Assembly and inspection | The use of robots in assembly is expected to increase because assembly is traditionally a labour-intensive activity |

In nearly all industrial robotic applications, the robot provides a substitute for human labour. This substitution tends to work best when the operation or task:

- Is repetitive, involving the same basic work motions every cycle
- Is hazardous or uncomfortable for the human worker (e.g., spray painting, spot welding, arc welding, and certain machine loading and unloading tasks)
- requires a work part or tool that is heavy and awkward to handle; and
- allows the robot to be used on several shifts

**CAD/CAM**

For over 30 years there has been a growing trend in manufacturing firms toward the use of computers to perform many of the functions related to design and production. The technology associated with this trend is called CAD/CAM, for computer-aided design and computer-aided manufacturing.

**Computer-aided design (CAD)** uses computers to create, modify, analyse, and optimise a design. Using CAD software, the designer can perform various analyses on the object. Once the design procedure has been completed, the computer-aided design system can generate the detailed drawings required to make the object.

**Computer-aided manufacturing (CAM)** involves the use of computers to plan, control, and manage production operations. Sometimes this is done directly – e.g. with the computer actually controlling a factory process the processes in the factory. Indirect connections between the computer system and the process involve applications in which the computer supports the production operations without actually monitoring or controlling them. These applications include planning and management functions that can be performed by the computer (or by humans working with the computer) more efficiently than by humans alone.

**Computer-integrated manufacturing (CIM)** includes all the engineering functions of CAD/CAM and the business functions of the firm as well. These business functions include order entry, cost accounting, employee time records and payroll, and customer billing.

Automated stock control programmes are another example of technology integrating several business functions. This technology combines software and hardware to monitor the quantity, location and status of stocks. Stock control systems are also used to automate sales order processing. To see this in action, look at this video of the Amazon.co.uk warehouse and also this factory tour of Dell Computers.

**Communications technology**

Technology has revolutionalised business communications and businesses can expect further significant change in the next few years. The developments on communications technology have significant implications for customer service & for businesses working more closely with suppliers. Marketing processes now widely affected by technology (e.g. customer relationship management software and email promotion)
The use of mobile communications technology is a good example. Think about the variety of mobile devices that are now in widespread business use:

- Laptop computers, PDAs
- Smart mobiles / Blackberrys
- GPS devices
- Wireless / Bluetooth devices

These and other mobile devices provide many business benefits, including:

- Facilitating flexible working
- Enabling better customer service
- Connecting remote teams (team working)

**Guided Revision Questions**

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
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<tbody>
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<td>Define the term “automation”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “CAD”?</td>
<td>2</td>
</tr>
<tr>
<td>Describe two benefits of using technology that combines stock control with handling sales orders</td>
<td>4</td>
</tr>
<tr>
<td>Describe two ways in which technology can reduce waste in a business</td>
<td>4</td>
</tr>
<tr>
<td>Explain the main benefits of using robots in a manufacturing operation</td>
<td>6</td>
</tr>
<tr>
<td>Outline the key benefits of using design and simulation technology in the development of new products</td>
<td>6</td>
</tr>
<tr>
<td>Discuss the link between increased use of technology in business and improved business productivity</td>
<td>8</td>
</tr>
</tbody>
</table>
Section 4 – Marketing and the Competitive Environment
Effective Marketing

In this section we consider:

- The purpose of marketing
- Different approaches to marketing
- Marketing objectives
- Segmentation
- Niche & mass markets
- B2C & B2B marketing

The Purpose of Marketing

What makes someone buy a product? Or more importantly, what makes them buy the product you are trying to sell?

In business, you need to persuade a customer to part with money in exchange for a good or a service. You have decide on what the product is going to be like (e.g. shape, colour, size, features); at what price are you going to sell it; where you are going to sell it (e.g. in a shop, over the Internet, by mail order); and how you going to help the customer find out about the product (e.g. advertise in the local newspaper or on the radio). Marketing is all of these things. Its hard work – but it is a vital part of running a successful business.

Marketing is often defined as:

“The process of identifying, anticipating (predicting) and satisfying customer needs profitably”

That’s a bit of a mouthful. What does it mean?

- Identifying – finding out by using marketing research about current products, the possibility of new products, and current markets and new markets
- Anticipating (predicting) – analysing the data collected and using the managers skills to judge what might happen in these markets and how the products might be suited or changed, adapted or updated
- Satisfying customer needs – making sure the person, business or government are happy with what they are buying, will not complain and will be happy to buy again if appropriate
- Profitably – adding value to the product so when sold, the price of the product is greater than cost of the inputs.

All of these marketing activities take place in a market.

Marketing Orientation

Businesses can develop new products based on either a marketing orientated approach or a product orientated approach.
• A marketing orientated approach means a business reacts to what customers want. The decisions taken are based around information about customers’ needs and wants, rather than what the business thinks is right for the customer. Most successful businesses take a market-orientated approach.

• A product orientated approach means the business develops products based on what it is good at making or doing, rather than what a customer wants. This approach is usually criticised because it often leads to unsuccessful products - particularly in well-established markets.

Most markets are moving towards a more market-orientated approach because customers have become more knowledgeable and require more variety and better quality. To compete, businesses need to be more sensitive to their customers needs otherwise they will lose sales to their rivals.

On the other hand some products are argued to create a need or want in the customer, especially products with a very high technological content. Mobile phones have moved from being a business accessory to being a big consumer brand item, with many additional gadgets, such as pictures, video and Internet access. Innovations create the need rather than the customer being able to second-guess how new technology is going to develop.

Role of marketing in a business

Marketing is perhaps the most important activity in a business because it has a direct effect on profitability and sales. Larger businesses will dedicate specific staff and departments for the purpose of marketing.

It is important to realise that marketing cannot be carried in isolation from the rest of the business. For example:

• The marketing section of a business needs to work closely with operations, research and development, finance and human resources to check their plans are possible.

• Operations will need to use sales forecasts produced by the marketing department to plan their production schedules.

• Sales forecasts will also be an important part of the budgets produced by the finance department, as well as the deployment of labour for the human resources department.

• A research and development department will need to work very closely with the marketing department to understand the needs of the customers and to test outputs of the R&D section.
Marketing Objectives

Marketing objectives set out what a business wants to achieve from its marketing activities. They need to be consistent with overall aims and objectives of the business. They also provide an important focus for the marketing team.

What makes a good marketing objective? It is often said that an effective marketing objective meets the SMART criteria:

**S**pecific Details exactly what needs to be done

**M**easurable Achievement or progress can be measured

**A**chievable Objective is accepted by those responsible for achieving it

**R**ealistic Objective is possible to attain (important for motivational effect)

**T**imed Time period for achievement is clearly stated

Some examples of marketing objectives which meet these criteria would be:

- Increase company sales by 12% in 2009
- Achieve a market share of 27% for Product C within 3 years of launch
- Increase the percentage of customers who rate service as “excellent” from 80% to 85% within 18 months

It is important that marketing objectives and marketing plans support the overall objectives of the business. Below is an example of how business objectives translate into marketing objectives and activities:

<table>
<thead>
<tr>
<th>Planning Stage</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Aims / Mission</td>
<td>Overall mission – to be the market leader</td>
</tr>
<tr>
<td>Business Objectives</td>
<td>To achieve a market share of 25% and annual profits of £2m</td>
</tr>
<tr>
<td>Marketing Objectives</td>
<td>Increase sales of existing products by 15%</td>
</tr>
<tr>
<td></td>
<td>Launch two new products into the market to add at least 5% to overall market share</td>
</tr>
<tr>
<td>Marketing Activities</td>
<td>Advertising campaign to promote new products</td>
</tr>
<tr>
<td></td>
<td>Decrease price of existing products by 10%</td>
</tr>
<tr>
<td></td>
<td>New packaging for existing products</td>
</tr>
</tbody>
</table>
Market Segmentation

You have already been introduced to market segmentation in your Unit 1 studies. You should already be aware that:

**Market segmentation is the technique used to enable a business to better target its products at the right customers**

Segments are usually measured in terms of sales value or volume. In the diagram below, segment B is twice the size of segment C.

![Diagram showing market segmentation with segments A, B, C, and D]

Why do businesses need to segment their markets? Because customers differ in the:

- Benefits they want
- Amount they are able to or willing to pay
- Media (e.g. television, newspapers, and magazines) they see
- Quantities they buy
- Time and place that they buy

Market segmentation offers the following potential benefits to a business:

<table>
<thead>
<tr>
<th>Better matching of customer needs</th>
<th>Customer needs differ. Creating separate products for each segment makes sense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhanced profits for business</td>
<td>Customers have different disposable incomes and vary in how sensitive they are to price. By segmenting markets, businesses can raise average prices and subsequently enhance profits</td>
</tr>
</tbody>
</table>
### Better opportunities for growth

Market segmentation can build sales. For example, customers can be encouraged to "trade-up" after being sold an introductory, lower-priced product

### Retain more customers

By marketing products that appeal to customers at different stages of their life ("life-cycle"), a business can retain customers who might otherwise switch to competing products and brands.

### Target marketing communications

Businesses need to deliver their marketing message to a relevant customer audience. By segmenting markets, the target customer can be reached more often and at lower cost

### Gain share of the market segment

Through careful segmentation and targeting, businesses can often achieve competitive production and marketing costs and become the preferred choice of customers and distributors

There are various methods (or “bases”) a business can use to segment a market. You’ll learn more about the details of these approaches in your later business studies. However, here is a summary:

<table>
<thead>
<tr>
<th>Geographic</th>
<th>Demographic</th>
<th>Behavioural</th>
<th>Psychographic</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Customers within 10 miles of the M25”</td>
<td>“A Level &amp; University Students”</td>
<td>“Customers wanting a value for money impulse buy”</td>
<td>“Customers who prefer to buy fairtrade food”</td>
</tr>
<tr>
<td>Customer location, Region, Urban/Rural, ACORN classification</td>
<td>Age, Gender, Occupation, Socio-economic group</td>
<td>Rate of usage, Benefits sought, Loyalty status, Readiness to purchase</td>
<td>Personality, Lifestyles, Attitudes, Class</td>
</tr>
</tbody>
</table>

### Niche Versus Mass Marketing

In most markets there is one dominant segment and several smaller (niche) segments.

For example, in the confectionery market, a dominant segment would be the plain chocolate bar. Over 90% of the sales in this segment are made by three dominant producers –
Cadbury’s, Nestle and Mars. However, there are many small, specialist niche segments (e.g. luxury, organic or fair-trade chocolate).

Niche marketing can be defined as:

**Where a business targets a smaller segment of a larger market, where customers have specific needs and wants**

Targeting a product or service at a niche segment has several advantages for a business (particularly a small business):

- Less competition – the firm is a “big fish in a small pond”
- Clear focus - target particular customers (often easier to find and reach too)
- Builds up specialist skill and knowledge = market expertise
- Can often charge a higher price – customers are prepared to pay for expertise
- Profit margins often higher
- Customers tend to be more loyal

The main disadvantages of marketing to a niche include:

- Lack of “economies of scale” (these are lower unit costs that arise from operating at high production volumes)
- Risk of over dependence on a single product or market
- Likely to attract competition if successful
- Vulnerable to market changes – all “eggs in one basket”

By contrast, mass marketing can be defined as:

**Where a business sells into the largest part of the market, where there are many similar products on offer**

The key features of a mass market are as follows:

- Customers form the majority in the market
- Customer needs and wants are more “general” & less “specific”
- Associated with higher production output and capacity (economies of scale)
- Success usually associated with low-cost operation, heavy promotion, widespread distribution or market leading brands

**Business to Business Marketing**

Most of your studies of marketing on your course will concern firms that ultimately sell to consumers (e.g. individuals, families). This is commonly referred to as “Business to Consumer” or “B2C” marketing.
But what of businesses that provide products and services to other businesses? This is known as “Business to Business” or “B2B” marketing.

The two approaches to marketing can be compared as follows:

<table>
<thead>
<tr>
<th>Business to Business</th>
<th>Business to Consumer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Based on relationships with business buyers</td>
<td>Products more important than relationships</td>
</tr>
<tr>
<td>Often small &amp; focused market</td>
<td>Usually larger markets</td>
</tr>
<tr>
<td>More complex &amp; longer buying process</td>
<td>Single step buying process; often short (e.g. impulse purchase)</td>
</tr>
<tr>
<td>More sophisticated buyers</td>
<td>Less sophisticated buyers</td>
</tr>
<tr>
<td>Aim is to turn prospects into buying customers</td>
<td>Emotional considerations affect buying behaviour</td>
</tr>
<tr>
<td>Educational element to promotion</td>
<td>Brands very important</td>
</tr>
</tbody>
</table>

**Guided Revision Questions**

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is meant by the term “marketing”</td>
<td>2</td>
</tr>
<tr>
<td>Define the term “niche market”</td>
<td>2</td>
</tr>
<tr>
<td>Distinguish between a niche and a mass market, using an industry example</td>
<td>4</td>
</tr>
<tr>
<td>Explain two reasons why a business will benefit from having loyal customers</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between a business that has a “marketing orientation” and one which has a “production orientation”</td>
<td>4</td>
</tr>
<tr>
<td>Describe two samples of marketing objectives which satisfy the SMART criteria</td>
<td>4</td>
</tr>
<tr>
<td>Question</td>
<td>Marks</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>-------</td>
</tr>
<tr>
<td>Why is important that marketing objectives are measurable?</td>
<td>4</td>
</tr>
<tr>
<td>Explain, with an example from a consumer products market, what is meant by segmentation</td>
<td>4</td>
</tr>
<tr>
<td>What is meant by an integrated marketing mix?</td>
<td>4</td>
</tr>
<tr>
<td>Explain, using two examples, what is meant by the term “B2B” marketing</td>
<td>4</td>
</tr>
<tr>
<td>Identify two differences between consumer marketing and business marketing</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between demographic and behavioural segmentation</td>
<td>4</td>
</tr>
<tr>
<td>Describe three ways in which a business can better understand the needs and wants of its target customers</td>
<td>6</td>
</tr>
<tr>
<td>Briefly explain the importance of marketing objectives to a business</td>
<td>6</td>
</tr>
<tr>
<td>Examine two advantages and disadvantages of a small business targeting a niche market</td>
<td>6</td>
</tr>
<tr>
<td>Examine the importance of operating efficiently for a business that competes in a mass market</td>
<td>8</td>
</tr>
</tbody>
</table>
INTRODUCTION TO THE MARKETING MIX

What is the Marketing Mix?

The marketing mix deals with the way in which a business uses price, product, distribution and promotion to market and sell its product.

The marketing mix is often referred to as the “Four P’s” - since the most important elements of marketing are concerned with:

- **Product** - the product (or service) that the customer obtains
- **Price** - how much the customer pays for the product
- **Place** – how the product is distributed to the customer
- **Promotion** - how the customer is found and persuaded to buy the product

It is known as a “mix” because each ingredient affects the other and the mix must overall be suitable to the target customer.

For instance:

- High quality materials used in a product can mean that a higher price is obtainable
- An advertising campaign carried in one area of the country requires distribution of the product to be in place in advance of the campaign to ensure there are no disappointed customers
- Promotion is needed to emphasise the new features of a product

The marketing mix is the way in which the marketing strategy is put into action - in other words, the actions arising from the marketing plan.

An example of the marketing mix, as applied to the launch of the iPhone, is illustrated below:

![Marketing Mix Diagram](image)

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What Makes for an Effective Marketing Mix?

An effective marketing mix is one which:

- Meets customer needs
- Achieves marketing objectives
- Is balanced and consistent
- Creates a competitive advantage

The marketing mix for each business and industry will vary; it will also vary over time. For most businesses, one or two elements of the mix will be seen as relatively more important than the others, as illustrated below:

### Marketing Strategy

Before you look at the marketing mix in more detail, you should briefly consider the role of marketing strategy.

Marketing strategies explain how the marketing function fits in with the overall strategy for a business. Examples of marketing strategies could be:

<table>
<thead>
<tr>
<th>Business Strategy</th>
<th>Example Marketing Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grow sales</td>
<td>Launch new products</td>
</tr>
<tr>
<td></td>
<td>Expand distribution (e.g. open more shops)</td>
</tr>
<tr>
<td></td>
<td>Start selling products into overseas markets</td>
</tr>
<tr>
<td>Increase profits</td>
<td>Increase selling prices</td>
</tr>
<tr>
<td></td>
<td>Reduce the amount spent on television advertising</td>
</tr>
<tr>
<td>Build customer awareness</td>
<td>Implement a public relations programme</td>
</tr>
<tr>
<td>--------------------------</td>
<td>----------------------------------------</td>
</tr>
<tr>
<td></td>
<td>Invest more in advertising</td>
</tr>
</tbody>
</table>

Once a strategy has been identified, then the business must develop a plan to turn the strategy into reality. The marketing plan is all about what marketing objectives need to be achieved and how the marketing mix will achieve them.
PRODUCTS

In this section we consider:

- The nature and importance of product in the marketing mix
- Product differentiation & unique selling points
- The role of branding and packaging
- Product life cycle
- Managing a portfolio of products

**What are Products?**

Products are at the heart of marketing. The product needs to exist for the other elements of the mix to happen.

What is a product? A product is:

*anything that is capable of satisfying customer needs*.

This definition therefore includes both:

- **Physical products** – e.g. trainers, games consoles, DVD players, take-away pizzas
- **Services** – e.g. dental treatment, accountancy, insurance, holidays, music downloads

A product can be said to have three elements:

<table>
<thead>
<tr>
<th>Core benefits</th>
<th>What the product does - the main functions of the product</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E.g. washing machine – it cleans clothes</td>
</tr>
<tr>
<td></td>
<td>Cinema ticket – it shows a film you want to see</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tangible or physical element</th>
<th>What the product is made of; what it looks like; dimensions or duration</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>E.g. 500g of ice-cream</td>
</tr>
<tr>
<td></td>
<td>A flat-screen, plasma television which is HDTV compatible</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Augmented benefits</th>
<th>The extra elements which add to the perceived value of the product in the eyes of the consumer</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Augmented benefits can be tangible (e.g. materials, weight, extra features) or intangible (e.g. brand name, after-sales service, reputation for reliability)</td>
</tr>
<tr>
<td></td>
<td>E.g. free installation, full money-back guarantee</td>
</tr>
</tbody>
</table>

Often the **augmented benefits** of a product are the key determinant of whether a customer decides to buy. Many successful businesses really understand this. A great example was cosmetics leader Elizabeth Arden. She certainly knew what she was selling. It wasn’t pots of cream and cosmetics, it was much more than that, she understood what her customers where really buying from her... she said

“I don’t sell cosmetics...I sell hope”

However, a business that focuses too much on the core or physical benefits of its products can soon find itself struggling with marketing.
Products can be split into two broad categories:

- **Goods** – physical products that you can touch and feel, e.g. food and clothing
- **Services** – products that are non-physical – watching a film, having a hair-cut

It is important to appreciate that a service is still a product – even though there is nothing you can touch. The marketing process for services is also often different to marketing goods. Services, such as banking, are mainly marketed through product differentiation. Similar products are adjusted to the target audience, for instance instant access account and long-term deposit accounts, or accounts for children. Businesses then use heavy promotion to highlight these differences.

It differs from goods marketing, because goods have greater opportunity to use packaging and physical product design.

**Product differentiation and USPs**

An important part of the marketing of the product is through **product differentiation**. This means **making the product different from its competitors**. Product differentiation can be achieved through:

- **Distinctive design** – e.g. Dyson; Apple iPod
- **Branding** – e.g. Nike, Reebok
- **Performance** – e.g. Mercedes, BMW

A key term to remember is USP, which is the acronym for **Unique Selling Point**.

A **Unique Selling Point** (sometimes called a Unique Sales Proposition) is a feature or benefit that separates a product from its competitors. The concept of a USP is one of the basics of effective marketing and business that has stood the test of time.

This could be a lower price, a smaller version of the product, offering extra functions, or even simply producing a standard product in a range of colours or designs.

A business needs to look at its unique selling points compared to competitors. If it doesn’t have any, the business will probably struggle to make the product seem attractive to customers (the remaining option is usually to compete solely on price).

If a business finds that its customers are switching to competitors or buying purely on price, it should be asked whether the business has identified the USPs for its products and services. If it has, then the question is whether it is communicating USPs clearly to customers?

**Creating Product Groups**

Most businesses sell more than one product. Often they will produce several similar products that appeal to different customers. A collection of such products is known as a “**product group**” or “**product range**”.

Good examples of product groups include:
Dell’s range of desktop and laptop computers

Sony’s range of DVD players and televisions

There are several advantages to having a product range rather than just one product:

- **Spread the risk** – a decline in one product may be offset by sales of other products
- Selling a single product may not generate enough returns for the business (e.g. the market segment may be too small to earn a living)
- A range can be sold to **different segments** of the market e.g. family holidays and activity holidays

However, a greater range of products can mean that the marketing resources (e.g. personnel and cash) are spread more thinly. Recently Unilever, who make over two hundred well known brands such as Dove and Flora margarine, decided to sell some of their product names to concentrate their investment on fewer products and brands.

**New Products**

To grow fast, businesses need to develop new products. But before a business can launch a new product, it needs to go through several stages before it appears in the market place.

The main stages are:

- **Marketing research** – find out what customers want, who they are, and where the gaps are in the marketplace
- **Product development and testing** – make prototypes; experiment by allowing a sample of potential customers to trial the product before it is launched
- **Distribution of product to outlets** – the product cannot be sold unless it is in a position for customers to buy it – books will need to be in the bookshops and hammers in the hardware stores
- **Promotional launch** to inform customers features of new product – this might be done locally, nationally or internationally – the customers need to know that the product is ready, available and that it might be the sort of thing they want to buy

At the first two stages (marketing research and product development/testing) many products are rejected because the findings of research shows that it will not be successful, or they cannot make a satisfactory prototype. Product testing might show that customers react badly to the product.

The new product launch needs all the elements of the mix to be in place to be successful.

**Brands and Branding**

A brand is a product with unique character, for instance in design or image. It is consistent and well recognised.

The advantages of having a strong brand are:
• Inspires customer loyalty leading to repeat sales and word-of-mouth recommendation

• The brand owner can usually charge higher prices, especially if the brand is the market leader

• Retailers or service sellers want to stock top selling brands. With limited shelf space it is more likely the top brands will be on the shelf than less well-known brands.

Some retailers use “own-label” brands, where they use their name of the product rather than the manufacturers like Tesco’s “Finest” range of meals and foodstuffs. These tend to be cheaper than the normal brands, but will give the retailer more profit than selling a normal brand.

Some brands are so strong that they have become global brands. This means that the product is sold in many countries and the contents are very similar. Examples of global brands include: Microsoft, Coca Cola, Disney, Mercedes and Hewlett Packard.

The strength of a brand can be exploited by a business to develop new products. This is known as brand extension – a product with some of the brand’s characteristics. Examples include Dove soap and Dove Shampoo (both contain moisturiser); Mars Bar and Mars Ice Cream

Brand stretching is where the brand is used for a diverse range of products, not necessarily connected. E.g. Virgin Airlines and Virgin Cola; Marks and Spencer clothes and food.

The logo on a product is an important part of the product. A logo is a symbol or picture that represents the business. It is important because it is easy to recognise, establishes brand loyalty and can create a favourable image.

Packaging

Packaging is sometimes known as the “fifth P” in the marketing mix. It is closely associated with product because it is in what most goods are delivered to the customer.

The main purposes of packaging are to:

• Protect the product on its journey from the manufacturer and warehouse to retailer and then to customer (who might use the packaging for storage e.g. jam jar)

• Promote the product by communicating information about the product

Packaging also contains key details on usage/storage and safety (most products need to comply with packaging legislation).

Product Life Cycle

The product life cycle is an important concept in marketing. It describes the stages a product goes through from when it was first thought of until it finally is removed from the market. Not all products reach this final stage. Some continue to grow and others rise and fall.

The main stages of the product life cycle are:
- **Introduction** – researching, developing and then launching the product
- **Growth** – when sales are increasing at their fastest rate
- **Maturity** – sales are near their highest, but the rate of growth is slowing down, e.g. new competitors in market or saturation
- **Decline** – final stage of the cycle, when sales begin to fall

This can be illustrated by looking at the sales during the time period of the product.

A branded good can enjoy continuous growth, such as Microsoft, because the product is being constantly improved and advertised, and maintains a strong brand loyalty.

**Extension strategies** extend the life of the product before it goes into decline. Again businesses use marketing techniques to improve sales. Examples of the techniques are:

- **Advertising** – try to gain a new audience or remind the current audience
- **Price reduction** – more attractive to customers
- **Adding value** – add new features to the current product, e.g. video messaging on mobile phones
- **Explore new markets** – try selling abroad
- **New packaging** – brightening up old packaging, or subtle changes such as putting crisps in foil packets or Seventies music compilations
Product Portfolio & the Boston Matrix

A business with a range of products has a portfolio of products. However, owning a product portfolio poses a problem for a business. It must decide how to allocate investment (e.g. in product development, promotion) across the portfolio.

A portfolio of products can be analysed using the Boston Group Consulting Matrix. This categorises the products into one of four different areas, based on:

- **Market share** – does the product being sold have a low or high market share?
- **Market growth** – are the numbers of potential customers in the market growing or not

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

- **Stars** are high growth products competing in markets where they are strong compared with the competition. Often Stars need heavy investment to sustain growth. Eventually growth will slow and, assuming they keep their market share, Stars will become Cash Cows.

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

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

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

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

**Guided Revision Questions**

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is meant by the term “product portfolio”?</td>
<td>2</td>
</tr>
<tr>
<td>Define the term “USP”</td>
<td>2</td>
</tr>
<tr>
<td>What is a product?</td>
<td>2</td>
</tr>
<tr>
<td>What is the product life cycle?</td>
<td>4</td>
</tr>
<tr>
<td>Identify two ways a business can develop a USP</td>
<td>4</td>
</tr>
<tr>
<td>What is a “question mark” or “problem child” product?</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between a “cash cow” and a “star” in the Boston Matrix</td>
<td>4</td>
</tr>
<tr>
<td>Explain the point in the product life cycle at which a product will normally start to generate a positive cash flow</td>
<td>4</td>
</tr>
<tr>
<td>Briefly describe the characteristics of a product that is labelled a “cash cow”</td>
<td>4</td>
</tr>
<tr>
<td>Explain the difference between product differentiation and a unique selling point</td>
<td>6</td>
</tr>
<tr>
<td>Explain why a product at the launch stage of the product life cycle often requires substantial advertising support</td>
<td>6</td>
</tr>
<tr>
<td>Explain, with use of an example, what is meant by an extension strategy</td>
<td>6</td>
</tr>
<tr>
<td>Why should a business aim to differentiate its products from those of competitors?</td>
<td>6</td>
</tr>
<tr>
<td>Describe three reasons why a new product may not reach the market</td>
<td>6</td>
</tr>
<tr>
<td>Why does a new product usually experience negative cash flow in the launch stage of the product life cycle?</td>
<td>6</td>
</tr>
<tr>
<td>Describe two factors that might lead to a product having a short product life cycle</td>
<td>6</td>
</tr>
<tr>
<td>Why is it useful for a business to have a “balanced portfolio” of products?</td>
<td>6</td>
</tr>
<tr>
<td>Describe how the Boston Matrix can help a business manage its product portfolio</td>
<td>8</td>
</tr>
<tr>
<td>Discuss the factors that lead to a product entering the decline phase of the product life cycle</td>
<td>8</td>
</tr>
<tr>
<td>Discuss whether a USP will help ensure that the customers of a business remain loyal</td>
<td>10</td>
</tr>
<tr>
<td>To what extent do you agree with the view that product is the most important part of the marketing mix?</td>
<td>10</td>
</tr>
</tbody>
</table>
**Promotion**

In this section, we consider:

- What is promotion?
- Effective methods of promotion for different types of product/business
- Factors to consider when choosing the promotional mix

**What is Promotion?**

It is a common mistake to believe that promotion by business is all about advertising. It isn’t. There are a variety of approaches that a business can take to get their message across to customers, although advertising is certainly an important one.

**Promotion is all about communication.** Why because promotion is the way in a business makes its products known to the customers, both current and potential.

The main aim of promotion is to ensure that customers are **aware** of the existence and positioning of products. Promotion is also used to **persuade** customers that the product is better than competing products and to remind customers about why they may want to buy.

It is important to understand that a business will use more than one method of promotion. The variety of promotional methods used is referred to as the **promotional mix.**

Which promotional methods are used depends on several factors:

<table>
<thead>
<tr>
<th>Stage in the life cycle</th>
<th>E.g. advertising is important at the launch stage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of the product</td>
<td>How much information is required by customers before they buy</td>
</tr>
<tr>
<td>Competition</td>
<td>What are rivals doing?</td>
</tr>
<tr>
<td>Marketing budget</td>
<td>How much can the firm afford?</td>
</tr>
<tr>
<td>Marketing strategy</td>
<td>Other elements of the mix (price, product, place etc)</td>
</tr>
<tr>
<td>Target market</td>
<td>Appropriate ways to reach the target market</td>
</tr>
</tbody>
</table>

The main methods of promotion are:

- Advertising
- Public relations & sponsorship
- Personal selling
- Direct marketing
- Sales promotion

A business will use a range of promotional activities for its product, depending on the **marketing strategy** and the **budget** available.

The way in which promotion is targeted is split into two types:
**Above the line promotion** – paid for communication in the independent media e.g. advertising on TV or in the newspapers. Though it can be targeted, it could be seen by anyone outside the target audience.

**Below the line promotion** – promotional activities where the business has direct control e.g. direct mailing and money off coupons. It is aimed directly at the target audience.

**Advertising**

Advertising is defined as any “paid-for method of promotion”. Advertising is the main form of “above the line promotion”.

Advertising presents or promotes the product to the target audience through a variety of **media** such as TV, radio, cinema, online and magazines to encourage them to buy.

The problem with advertising is that consumers are bombarded with advertising messages every day. How can a business cut through the advertising noise and get a message across effectively? And how can a business measure the effectiveness of an advertising campaign. It is often said that businesses waste half their advertising spend – the problem is that they don’t know which half!

When deciding which type of advertising to use – known as an **advertising medium** – a business needs to consider the following factors:

- **Reach of the media** – national or local; number of potential customers it could reach; how long before the message is seen
- **Nature of the product** – the media needs to reflect the image of the product; a recruitment ad would be placed in a trade magazine or newspaper but a lipstick ad would be shown on TV or women’s magazines
- **Position in product life cycle** – launch stage will need different advertising from products undergoing extension strategies
- **Cost of medium & size of advertising budget** – e.g. local newspaper advertising is cheaper than radio, which in turn is cheaper than TV. But the business will also want to consider cost per head if reaching a larger audience
- **Online of offline** – there has been substantial growth in businesses that advertise online as they swap some (sometimes all) of their advertising budgets to reach Internet users. The rapid growth of Google’s advertising revenues in the UK is an illustration of how powerful online advertising has become

Advertising can also be split into two main types:

- **Persuasive advertising** - this tries to entice the customer to buy the product by informing them of the product benefit
- **Informative advertising** - this gives the customer information. Mostly done by the government (e.g. health campaigns, new welfare benefits)

Sometimes a business will employ an **advertising agency** to deal with its needs. An agency plans, organises and produces **advertising campaigns** for other businesses. The advantage of an agency managing the campaign is that it has the expertise a business may not have, e.g. copywriters, designers and media buyers.
Businesses need to be fully aware of the laws that govern advertising. The main law is the Trade Descriptions Act – goods advertised for sale must be as they are described. Also the advertising industry has its own Code of Practice, and is regulated by the Advertising Standards Authority where complaints about the nature of advertising can be dealt with.

The main advantages and disadvantages of advertising as method of promotion are:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wide coverage</td>
<td>Often expensive</td>
</tr>
<tr>
<td>Control of message</td>
<td>Impersonal</td>
</tr>
<tr>
<td>Repetition means that the message can be</td>
<td>One way communication</td>
</tr>
<tr>
<td>communicated effectively</td>
<td>Lacks flexibility</td>
</tr>
<tr>
<td>Can be used to build brand loyalty</td>
<td>Limited ability to close a sale</td>
</tr>
</tbody>
</table>

**Public Relations & Sponsorship**

Public relations is a broad series of activities involving a business managing its relationships with different parts of the public, e.g. customers, the media, local communities, suppliers, employees and investors.

The main objectives of public relations are:

- To achieve **favourable publicity** about the business
- To **build the image and reputation** of the business and its products, particularly amongst customers
- To communicate effectively with customers and other stakeholders

Public relations, which is often shortened just to “PR”, has several advantages over advertising in terms of promotion:

- No direct charge is made for PR, though a business will need to pay for its own PR department or external PR consultant
- PR is arguably more powerful because the message the business communicates through PR is often more believable than paid for advertising

However there is no guarantee that PR will reach its target audience (the media may fail to feature the story) whereas advertising must be displayed since the space in the newspaper is paid for.

**Sponsorship** is a specialised kind of public relations and increasingly popular, particularly with larger businesses. A business will sponsor an event, team or individual in order to build brand awareness. A secondary objective might be to emphasise social or ethical credentials, but most sponsorship really does have a commercial objective at heart.

The 2012 Olympics in London, together with all major sporting events, sports celebrities and sporting teams all benefit from substantial corporate sponsorship. At a local level, it is common for small businesses to sponsor local teams.
**Personal Selling & Merchandising**

Personal selling is where businesses use people (the “sales force”) to sell the product after meeting face-to-face with the customer. The sellers promote the product through their attitude, appearance and specialist product knowledge. They aim to inform and encourage the customer to buy, or at least trial the product.

A good example of personal selling is found in department stores on the perfume and cosmetic counters. A customer can get advice on how to apply the product and can try different products. Products with relatively high prices, or with complex features, are often sold using personal selling. Great examples include cars, office equipment (e.g. photocopiers) and many products that are sold by businesses to other industrial customers.

The main advantages and disadvantages of personal selling can be summarised as follows:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>High customer attention</td>
<td>High cost</td>
</tr>
<tr>
<td>Message is customised</td>
<td>Labour intensive</td>
</tr>
<tr>
<td>Interactivity</td>
<td>Expensive</td>
</tr>
<tr>
<td>Persuasive impact</td>
<td>Can only reach a limited number of customers</td>
</tr>
<tr>
<td>Potential for development of relationship</td>
<td></td>
</tr>
<tr>
<td>Adaptable</td>
<td></td>
</tr>
<tr>
<td>Opportunity to close the sale</td>
<td></td>
</tr>
</tbody>
</table>

Point-of-sale merchandising can be said to be a specialist form of personal selling. POS merchandising involves face-to-face contact between sales representatives of producers and the retail trade. A merchandiser will visit a range of suitable retail premises in his/her area and encourage the retailer to stock products from a range. The visit also provides the opportunity for the merchandiser to check on stock levels and to check whether the product is being displayed optimally.

**Direct Marketing**

Direct marketing is a catch-all term that describes a range of promotional activities that are aimed directly at the customer, so bringing the promotional message straight to the target audience.

Direct mail, telemarketing and email marketing can all be useful methods of targeting the kind of customer who is likely to buy from the business. However, each of them requires careful preparation and consideration towards the audience, and knowledge of how to manage customer data efficiently and within the boundaries of the law.

The three most common forms of direct marketing are:

| Direct mail | This involves sending promotional materials to target customers through the post. Direct mail can be a relatively low-cost exercise with specific customers targeted. It is also easy to evaluate the successes or failure of |

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Email marketing

Use of email for direct marketing has grown rapidly. It is a very cheap and quick method of promotion which allows the message to encourage an instant response. For example, viral marketing is a good idea to get customers to recommend a friend and increase the size of customer database in return for a reward (discount etc).

However, there are many problems with email marketing. Not the least is that the use of spam filters on many email systems makes it harder for legitimate email marketing materials to reach the intended recipient. Email marketing must only be sent to those who have opted into received such promotion. However, many businesses continue to flout this golden rule, contributing to the substantial volume of email spam.

Telemarketing

Telemarketing encompasses all telephone-based marketing activity including sales, customer services and market research. It’s useful for following up business-to-business leads, setting up meetings or even closing a deal.

Telemarketing is sometime used as an alternative (or addition) to personal selling. It is relatively low-cost, particularly compared to the costs of keeping a full-time sales force on the road. It is also easy to monitor and can be outsourced for a fee.

The big downside to telemarketing is that cold calling has a very negative perception, especially in the consumer sector.

Direct marketing has the following advantages and disadvantages:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus limited resources on targeted promotion</td>
<td>Response rates vary enormously</td>
</tr>
<tr>
<td>Can personalise the marketing message</td>
<td>Negative image of junk mail and email spam</td>
</tr>
<tr>
<td>Relatively easy to measure response &amp; success</td>
<td>Databases expensive to maintain and keep accurate</td>
</tr>
<tr>
<td>Easy to test different marketing messages</td>
<td></td>
</tr>
<tr>
<td>Cost-effective if customer database is well managed</td>
<td></td>
</tr>
</tbody>
</table>

Sales Promotion

Sales promotion is the process of persuading a potential customer to buy the product. Sales promotion is designed to be used as a short-term tactic to boost sales – it is rarely suitable as a method of building long-term customer loyalty.
Some sales promotions are aimed at consumers. Others are targeted at intermediaries and at the firm’s sales force.

When undertaking a sales promotion, there are several factors that a business must take into account:

- What does the promotion cost – will the resulting sales boost justify the investment?
- Is the sales promotion consistent with the brand image? A promotion that heavily discounts a product with a premium price might do some long-term damage to a brand
- Will the sales promotion attract customers who will continue to buy the product once the promotion ends, or will it simply attract those customers who are always on the look-out for a bargain?

There are many methods of sales promotion, including:

- **Money off coupons** – customers receive coupons, or cut coupons out of newspapers or a products packaging that enables them to buy the product next time at a reduced price
- **Competitions** – buying the product will allow the customer to take part in a chance to win a prize
- **Discount vouchers** – a voucher (like a money off coupon)
- **Free gifts** – a free product when buy another product
- **Point of sale materials** – e.g. posters, display stands – ways of presenting the product in its best way or show the customer that the product is there.
- **Loyalty cards** – e.g. Nectar and Air Miles; where customers earn points for buying certain goods or shopping at certain retailers – that can later be exchanged for money, goods or other offers

**Loyalty cards** have recently become an important form of sales promotion. They encourage the customer to return to the retailer by giving them discounts based on the spending from a previous visit. Loyalty cards can offset the discounts they offer by making more sales and persuading the customer to come back. They also provide information about the shopping habits of customers – where do they shop, when and what do they buy? This is very valuable marketing research and can be used in the planning process for new and existing products.

The main advantages and disadvantages of sales promotion are:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective at achieving a quick boost to sales</td>
<td>Sales effect may only be short-term</td>
</tr>
<tr>
<td>Encourages customers to trial a product or switch brands</td>
<td>Customers may come to expect or anticipate further promotions</td>
</tr>
<tr>
<td></td>
<td>May damage brand image</td>
</tr>
</tbody>
</table>
## Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is meant by the term “direct marketing”</td>
<td>2</td>
</tr>
<tr>
<td>Define the term “sales promotion”</td>
<td>2</td>
</tr>
<tr>
<td>Explain the difference between promotion and advertising</td>
<td>4</td>
</tr>
<tr>
<td>Describe how sponsorship differs from other forms of public relations</td>
<td>4</td>
</tr>
<tr>
<td>Describe the main role of promotion in the marketing mix</td>
<td>4</td>
</tr>
<tr>
<td>Distinguish between advertising and public relations</td>
<td>4</td>
</tr>
<tr>
<td>Outline three reasons why a business should conduct public relations activities</td>
<td>4</td>
</tr>
<tr>
<td>Briefly explain why businesses promote their products at trade fairs and exhibitions</td>
<td>4</td>
</tr>
<tr>
<td>Identify four examples of sales promotions</td>
<td>6</td>
</tr>
<tr>
<td>Distinguish between direct marketing and personal selling</td>
<td>6</td>
</tr>
<tr>
<td>Describe two ways in which a business could assess whether its promotional activities had been effective</td>
<td>6</td>
</tr>
<tr>
<td>Explain, with an example, the kinds of business that rely on personal selling as a key method of promotion</td>
<td>6</td>
</tr>
<tr>
<td>Describe two advantages and disadvantages of using direct marketing</td>
<td>6</td>
</tr>
<tr>
<td>Analyse three factors that a business will consider when it determines its promotional mix</td>
<td>8</td>
</tr>
</tbody>
</table>
PRICE

In this section we consider:

- What is price?
- Pricing strategies, methods and tactics
- Matching price to marketing objectives

What is Price?

Price is:

- The money charged for a product or service
- Everything that a customer has to give up in order to acquire a product or service
- Usually expressed in terms of £

The price a business charges for its product or service is one of the most important business decisions management make. Setting a price that is too high or too low will - at best - limit the business growth. At worst, it could cause serious problems for sales and cash flow.

So pricing is important. The bad news for entrepreneurs is that pricing is a really tough to get right. There are so many factors to consider, and much uncertainty about whether a price change will have the desired effect.

The law of demand states that, for nearly all products, the higher the price the lower the demand. In other words, sales will fall if prices are put up. However higher prices can also mean higher profits. So how does a business decide how to set a price for its products?

Pricing and Business Objectives

The price a business charges needs to take account of the strategic objectives of the business.

For example, it may be that the objective is to position the business as the highest quality provider – in this case, a high price would be used to signal high quality to the consumer. Exclusive designer fashion labels and luxury holiday businesses apply this strategy.

At the other end of the pricing scale, a business that positions itself as a low-cost or discount provider will look to set prices that are lower or as low as any rival. The strategy is to gain competitive advantage by offering the lowest prices (not just in the short-term). The battles in the discount supermarket and low-cost airline markets are great examples of this strategy in action.

In general, a business tries to set a price which maximises the sales revenue. Sales revenue is the total amount of money made from sales and is the price of the product multiplied by the number of sales.

For a new business with a new product setting a price can be difficult to do because it has no experience of what customers are prepared to pay. Market research can help identify competitor prices, but the ultimate “proof of the pudding” is starting to sell at a particular price to see what happens.

- If the business gets the price too high, sales might be lost
There are several factors a business needs to consider in setting the price:

- **Competitors** – a huge impact on pricing decisions. The relative market shares (or market strength) of competitors influences whether a business can set prices independently, or whether it has to follow the lead shown by competitors.

- **Costs** – a business cannot ignore the cost of production or buying a product when it comes to setting a selling price. In the long-term, a business will fail if it sells for less than cost, or if its gross profit margin is too low to cover the fixed costs of the business.

- **The state of the market for the product** – if there is a high demand for the product, but a shortage of supply, then the business can put prices up.

- **The state of the economy** – some products are more sensitive to changes in unemployment and workers wages than others. Makers of luxury products will need to drop prices especially when the economy is in a downturn.

- **The bargaining power of customers in the target market** – who are the buyers of the product? Do they have any bargaining power over the price set? An individual consumer has little bargaining power over a supermarket (though they can take their custom elsewhere). However, an industrial customer that buys substantial quantities of a product from a business may be able to negotiate lower or special prices.

- **Other elements of the marketing mix** – it is important to understand that prices cannot be set without reference to other parts of the marketing mix. The distribution channels used will affect price – different prices might be charged for the same product sold direct to consumers or via intermediaries. The price of a product in the decline stage of its product life-cycle will need to be lower than when it was first launched.

### Pricing Strategies and Tactics

It is important to make a distinction between pricing strategies and pricing tactics:

| Pricing Strategies | These are adopted over the medium to long term to achieve marketing objectives
|                   | They have a significant impact on marketing strategy |
| Pricing Tactics   | These are adopted in the short run to suit particular situations
|                   | Tactics have only limited impact beyond short-term sales of the product itself |

It may also be that the pricing strategies a business can implement are constrained by the competitive position of the business. It is often said that there are four categories of position a business can find itself in which influence the control it has over pricing:

| Price takers | A business has no option but to charge the ruling market price |
| Price makers | The business has a strong enough competitive position to be able to fix its own price – either higher or lower than the competition |
Price leaders
Market leaders whose market share is so strong that its price changes are closely followed (and often copied) by rivals

Price followers
A business that just follows the price-changing lead of the market leader (ignoring the rest of the competition)

There are several different pricing strategies available to a business:

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost-plus pricing</td>
<td>Setting a price by adding a fixed amount or percentage to the cost of making or buying the product. In some ways this is quite an old-fashioned and somewhat discredited pricing strategy, although it is still widely used. After all, customers are not too bothered what it cost to make the product – they are interested in what value the product provides them. Cost-plus (or “mark-up”) pricing is widely used in retailing, where the retailer wants to know with some certainty what the gross profit margin of each sale will be. An advantage of this approach is that the business will know that its costs are being covered. The main disadvantage is that cost-plus pricing may lead to products that are priced un-competitively.</td>
</tr>
<tr>
<td>Penetration pricing</td>
<td>This involves setting a very low price to gain as many sales as possible. Often used to support the launch of a new product, penetration pricing works best when a product enters a market with little product differentiation – so a lower price than rival products is a competitive weapon. You often see the tagline “special introductory offer” – the classic sign of penetration pricing. The aim of penetration pricing is usually to increase market share of a product, providing the opportunity to increase price once this objective has been achieved.</td>
</tr>
<tr>
<td>Price skimming</td>
<td>Setting a high price before other competitors come into the market. This is often used for the launch of a new product which faces little or now competition – usually due to some technological features. Such products are often bought by “early adopters” who are prepared to pay a higher price to have the latest or best product in the market. Price skimming as a strategy cannot last for long, as competitors soon launch rival products which puts pressure on the price (e.g. the launch of rival products to the iPhone or iPod)</td>
</tr>
</tbody>
</table>

The main pricing tactics used by businesses are summarised below:

Loss leaders
Sometimes a business may use a **loss leader**. This is a product where the price is so low that the retailer may not make any profit or even a loss on the sale, but does attract shoppers to buy other full price products.

By definition, selling at a loss cannot be a successful long-term pricing strategy for a business that aims to make a profit. However, tactical use of loss-leaders is an important weapon in the battle for market share, particularly in markets such as electrical and grocery retailing.

**Predatory pricing (note: this is illegal)**

With predatory pricing, prices are deliberately set very low by a dominant competitor in the market in order to **restrict or prevent competition**. The price set might even be free, or lead to losses by the predator. Whatever the approach, predatory pricing is illegal under competition law.

**Price discrimination**

In contrast to predatory pricing, price discrimination is perfectly legal and very common. It involves charging a **different price to different groups of people for the same product**. For example:

- Student and senior citizen discounts, off peak fares cheaper than peak fares
- In the airline and hotel industries, spare seats and rooms are sold at the last minute at greatly reduced prices (price discrimination used to sell off spare capacity)
- Reduced prices for cinemas and theatres in the afternoons

**Psychological pricing**

Sometimes prices are set at what seem to be unusual price points. For example, why are DVD’s priced at £12.99 or £14.99? The answer is the perceived price barriers that customers may have. They will buy something for £9.99, but think that £10 is a little too much. So a price that is one pence lower can make the difference between closing the sale, or not!

**Guided Revision Questions**

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
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</thead>
<tbody>
<tr>
<td>Define the term “price skimming”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “premium pricing”?</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by “inelastic demand”?</td>
<td>2</td>
</tr>
<tr>
<td>Define the term “price elasticity of demand”</td>
<td>2</td>
</tr>
<tr>
<td>Distinguish between a pricing strategy and a pricing tactic</td>
<td>4</td>
</tr>
<tr>
<td>Why might a firm use penetration pricing?</td>
<td>4</td>
</tr>
<tr>
<td>Question</td>
<td>Marks</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>Explain two reasons why a business might sell a product as a loss leader</td>
<td>4</td>
</tr>
<tr>
<td>Define, using an example, the term “psychological pricing”</td>
<td>4</td>
</tr>
<tr>
<td>What is the difference between a price-taker and a price-leader?</td>
<td>4</td>
</tr>
<tr>
<td>Give two examples of a business that might adopt prestige or premium pricing</td>
<td>4</td>
</tr>
<tr>
<td>Explain why predatory pricing is illegal</td>
<td>4</td>
</tr>
<tr>
<td>Explain, using an example, what is meant by “price discrimination”</td>
<td>4</td>
</tr>
<tr>
<td>Describe two reasons why a business might set a promotional price</td>
<td>4</td>
</tr>
<tr>
<td>Outline two advantages and disadvantages of cost-plus pricing</td>
<td>6</td>
</tr>
<tr>
<td>Describe the relationship between price and demand</td>
<td>6</td>
</tr>
<tr>
<td>Outline four examples of non-price competition</td>
<td>6</td>
</tr>
<tr>
<td>Explain why price is so important to the sales revenue achieved by a business</td>
<td>6</td>
</tr>
</tbody>
</table>
**PRICE ELASTICITY OF DEMAND**

**What is Price Elasticity of Demand?**

This is an important topic, since understanding how demand for a product might change as price changes is essential to an effective marketing strategy.

First, a quick acronym - price elasticity of demand is often to just “Ped”: much quicker to write, particularly in an exam. So we’ll use it here!

**Ped** measures the **responsiveness of demand** for a product following a **change in its own price**.

The formula for calculating the co-efficient of elasticity of demand is:

\[
\text{Percentage change in quantity demanded} \div \text{the percentage change in price}
\]

Since changes in price and quantity usually move in opposite directions, we usually do not bother to put in the minus sign. We are more concerned with the **co-efficient** of elasticity of demand.

By calculating Ped, a business can assess how a change in price will affect the demand for its products. This is really useful information for any marketing plan, but also has implications for other aspects of the business (e.g. finance and operations).

Firms can use PED estimates to predict:

- The effect of a change in price on the total revenue & expenditure on a product
- The likely **price volatility** in a market following changes in supply – this is important for commodity producers who may suffer big price movements from time to time
- The effect of a **change in an indirect tax** (e.g. VAT, fuel or other duties) on price and quantity demanded and also whether the business is able to pass on some or all of the tax onto the consumer
- Information on the PED can be used by a business as part of a policy of **price discrimination** (also known as ‘yield management’). This is where a business decides to charge different prices for the same product to different segments of the market e.g. peak and off peak rail travel or prices charged by many of our domestic and international airlines
- A business contemplating a tactical price-war or planning a promotional discount based on price (e.g. 50% off for a limited period) will want to know how responsive customer demand will be to the pricing tactics used

**Understanding values for price elasticity of demand**

1. **If Ped = 0** demand is said to be **perfectly inelastic**. This means that demand does not change at all when the price changes – the demand curve will be drawn as vertical.
2. If $\text{Ped}$ is between 0 and 1 (i.e. the percentage change in demand from A to B is smaller than the percentage change in price), then demand is inelastic.

3. If $\text{Ped} = 1$ (i.e. the percentage change in demand is exactly the same as the percentage change in price), then demand is said to unit elastic. A 15% rise in price would lead to a 15% contraction in demand leaving total spending by the same at each price level.

4. If $\text{Ped} > 1$, then demand responds more than proportionately to a change in price i.e. demand is elastic. For example a 20% increase in the price of a good might lead to a 30% drop in demand. The price elasticity of demand for this price change is \(-1.5\).

What Determines Price Elasticity of Demand?

The following factors affect Ped:

1. The number of close substitutes for a good – the more close substitutes in the market, the more elastic is demand because consumers can easily switch their demand if the price of one product changes relative to others.

2. The cost of switching between products – there may be significant costs involved in switching between products. In this case, demand tends to be relatively inelastic. For example, mobile phone service providers may insist on 12 or 18-month contracts being taken out.

3. The degree of necessity or whether the good is a luxury – goods and services deemed by consumers to be necessities tend to have an inelastic demand whereas luxuries tend to have a more elastic demand.

4. The % of a consumer’s income allocated to spending on the good – goods and services that take up a high proportion of a household’s income will tend to have a more elastic demand than products where large price changes makes little or no difference to someone’s ability to purchase the product.

5. The time period allowed following a price change – demand tends to be more price elastic, the longer that we allow consumers to respond to a price change.

6. Whether the good is subject to habitual consumption – when this occurs, the consumer becomes less sensitive to the price of the good in question because their default position is to buy the same products at regular intervals.

7. Peak and off-peak demand - demand tends to be price inelastic at peak times and more elastic at off-peak times.

8. The breadth of definition of a good or service – if a good is broadly defined, i.e. the demand for petrol or meat, demand is often inelastic. But specific brands of petrol or beef are likely to be more elastic following a price change.

Price elasticity and Business Revenues

Ped can be used to predict what will happen to total revenues based on a change in price:

Here are some examples:

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### Change in the market

<table>
<thead>
<tr>
<th>Change in the market</th>
<th>What happens to total revenue?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ped is inelastic and a firm raises its price.</td>
<td>Total revenue increases</td>
</tr>
<tr>
<td>Ped is elastic and a firm lowers its price.</td>
<td>Total revenue increases</td>
</tr>
<tr>
<td>Ped is elastic and a firm raises price.</td>
<td>Total revenue decreases</td>
</tr>
<tr>
<td>Ped is -1.5 and the firm raises price by 4%</td>
<td>Total revenue decreases</td>
</tr>
<tr>
<td>Ped is -0.4 and the firm raises price by 30%</td>
<td>Total revenue increases</td>
</tr>
<tr>
<td>Ped is -0.2 and the firm lowers price by 20%</td>
<td>Total revenue decreases</td>
</tr>
<tr>
<td>Ped is -4.0 and the firm lowers price by 15%</td>
<td>Total revenue increases</td>
</tr>
</tbody>
</table>

### Some problems with the price elasticity of demand concept

It is important to understand that the calculation of Ped is just an estimate and that it might change over time. Markets change – customers become more or less sensitive to price changes. The tastes and preferences of consumers change; new methods of distribution are developed; consumers become more aware of pricing information. All of these (and other factors) affect Ped. Management need to be aware of the factors that influence demand and act accordingly. But keeping an eye on Ped remains important.

### Income Elasticity of Demand

The amount that customers demand is affected by price (Ped). However, it is also affect by the incomes of consumers. This leads onto another important elasticity – the income elasticity of demand (often shortened to Yed).

**Income elasticity of demand** measures the relationship between a change in quantity demanded for good X and a change in real income. The formula for calculating income elasticity is:

\[
\text{% change in demand divided by the % change in income}
\]

Most products have a **positive income elasticity of demand**. So as consumers’ income rises more is demanded at each price.

1. **Normal necessities** have an income elasticity of demand of **between 0 and +1** for example, if income increases by 10% and the demand for fresh fruit increases by 4% then the income elasticity is +0.4. Demand is rising less than proportionately to income.

2. **Luxury goods and services** have an income elasticity of demand > +1 i.e. demand rises more than proportionate to a change in income – for example a 8% increase in income might lead to a 10% rise in the demand for restaurant meals. The income elasticity of demand in this example is +1.25.
However, there are some products (economists call them “inferior goods”) which have a negative income elasticity of demand, meaning that demand falls as income rises. Typically inferior goods or services tend to exist where superior goods are available if the consumer has the money to be able to buy it. Examples include the demand for cigarettes, low-priced own label foods in supermarkets and the demand for council-owned properties.

The income elasticity of demand is usually strongly positive for

- Fine wines and spirits, high quality chocolates (e.g. Lindt) and luxury holidays overseas
- Consumer durables - audio visual equipment, 3G mobile phones and designer kitchens
- Sports and leisure facilities (including gym membership and sports clubs)

In contrast, income elasticity of demand is lower for

- Staple food products such as bread, vegetables and frozen foods
- Mass transport (bus and rail)
- Beer and takeaway pizza!
- Income elasticity of demand is negative (inferior) for cigarettes and urban bus services

**Product ranges and longer term trends**

However the income elasticity of demand varies within a product range. For example the Yed for own-label foods in supermarkets is less for the high-value “finest” food ranges that most major supermarkets now offer. There is a general downward trend in the income elasticity of demand for many products, particularly foodstuffs. One reason is that as a society becomes richer, there are changes in tastes and preferences. What might have been considered a luxury good several years ago might now be regarded as a necessity? How many of you regard a Sky sports subscription as a pure necessity?

The income elasticity of demand for most types of food is pretty low – occasionally negative (e.g. for margarine) and likewise the own price elasticity of demand for most foodstuffs is also inelastic.

**How do businesses make use of estimates of income elasticity of demand?**

Knowledge of income elasticity of demand helps firms predict the effect of an economic cycle on sales. Luxury products with high income elasticity see greater sales volatility over the business cycle than necessities where demand from consumers is less sensitive to changes in the cycle.

Since the early 1990s the British economy has enjoyed a run of many years of sustained growth and rising real living standards. But in 2008 the economy headed into turbulent territory with reports of a large decline in people’s real disposable income. The slowdown and probable recession will undoubtedly affect the pattern of demand for different goods and services – in general, producers of goods and services towards the lower end of the price chain will tend to do better as consumers tighten their purse strings and look to make savings. But there was also plenty of evidence emerging in the summer of 2008 that luxury retailers were doing well despite mounting economic worries.
**PLACE (DISTRIBUTION)**

In this section, we consider:

- The meaning and purpose of place (distribution)
- Different distribution channels
- Factors to consider when choosing distribution channels

**What is Place?**

Place (or its more common name “distribution”) is **about how a business gets its products to the customers**.

It is one thing having a great product, sold at an attractive price. But what if:

- Customers are not near a retailer that is selling the product?
- A competing product is stocked by a much wider range of outlets?
- A competitor is winning because it has a team of trained distributors or sales agents who are out there meeting customers and closing the sale?

Distribution matters for a business of any size – it is a crucial part of the marketing mix.

The objective of distribution is clear. It is to:

**To make products available in the right place at the right time in the right quantities**

Distribution is achieved by using one or more **distribution channels**, including:

- Retailers
- Distributors / Sales Agents
- Direct (e.g. via e-commerce)
- Wholesalers

A distribution channel can be defined as:

**"all the organisations through which a product must pass between its point of production and consumption"**

Looking at that definition, you can see that a product might pass through several stages before it finally reaches the consumer. The organisations involved in each stage of distribution are commonly referred to as **“intermediaries”**.

Why does a business give the job of selling its products to intermediaries? After all, using an intermediary means giving up some control over how products are sold and who they are sold to. An intermediary will also want to make a profit by getting involved.

The answer lies in efficiency of distribution costs. Intermediaries are specialists in selling. They have the contacts, experience and scale of operation which means that greater sales can be achieved than if the producing business tried to run a sales operation itself.

The main function of a distribution channel is to provide a link between production and consumption. Organisations that form any particular distribution channel perform many key functions:

<table>
<thead>
<tr>
<th>Information</th>
<th>Gathering and distributing market research and intelligence - important for marketing planning</th>
</tr>
</thead>
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Promotion | Developing and spreading communications about offers  
Contact | Finding and communicating with prospective buyers  
Matching | Adjusting the offer to fit a buyer's needs, including grading, assembling and packaging  
Negotiation | Reaching agreement on price and other terms of the offer  
Physical distribution | Transporting and storing goods  
Financing | Acquiring and using funds to cover the costs of the distribution channel  
Risk taking | Assuming some commercial risks by operating the channel (e.g. holding stock)

All of the above functions need to be undertaken in any market. The question is - who performs them and how many levels there need to be in the distribution channel in order to make it cost effective?

**How Many Stages in the Distribution Channel?**

Each layer of marketing intermediaries that performs some work in bringing the product to its final buyer is a "channel level". The figure below shows some examples of channel levels for consumer marketing channels:

![Diagram of distribution channels](image)

In the figure above, the first two channels are "indirect-marketing channels". Channel 1 contains two intermediary levels - a wholesaler and a retailer. A wholesaler typically buys and stores large quantities of several producers’ goods and then breaks into the bulk deliveries to supply retailers with smaller quantities. For small retailers with limited order quantities, the use of wholesalers makes economic sense. This arrangement tends to work best where the retail channel is fragmented - i.e. not dominated by a small number of...
large, powerful retailers who have an incentive to cut out the wholesaler. A good example of this channel arrangement in the UK is the distribution of drugs.

Channel 2 contains one intermediary. In consumer markets, this is typically a retailer. The consumer electrical goods market in the UK is typical of this arrangement whereby producers such as Sony, Panasonic, Canon etc. sell their goods directly to large retailers and e-tailers such as Comet, Tesco and Amazon which then sell onto the final consumers.

Channel 3 is called a "direct-marketing" channel, since it has no intermediary levels. In this case the manufacturer sells directly to customers. An example of a direct marketing channel would be a factory outlet store. Many holiday companies also market direct to consumers, bypassing a traditional retail intermediary - the travel agent.

What factors should be taken into account in choosing the best distribution channel? Here is a summary:

- **Nature of the product**
  - Perishable/fragile? A product with a short-life
  - Technical/complex? Complex products are often sold by specialist distributors or agents
  - Customised? A direct distribution approach often works best for a product that the end consumer wants providing to a distinct specification
  - Type of product – e.g. convenience, shopping, speciality
  - Desired image for the product – if intermediaries are to be used, then it is essential that those chosen are suitable and relevant for the product.

- **The market**
  - Is it geographically spread?
  - Does it involve selling overseas (see further below)
  - The extent and nature of the competition – which distribution channels and intermediaries do competitors use?

- **The business**
  - Its size and scope – e.g. can it afford an in-house sales force?
  - Its marketing objectives – revenue or profit maximisation?
  - Does it have established distribution network or does it need to extend its distribution option
  - How much control does it want over distribution? The longer the channel, the less control is available

- **Legal issues**
  - Are there limitations on sale?
  - What are the risks if an intermediary sells the product to an inappropriate customer?

**Distribution in more detail**

Let’s look at each distribution channel in a little more detail.
Retailers

The most popular distribution channel for consumer goods, retailers operate outlets that trade directly with household customers. Retailers can be classified in several ways:

- Type of goods being sold (e.g. clothes, grocery, furniture)
- Type of service (e.g. self-service, counter-service)
- Size (e.g. corner shop; superstore)
- Ownership (e.g. privately-owned independent; public-quouted retail group)
- Location (e.g. rural, city-centre, out-of-town)
- Brand (e.g. nationwide retail brands; local one-shop name)

Retailers enable producers to reach a wider audience, particularly if broad coverage by the major retail chains can be obtained. The big downside to using a retailer is the loss of profit margin. A high street retailer will typically look to take at least 40-50% of the final consumer price.

Wholesalers

Wholesalers stock a range of products from several producers. The role of the wholesaler is to sell onto retailers. Wholesalers usually specialise in particular products – for example food products.

Distributors and dealers

Distributors or dealers have a similar role to wholesalers – that of taking products from producers and selling them on. However, they often sell onto the end customer rather than a retailer. They also usually have a much narrower product range. Distributors and dealers are often involved in providing after-sales service.

Franchises

Franchises are independent businesses that operate a branded product (usually a service) in exchange for a licence fee and a share of sales. Franchises are commonly used by businesses (franchisors) that wish to expand a service-based product into a much wider geographical area.

Agents

Agents sell the products and services of producers in return for a commission (a percentage of the sales revenues).
Selling direct

A key decision a business has to make about distribution is whether to sell “direct”.

Direct marketing means selling products by dealing directly with consumers rather than through intermediaries.

Traditional methods include mail order, direct-mail selling, cold calling, telephone selling, and door-to-door calling. More recently telemarketing, direct radio selling, magazine and TV advertising, and on-line computer shopping have been developed.

The main advantages of selling direct are that there is no need to share profit margins and the producer has complete control over the sales process. Products are not sold alongside those of competitors either.

There may also be specific market factors that encourage direct selling:

- There may be a need for an expert sales force, to demonstrate products, provide detailed pre-sale information and after-sales service
- Retailers, distributors, dealers and other intermediaries may be unwilling to sell the product
- Existing distribution channels may be owned by, or linked to, competing producers (making it hard to obtain distribution by any other means than direct)

However, there are significant costs associated with selling direct which may be higher than the costs associated with using an intermediary to generate the same level of sales.

There are several potential advantages of using an intermediary:

- More efficient distribution logistics
- Overall costs (even taking into account the intermediaries’ margin or commission) may be lower
- Consumers may expect choice (i.e. the products and brands of many producers) at the point of sale
- Producers may not have sufficient resources or expertise to sell direct

Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
<th>Marks</th>
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</thead>
<tbody>
<tr>
<td>Define the term “distribution channel”</td>
<td>2</td>
</tr>
<tr>
<td>What is meant by the term “intermediary”?</td>
<td>2</td>
</tr>
<tr>
<td>Distinguish between a retailer and a wholesaler</td>
<td>4</td>
</tr>
<tr>
<td>What is the role of a distributor for a manufacturer of industrial products?</td>
<td>4</td>
</tr>
<tr>
<td>Describe three functions of a distribution channel</td>
<td>5</td>
</tr>
<tr>
<td>Describe three roles that a retailer provides for its customers</td>
<td>6</td>
</tr>
<tr>
<td>Examine why a business might decide to use multiple distribution channels</td>
<td>6</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Question</th>
<th>Mark</th>
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<tbody>
<tr>
<td>Explain why a new business might find it difficult to achieve adequate</td>
<td>6</td>
</tr>
<tr>
<td>distribution</td>
<td></td>
</tr>
<tr>
<td>Explain why direct distribution via the Internet has become so popular</td>
<td>8</td>
</tr>
<tr>
<td>with businesses in recent years</td>
<td></td>
</tr>
<tr>
<td>Analyse three factors that a manufacturing business will consider in</td>
<td>8</td>
</tr>
<tr>
<td>selecting its distribution strategy</td>
<td></td>
</tr>
<tr>
<td>Discuss whether distribution is more important than promotion in the</td>
<td>8</td>
</tr>
<tr>
<td>marketing mix</td>
<td></td>
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</tbody>
</table>
MARKETING AND COMPETITIVENESS

In this section we consider:

- What is meant by competitiveness?
- What determines whether a business’ product is competitive in the market?
- How marketing is affected by market conditions and degree of competition in a market
- Methods of improving competitiveness

Competitiveness

Competitiveness can be defined as:

The ability of a business to deliver better value to customers than competitors

A key part of all business activity – in which marketing plays a key role – is the search for sustainable competitive advantage. This phrase means exactly “what is says on the tin” (to borrow a well-known advertising slogan 😊)

Competitive advantage means:

- The ability of a business to add more value for its customers than its rivals and attain a position of relative advantage
- A situation where a business has an advantage over its competitors by being able to offer better value, quality and/or service

The key word in the bullets above is “value”. Value is what a customer is prepared to money for. A business that offers better value than competitors will enjoy an advantage.

A good way to think about value is to consider a purchase that you have made which, looking back, you consider to be good value. What was it about that purchase that you feel happy about?

- The price you paid?
- The features or benefits that you obtained from the product
- The enjoyment or satisfaction you have gained from owning or experiencing the product?
- The time you have saved?

A customer’s perception of value is very personal. It is usually based on several intangible factors as well as tangible factors. The hard bit for a “competitive” business is to work out what you as a customer value – and then deliver that to you!

Market Structures and the Degree of Competition

Very few, if any, businesses operate without facing competition. It is not enough to understand what customers value (see above). A business has to be able to deliver customer value better than the competition. The ability to do this is heavily influenced by the structure of the market in which a business operates. The more competitive a market is – the harder the task becomes.
There are two basic approaches to analysing market structure:

**Economist Approach:**

In economics, there are four main categories of market structure:

<table>
<thead>
<tr>
<th>Category</th>
<th>Key Features</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Perfect Competition</strong></td>
<td>Many competitors – all offering the same product</td>
</tr>
<tr>
<td>(rare in reality)</td>
<td>Intense competition</td>
</tr>
<tr>
<td></td>
<td>Competitors have to accept the same price</td>
</tr>
<tr>
<td><strong>Monopolistic Competition</strong></td>
<td>Many small firms offering differentiated products</td>
</tr>
<tr>
<td></td>
<td>Each firm has a small market share</td>
</tr>
<tr>
<td></td>
<td>Examples include restaurants + many local service businesses</td>
</tr>
<tr>
<td><strong>Oligopoly</strong></td>
<td>Market dominated by a small number of firms, each with a large market share</td>
</tr>
<tr>
<td></td>
<td>Tend to compete on non-price factors, including branding</td>
</tr>
<tr>
<td></td>
<td>Potentially anti-competitive – particularly if competitors collude on price</td>
</tr>
<tr>
<td></td>
<td>Examples – retail banking, confectionery, grocery retailing</td>
</tr>
<tr>
<td><strong>Monopoly</strong></td>
<td>One supplier in the market</td>
</tr>
<tr>
<td></td>
<td>Has control over price and output – potentially bad news for customers</td>
</tr>
<tr>
<td></td>
<td>Tend to be heavily regulated to protect consumers</td>
</tr>
</tbody>
</table>

**Porters Model of Industry Rivalry (“Five Forces)**

This alternative model looks at the nature of competition in a market in terms of the following competitive forces:
Dealing with each “force” in turn:

**Threat of Market Entry**

New entrants to an industry can raise the level of competition, thereby reducing its attractiveness. The threat of new entrants largely depends on the barriers to entry. High entry barriers exist in some industries (e.g. shipbuilding) whereas other industries are very easy to enter (e.g. estate agency, restaurants).

**Threat from Substitutes**

The presence of substitute products can lower industry attractiveness and profitability because they limit price levels.

**Bargaining Power of Suppliers**

Suppliers are the businesses that supply materials & other products into the industry. The cost of items bought from suppliers (e.g. raw materials, components) can have a significant impact on a company's profitability. If suppliers have high bargaining power over a company, then in theory the company's industry is less attractive.

**Bargaining Power of Customers**

Customers are the people / organisations who create demand in an industry.

**Intensity of Rivalry**

The intensity of rivalry between competitors in an industry will depend on:

- **The structure of competition** - for example, rivalry is more intense where there are many small or equally sized competitors; rivalry is less when an industry has a clear market leader

- **The structure of industry costs** - for example, industries with high fixed costs encourage competitors to fill unused capacity by price cutting

- **Degree of differentiation** - industries where products are commodities (e.g. steel, coal) have greater rivalry; industries where competitors can differentiate their products have less rivalry

- **Switching costs** - rivalry is reduced where buyers have high switching costs - i.e. there is a significant cost associated with the decision to buy a product from an alternative supplier
Strategic objectives - when competitors are pursuing aggressive growth strategies, rivalry is more intense. Where competitors are "milking" profits in a mature industry, the degree of rivalry is less.

Exit barriers - when barriers to leaving an industry are high (e.g. the cost of closing down factories) - then competitors tend to exhibit greater rivalry.

Improving Competitiveness

What can a business do to improve its marketing competitiveness, given the structure of the market in which it operates?

Taking the Porter model as an approach, here are three strategies a business could adopt:

Reduce Customer Bargaining Power

- Reduce over-reliance on customers – spread sales over more customers
- Focus marketing efforts on the most profitable customers

Reduce Supplier Bargaining Power

- Build relationships with key suppliers – achieve lower buying prices and better credit terms
- Have an alternative source of supply so that business is not over-reliant on one supplier

Create Barriers against Competition

- Build a brand
- Capture a fair share of distribution – perhaps by using multiple distribution channels
- Operate efficiently to compete at low cost

Guided Revision Questions

<table>
<thead>
<tr>
<th>Question</th>
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<tr>
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<tr>
<td>What is meant by the term “competitive rivalry”</td>
<td>2</td>
</tr>
<tr>
<td>What is the definition of a “legal monopoly”?</td>
<td>2</td>
</tr>
<tr>
<td>Define the term “market structure”</td>
<td>2</td>
</tr>
<tr>
<td>Explain, using an example, what is meant by a “barrier to entry”</td>
<td>4</td>
</tr>
<tr>
<td>Explain two factors that would determine the amount of bargaining power that a supplier has over its customer</td>
<td>4</td>
</tr>
<tr>
<td>Describe, using an example industry, the main characteristics of a market categorised as an oligopoly</td>
<td>6</td>
</tr>
<tr>
<td>Distinguish between the two market structures of monopoly and oligopoly</td>
<td>6</td>
</tr>
<tr>
<td>Explain why a business that has weak bargaining power with a supplier might be at a competitive disadvantage</td>
<td>6</td>
</tr>
<tr>
<td>Explain two ways in which a business can become more cost-effective</td>
<td>6</td>
</tr>
</tbody>
</table>
Discuss whether having a high market share provides a business with significant competitive advantages | 8
Describe three factors that a business would consider before it decided to enter a new market dominated by just a few large competitors | 8
To what extent do you believe that having a strong brand or product USP acts as an effective barrier to entry? | 8