Intro to Business:

A Primer

Companion text to CapsimCore®
Business Simulation

Edition 2

CAPSIM Core®

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Introduction

One way to learn about business is to read textbooks, learn definitions, discuss case studies, and pass an exam. With Intro to Business: A Primer, in conjunction with CapsimCore Business Simulation, we take a less theoretical and more hands-on approach.

We're going to learn business by managing a business.

The approach makes sense for two reasons. First, business itself is practical. If there were a single true theory of business success, then every person who started a business and followed the theory would be able to create a profitable and sustainable enterprise. Unfortunately, it's not that simple. Business requires the practical application of people, skills, ideas and money, and it requires some trial and error before you succeed. Second, it is in that process of trial and error that mastery develops. If you want to master the basics of business, rather than learn only the theory, this program is for you.

CapsimCore is a basic business simulation designed to give you hands-on experience in running a company. It provides the opportunity to work with all the essential managerial functions including marketing, production, and finance, and to experience the interactions and interrelationships that businesses engage in – internally and externally – to succeed. You can apply many of the concepts you'll read about in this book directly to the simulation.

It starts with an idea . . .

Every business requires three basic resources to function and compete: ideas, people and money. In the world of business, those resources are configured and reconfigured over and over again to satisfy the needs and wants of the market.

Sometimes businesses are based on a brilliant idea that completely changes how we do something – such as the way smart phones revolutionized the way we find, manage, and communicate information. Sometimes businesses find a new way to make us want more of what we already have – like the fashion industry urging us to update our wardrobe every season. Some businesses continually improve on a basic product – whether that's cars, light bulbs, fabricated steel or dishwasher detergent. Sometimes we're being sold an emotion – by the entertainment industry, for example – or a service, like haircuts or gym memberships. Whatever the business, it begins with an idea.

. . . add some good management

Individual brilliance, great ideas, even revolutionary technologies however, are only parts of the equation. The real art of business is to take the basic resources – ideas, people and money – and get them working together as a growing, functional operation.

Building a business requires the ability to understand and manage the network of interrelationships that delivering your product or service to the market requires.

And to do that, every single business relies on some standard elements and practices. For example: accounting to keep track of your money; marketing to entice customers to buy; and production to get your product or service into the customers' hands. Put simply, businesses need effective management.

The roots of the word manage come from the Latin words manus agere (to lead by hand) and mansionem agere (to run the house for the owner). The dictionary defines management as "the person or persons controlling and directing the affairs of a business or institution." It is the people who have their hands on the controls of the organization. In CapsimCore you will get your hands on some critical management tools and begin to build your skills using them. Those tools include accounting statements, forecasts, market data and more – all applied to the task of creating and managing a successful enterprise.

The forms that businesses take might be limitless, but the essence of how to run a company remains universal. The company you will run in this course designs, builds, and sells electronic sensors, but our goal is not to learn about sensors, it's to build the skills you need to effectively manage a business – any business organization at all.

It starts with an idea....

Smart phones have stimulated many new business ideas. Jack Dorsey is responsible for a few, creating two start-ups offering products we didn't know we needed or wanted until we had them. Twitter is one. Dorsey co-founded the social networking site in 2006. Twitter went public in 2013 but by 2016, while it had a market capitalization of around $12 billion, its stock had fallen 70% from its high soon after the IPO. With management instability and takeover rumors, Twitter struggles to turn its promise into profits.

Square is another of Dorsey's ideas. Square is a small credit card reader that plugs into a smart phone or tablet, replacing card-processing equipment and making it simple for any small merchant to accept credit cards. Square went public in late 2015 but its IPO was labeled 'lackluster' and it was valued at $2.9 billion – less than half its private valuation a year before. Profits continue to be elusive.

Uber, another San Francisco start-up, launched the smart phone ride-on-demand app that streamlined personal transport. But it hasn't been an easy ride. Traditional taxi unions, limo companies and city governments -- the "rent seekers" in the market -- have attempted to maintain the status quo through regulation and litigation. Unrest among Uber drivers protesting changes to their compensation has also plagued the company. However, Uber spread quickly to more than 60 countries and around 270 cities and, as it has raised around $14.1 billion revenue between2010 and 2019, it isn't rushing to go public. But while Uber competitor SideCar has already come and gone, its major rival Lyft partnered with India's Ola, China's Didi Kuaidi and GrabTaxi in 2016, forming a ride share partnership now covering about half the world's population.

Twitter, Square, Uber, Lyft and others are great ideas that were turned into businesses but still require excellent, fleet-footed management to become fully established firms that make a profit.

How many other businesses can you name that offered new products we didn't know we needed until we saw them?

. . . and develop mastery.

The good news is that brilliant and successful business-people – whether Mukesh Ambani, Bill Gates, Rupert Murdoch, or Mark Zuckerberg – were not born with a "business success" gene. Their success is not simply due to an inbuilt talent, and this means any one of us could be successful in business one day.

The bad news is that like all successful business-people, we need to devote thousands and thousands of hours to our goal – trying and failing, learning from our mistakes, and trying again – because it turns out that while many of us have the right attributes to be successful in business, not all of us are willing to invest the time. To become expert in any field, we need to engage in what is called "deep practice".

Deep practice

That's not to say genetics is always irrelevant – if you want to be a world-class basketball player, it helps to be tall – but few occupations require specialized characteristics such as height. Most require a combination of skills that can be developed and honed through practice, and this is especially true for business acumen.

Sensors: a fast-growing sector

Electronic sensors – the product you will be designing, producing, marketing, and selling during your simulation – exist in many applications.

One crucial sector is the fast-growing consumer electronics market. With "wearables" a hot trend in electronic devices, the health-conscious, tech-savvy buyers in the "quantified-self" market are being offered devices to measure their energy input and output against personal fitness goals. Wearables all require sensors.

Jawbone (an industrial design company that first developed sleek, in-ear Bluetooth devices) launched its first fitness-tracking wrist band Up in late 2011. Up had early technical problems which Nike+ took advantage of by promoting its rival FuelBand. Four years later, however, neither product was a blip on the market share chart for wearables. By 2016 the market was dominated by Fitbit, Apple and Xiaomi. According to CCS Insight's Wearable Forecast Worldwide February 2019, the market is set to grow to $30 billion by 2023, with smart watches accounting for more than half of the revenue.

At the All Things Digital Conference in May 2013, Apple CEO Tim Cook said there were problems to be solved in building wearable electronics – but the growing market would be good news for the sensor industry: "The whole sensor field is going to explode," Cook said. "It's already exploding. It's a little all over the place right now, but with the arc of time, it will become clearer I think."

According to a report by International Data Corporation (IDC) Worldwide Quarterly Wearable Device Tracker published in May 2020, the number of wearable devices shipped worldwide grew 29.7% in Q1 of 2020. The total device volume worldwide was a whopping 72.6 million units. The number of devices shipped in 3rd quarter 2015 were up 197% over the same quarter 2014 – from 7.1 million units to 21 million units. Nature Magazine reports that continuous data from wearable devices can also be captured and used to monitor the health of cancer patients in real-time and remotely. However, integrating data into the existing electronic health systems and creating frameworks to overcome barriers such as patient engagement would require multidisciplinary collaboration and implementation on a large scale (Low, C.A. Harnessing consumer smartphone and wearable sensors for clinical cancer research. npj Digit. Med. 3, 140 (2020). https://doi.org/10.1038/s41746-020-00351-x).

Success is often embedded in environmental influences. For example, the presence or absence of a great coach or mentor matters significantly. The presence of a role model in the culture also influences success. The opportunity to develop a skill matters most of all. You can't become a pianist if there are no pianos!

After only 100 hours of deep practice, a person becomes noticeably better at a subject than others who haven't done that work. At 1000 hours, he or she becomes highly skilled in that subject, and it doesn't stop there. So "talent" becomes somewhat predictable and measurable. You can say a person with 100 hours of deep practice is less competent than a person with 1,000 hours of deep practice.

Viewed in this way, talent becomes a choice. The choice is to trade off the time to develop one talent, for time spent on something else. The more time spent focused on a single talent, the less time can be given to others.

Business acumen is a function of deep practice; talent has little to do with it.

Simulations and deep practice

Simulations are designed to offer focused opportunities for deep practice. That's why they are often more effective than passive tools such as textbooks, videos, or lectures.

By the way, "deep practice" is very different from "ordinary practice." Commuters who drive to school or work can accumulate thousands of hours of driving, but that doesn't make them expert drivers. The key to deep practice is self-awareness. That is, paying attention to what you are doing well and not so well. This is so important to learning that scientists use a specific term for it: "metacognition," or thinking about the way you think and learn.

Deep practice has these characteristics:

- It is intentional. You are consciously seeking improvement as you practice.
- It is at the limits of your present capability.
- You fail. Often. If you didn't, you wouldn't be at the limits of your capability. You try again.
- You are seeking incremental improvement in each practice session, not breakthroughs.
- You are practicing the right things, not the wrong things. This often requires a coach.
- You have a feedback system in place, one that tells you when you are right and when you are wrong.
- You spend between half an hour and three hours a day in deep practice. If you spend more, you are getting diminishing returns. There is only so much you can accomplish in one day.

Simulations work because they are hands-on experiences that mimic the real world. Well-designed simulations, such as ***CapsimCore Business Simulation,*** present problems at the limits of your capabilities, offer positive and negative feedback, have a "coach," and work your brain in a way that builds your business skills. Throughout the training, you can witness the incremental improvements in yourself over time.

Here's a list of "do's and don'ts" to enable you to use the simulation to develop your business acumen, in much the same way that you'd use a gym to build muscle.

Do's:

- Feedback is critically important to deep practice. The simulation delivers it via your online interface and in your reports. Both positive feedback and negative feedback are important. When the results come in, compare your expectations with the actual results. Why were you right? Why were you wrong? This applies when your results are both better and worse than expected.
- Focus on your portion of the company's decisions each round. In sports, a player may spend a day of practice on only one skill. This same principle applies to business acumen and management skills.
- Add a new skill each round such as pricing for products, sales forecasting, production analysis, financial modeling, and so forth.
- Practice the old skills as well as the new skill.
- Use your coaches. These include your instructor, of course, but also the automated coaches that produce the end of round report available on your interface. If you encounter something you do not understand, the answer is probably in the online support system or you can contact support@Capsim.com

Don'ts:

- Don't treat failure as a bad thing. Failure is a good thing. It means that you are practicing at the limits of your ability. It has been estimated that Olympic ice skaters fall 20,000 times on their way to a gold medal. The skaters practice at their limits, focusing on the movements that make them fall. Failure is also feedback. An emergency loan, a stock-out, a capacity shortage – simulations are designed to highlight mistakes such as these – but the important questions are, "What led to the failure?" and "How can I avoid this in the future?"
- Don't ask others to do it for you. Do the work yourself. Don't seek help from past or present students. This is the equivalent of going to the gym to watch other people work out.
- Don't be concerned with the confusion you feel at the beginning of the simulation. Of course you're confused – you've never run a multimillion-dollar company before. Trust the process. The confusion will fade.
- Don't focus on your mistakes. That angst locks you in place and prevents growth. As difficult as it is to accept, if you are not looking bad, you are not growing.

So let's begin.

This text can be read in conjunction with your CapsimCore simulation experience. It is designed to enlarge on the concepts you'll come across in the simulation and introduce the way they work through examples in real, operating companies.

Remember, the best way to learn is to try, fail, try again and be persistent! Our hope is that you'll find this a fun learning experience that will motivate you to continue to develop your business management skills.

1 Overview: what is a business?

Learning Goals

After reading this chapter you will be able to:

- Define what a business represents and why businesses exist.
- Define essential business concepts including products, services,profits, and stakeholders.
- Describe the major functions of business.
- Discuss the role of management in business success.
- Differentiate between performance effectiveness and efficiency.
- Describe the enterprise system and how it relates to business.
- Differentiate between internal and external stakeholders.
- Discuss key market concepts such as specialization, uncertainty, and risk.
- Compare and contrast economic and opportunity costs.
- Describe the differences between financial and managerial accounting.

What is a business?

A business can be defined as any organization that provides products, services or both to individual consumers or to other organizations. The essential role of a business is to create products or offer services that satisfy customer needs or wants. Whether it's creating smart phones or offering home delivery of groceries, businesses could not exist without someone desiring their products or services.

Let us start with some basic definitions of essential concepts:

PRODUCT: a good that has tangible characteristics and that provides satisfaction or benefits (e.g., an automobile).
SERVICE: an activity that has intangible characteristics and that provides satisfaction or benefits (e.g., a mechanic performing automotive repair).
PROFIT: the basic goal of most businesses. Profit is the difference between what it costs to make and sell a product or service and what the customer pays for it.
STAKEHOLDERS: groups of people who have a vested interest (a "stake") in the actions a business might take. There are four major groups of stakeholders: (1) owners, (2) employees, (3) customers, and (4) society. The specific interests of each of these stakeholder groups may sometimes conflict with each other.

To summarize, a business sells products or services with the specific goal of making a profit, and in the process has an impact on various stakeholders.

Business, however, is much more interesting than its definitions. As described in the introduction, every business requires three basic resources – people, ideas, and money – that are configured and reconfigured over and over again to satisfy the needs and wants of customers. In that process there may be winners and losers, there may be cheaters, heroes, hard work, laughter, tears – the theory of business may be straightforward, but the experience of business is an exciting, ever-changing story, as you will discover in the CapsimCore Business Simulation.

Let's look at the way businesses deploy their three important resources.

Business Functions and Functioning

Each business must employ people to entice customers, produce its products or services, organize workflow, plan to fund or pay for its operations, and more. Whatever type of business it is, the work that must be done will typically fall into four basic "business functions."

MARKETING comprises all the activities designed to provide the goods and services that satisfy customers. These activities include market research, development of products, pricing, promotion, and distribution.

PRODUCTION refers to the activities and processes used in making products or delivering services. These activities involve designing the production processes (investments in facilities and equipment) and the efficient management and operation of those processes.

ACCOUNTING is the process that tracks, summarizes, and analyzes a company's financial position.

FINANCE refers to the activities concerned with funding a company and using resources effectively.

There is no one simple formula for successful business functioning or performance. Put simply, ideas (innovation + product development) + people (marketing + operations + leadership) + money (finance + accounting) ***does not equal*** a well-functioning business. Business is all about complex interactions – external interactions with customers, competitors, communities, and regulators – and internal interactions between all the people who operate the functions of the business itself. Engineers, computing wizards, accountants, human resource professionals, creative designers, marketers, and sales people – they may all be necessary to a business, but they are not sufficient to guarantee success.

To be successful, businesses need good managers who are able to see the big picture and understand how all the individual business functions work together. Fortunately, we know a lot about what goes into good management.

Managing a Business

As we discussed earlier, without customers a business would not be sustainable. This fact also applies to managers – without managers a business would wither and die. Successful management requires individuals who juggle the trade-offs and compromises necessary to keep a complex business moving along a clear strategic track. These individuals must also display intellectual flexibility to adjust to changing customer demands and be able to harness the impact of creative abrasion that results from dealing with various business stakeholders who often have colliding agendas that must be met in the drive for success, profitability, and sustainability.

When we say "success," however, what do we really mean? One useful way to think about success in management is that it entails the two "E's" of performance: effectiveness and efficiency. Performance effectiveness means doing the right thing. Performance efficiency means ***doing things righ***t.

Being ***effective*** involves committing to a course of action that allows you to accomplish your goals. It is a measure of how appropriately and successfully your actions achieve your goal. Being ***efficient*** refers to employing the right processes to achieve the goal. Efficiency is measured by comparing the resources invested with the outcomes achieved.

Decisions that shape the marketing, production, and financial functions of a business are often made in environments that are specialized, complex, uncertain, and risky. Managing these functions requires planning, organizing, leading, and controlling all the important variables.

PLANNING: Determining what the organization needs to do and how to get it done.
ORGANIZING: Arranging the organization's resources and activities in such a way as to make it possible to accomplish the plan.
LEADING: Enacting the plan, including guiding and motivating employees to work toward accomplishing the necessary tasks.
CONTROLLING: Measuring and comparing performance to expectations established in the planning process and adjusting either the performance or the plan.

Regardless of the business functions or the types of managerial decisions to be made, effective and efficient management cannot be achieved without leadership. At higher levels of responsibility, people who may be referred to as chief executives or senior managers fill leadership roles. Of course, the more people, functions, and processes a company has, the more its senior management will need to align and coordinate management activities. You will have the opportunity to experience a plethora of management challenges in your simulated company, particularly if you are operating in a

Innovation sparks growth

Chobani

He has been called the "Steve Jobs of yogurt". Hamdi Ulukaya, a Turkish immigrant to the U.S., built the Chobani yogurt company that made him a billionaire in six years on an obsession for brewing the perfect cup of yogurt.

In 2005 Ulukaya bought a defunct yogurt factory from Kraft in New Berlin, N.Y., with a U.S. Government-backed small business loan - and went on to shake up an industry owned by the major food companies. In 2007 he launched an innovation into the already crowded yogurt market: low-fat, sugar-free, Greek-style yogurt with a taste customers loved.

As Ulukaya told USA Today: "I literally lived in the plant for 18 months to make that perfect cup. And then five years after, it just exploded. I did not have all the ideas right from the beginning. I just jumped in and learned the swimming right in there."

Chobani went from six employees to 3,000 in five years and added a second plant in Twin Falls, Idaho, in 2012. When Ulukaya launched Chobani, Greek yogurt was 1% of the market in the U.S. Within five years it was almost 60%. "So we take quite a bit of credit for that," he said. "What we did was make it for everyone, and we made it delicious. And when people tasted it for the first time, this wow effect came in."

Sales of Chobani yoghurt hit a billion dollars in 2013, but a product recall that same year proved costly. By 2015 competition was intense and sales growth slower. Along with private equity funds and management assistance from TPG Capital, the company started looking to more innovation to stimulate growth. Chobani launched its "flip" range including Mango and Sriracha, or Chipotle Pineapple, mixing yoghurt with crunchy, savory toppings for all-day snacking. Innovation surrounding Chobani, however, has not been restricted to yogurt. As Ulukaya told USA Today: "That old plant that we turned back to life opened four different other factories somewhere else because of the butterfly effect. So you open the Greek yogurt factory. Then somebody has to make a cup factory. Somebody has to make a foil factory. Somebody has to make a fruit factory. Then the farmers have to add more cows. Then the people have to work on the farms. Then the trucks have to go up to those factories. All of that contributes to billions and billions of dollars invested and thousands of jobs created."

team where each team member, depending on his or her business function, will pursue different interests.

The Big Picture: The Enterprise System

Now that we've discussed some basics about business, business functions, and management, let's look a little closer at the economic forces that impact business functioning.

Businesses operate within an overall economic system. There are at least three key terms to understand when thinking about overall economic systems.

> **MARKET:** a mechanism that facilitates the exchange of goods and services between buyers and sellers.
> **DEMAND:** the quantity of goods and services that consumers are willing to buy at different prices.
> **SUPPLY:** the quantity of goods and services that businesses are willing to provide at those prices.

The terms of a sales transaction, or the quantity of goods traded and the trading price, are determined by the supply of and demand for any particular good or service.

Economic systems are typically, but not always, embedded in a framework of activities that are carried out by mostly democratic elected representatives (the government) of a society within its geographic boundaries. Activities that serve the society by fulfilling basic needs (e.g. roads, defense, security) or needs that no other business can serve (e.g. judicial branches) are performed by ***public enterprises.***

Unlike public enterprises, the simulated company you will run in the CapsimCore Simulation is a ***private enterprise.*** In private enterprise systems individual citizens (rather than governments) own and operate the majority of businesses. Private enterprise systems require four essential conditions:

1. Private property
2. Freedom of choice
3. The right to keep profits
4. An environment where fair competition can occur

The theory underlying the private enterprise system is that competition among businesses will produce an efficient allocation of resources across the economy. Goods and services are desired where they produce the greatest benefit or are used most productively. Throughout this economic process, pressure is exerted from several areas. For example, there is pressure to lower prices and pressure to innovate through technological and procedural improvements.

When businesses compete in a private enterprise system, value is created for consumers. Customers are offered additional choices because businesses are motivated to innovate often through technological advancements to improve their offerings and make them more attractive. ***Innovation*** of processes, products, and services also motivates businesses to price their offerings attractively to position themselves for future and sustainable success.

Internal and External Stakeholders

Within an economic system are various groups with a stake in the way businesses operate. Earlier, we defined these different groups as business "stakeholders". All businesses will have stakeholders from the four categories we discussed. One way to think of these stakeholders is in terms of their being either internal or external to a business.

The key internal stakeholders are owners (stockholders/shareholders), who derive economic benefits when the business makes a profit, and whose investments lose value when it doesn't; and employees, who also derive economic benefits through wages but can experience additional benefits (such as training and experience) or disadvantages (exposure to toxins/accidents). The key external stakeholders are customers, who want the best product or service possible for the lowest possible price; and the society at

Stakeholders' changing needs and demands

The Easy-Bake Oven may have been a favorite toy of American children for more than 50 years, but in recent years Hasbro, its manufacturer, has had to respond dramatically to stakeholders including both customers and government regulators.

The toy, launched in 1963, is a working oven in which mini portions of cake batter and other treats are fed on small trays into a slot and emerge cooked. In 2003 it was voted Parenting magazine's Toy of the Year. In 2006 it was inducted into the American Toy Hall of Fame.

Since then, however, Hasbro has dealt with health and safety concerns, environmental legislation, and claims of sexism related to the Easy-Bake design.

In early 2007 nearly a million of the pink-and-purple ovens were recalled. Hasbro had received 249 reports of children getting their hands or fingers caught in the oven's opening, including 77 reports of burns, 16 of which were reported as second- and third-degree burns, with one leading to a partial finger amputation for a 5-year-old girl.

After the recall, a redesigned oven was launched, powered by the heat source the Easy-Bake used from the beginning – an incandescent bulb. Environmental legislation announced by President George W. Bush that same year, however, required a phase-out of incandescent bulbs by 2012. In 2011 Hasbro launched a new oven, powered by a heating element.

The next year, a New Jersey teen, McKenna Pope, collected 40,000 signatures – including those of several celebrity chefs – asking Hasbro to launch an Easy-Bake that was gender neutral. McKenna claimed the oven's feminine-looking pinks and purples alienated her younger brother. At the 2013 Toy Show, Hasbro launched an oven in black and silver. Responding to this pressure may have proved controversial internally, however, because it was not Hasbro's first attempt to appeal to boys. In 2002 it had launched the Queasy Bake Cookerator, making "boy friendly" treats such as Chocolate Crud Cake and Dip 'N Drool Dog Bones. The product failed to reach adequate sales and was withdrawn.

It can be difficult – even for an established product such as the Easy-Bake and an established manufacturer such as Hasbro – to keep up with the various pressures from different stakeholders.

large that may also be benefited (more jobs for more people leading to more tax revenue) or disadvantaged (toxic waste in the water system/market failures).

The private enterprise system needs laws to make corrections when markets do not produce outcomes desirable for the people who live in a society. The laws are set by governments elected to act on behalf of the whole society – and they are designed to protect all stakeholders according to a mutual sense of justice. In this sense, governments establish rules for the overall economic system designed to balance the needs of the society with the drivers of profit.

Stakeholders in an oil spill

On April 20th 2010, an explosion on the Deepwater Horizon oil rig, operated by British Petroleum in the Gulf of Mexico, triggered the largest marine oil spill of its type in U.S. history.

The rig sank, 11 people were killed, 17 were seriously wounded and oil flowed underwater from the well, discharging more than 200 million gallons before it was declared fully capped in September. On April 30th President Barack Obama said: "This oil spill is the worst environmental disaster America has ever faced ... Make no mistake: We will fight this spill with everything we've got for as long as it takes. We will make BP pay for the damage their company has caused. And we will do whatever's necessary to help the Gulf Coast and its people recover from this tragedy."

The scale of the disaster resulted in adverse effects on a very wide range of stakeholders. Owners saw their investment in BP halved as the market capitalization of the company plunged from $180 billion in April 2010 to $90 billion by June of that year. Employees suffered not only from the direct and indirect effects of the deaths and injuries, but from the impact of working for the world's largest oil producer one day, and its most infamous the next. Customers felt less inclined to buy BP products with BP-branded gas stations in the U.S. (most of which are not owned by BP) suffering losses of between 10% and 40% of sales.

It was, however, society that felt the largest impacts. In Louisiana, for example, 17% of all jobs are related to the oil industry. Job losses in the state followed a moratorium on offshore drilling, implemented while investigations were underway. Jobs were lost in tourism (the industry reports losing $23 billion in the region) and fishing (reported losses of $2.5 billion), as the effects of the spill and cleanup efforts devastated both industries. Health issues included 143 cases of chemical poisoning in the first two months of the disaster alone, with the American Journal of Disaster Medicine suggesting "cancers, liver and kidney disease, mental health disorders, birth defects and developmental disorders should be anticipated among sensitive populations and those most heavily exposed." The oil spill area included more than 8,000 species of fish, birds, mollusks, crustaceans, sea turtles and marine mammals, with effects on these animals including death from oil or the cleanup chemicals, disease, birth defects and mutations, and lesions and sores.

The company was charged with 11 counts of manslaughter under U.S. law for the deaths of workers and tried under provisions of the Clean Water Act. The U.S. Government National Commission investigation into the disaster placed blame for the spill squarely at the feet of BP and its contractors Halliburton and Transocean, citing cost cutting and insufficient safety procedures. By July 2015 agreement had been reached to settle all federal and state claims, leaving BP a total bill of $53.8 billion for cleanup, compensation, and environmental fines. The disaster is one of the most vivid examples in recent history of how errors in business can negatively and dramatically impact a wide range of stakeholders.

All areas of law or regulation that influence business practice contribute to our shared definition of fairness. Examples include establishing standards of conduct in negotiating contracts with a company's buyers or suppliers, providing information (advertising) to consumers, providing information to potential investors, and negotiating with employees or their representatives.

To summarize, we have an overall economic system based on privately owned businesses, regulated to ensure the rights of all stakeholders are protected, and fueled by transactions between buyers and sellers in various markets. Next, let's look at the notion of a market.

Markets – the engine that keeps it all running

A market – according to our definition – is a mechanism that facilitates the exchange of goods and services between buyers and sellers. From cavemen trading stone tools for bison meat, to the NASDAQ (an electronic market for buyers and sellers of stock), informal and formal markets have existed as long as human demand has been able to find a source of supply.

Some terms you'll come across in relation to markets are ***specialization***, ***uncertainty***, and ***risk***.

In an economic context, ***specialization*** is a measure of how broadly or narrowly the range of activities performed by a business is defined. A bicycle shop, for example, is a more specialized retail store than Wal-Mart because the bicycle shop focuses on a narrow and deep range of products. Specialization creates an opportunity for greater efficiency and increased productivity. The division of tasks that comes with specialization introduces a need for coordination of those specialized tasks. These different levels of specialization and different kinds of coordinating mechanisms create a complex economic environment.

Everyday life – specialization and complexity

It's Sunday morning and you decide to en joy breakfast at a local café. Your need is specialized and so is the café business serv ing breakfast – but think about the complexity of the separate activities in different types of industries and markets that have to be precisely coordinated to provide your breakfast experience: agriculture (growing the tomatoes, collecting the eggs); transport (moving everything from supplier to wholesaler to your table); grocery wholesaling (from the napkins to the ketchup); construction (the building you are sitting in); furniture (the chair you are sitting in); food service (cooks, kitchen hands, wait-staff); banking (lending money to all of the other industries to keep them operating); entertainment (the music playing in the background) …. it's a

complex web of markets matching supply with demand.

Markets are also characterized by ***uncertainty*** and ***risk***. Uncertainty refers to not knowing an exact outcome or not being able to predict the exact consequences of a choice in a decision situation. The greater the uncertainty, the less you can know about the results of a particular choice. Decision makers must work to reduce uncertainty by compiling as much relevant information as possible about a decision situation. Risk is also associated with the consequences of choice; therefore risk is a measure of the significance of those decisions.

Decision making – the critical skill

When planning, organizing, operating, and controlling a company, decisions are constantly made and the quality of those decisions determines, to a large extent, whether and how the company will achieve its goals. In today's world of work, teams make the vast majority of strategic, high-impact decisions. These teams can range from product development teams and quality control teams to top management teams comprised of executives from each business function.

Everyday life – risk

Think about tossing a coin. You cannot consistently predict when you flip a coin whether it will land with the "head" or the "tail" side up. Not knowing which side will land facing up is a form of uncertainty. Place a bet with a friend about which side will land facing up and the amount of the bet is a measure of the risk. If you bet 20 cents, then the risk associated with the bet is small. If you are in the same economic position and bet $100,000, then the risk associated with the bet is enormous.

The process of defining problems and opportunities that merit attention, generating and evaluating alternative courses of action, and committing to the action that is most likely to produce the optimal result is one way to describe the decision-making process.

Decision making also involves comparing the economic and opportunity rewards (benefits) and sacrifices (costs) involved in a course of action and committing to the one that best meets your goals. The objective is to make the parties involved "better off" than they were before the transaction took place. Typically, good decisions are commitments that help you accomplish your goals in whatever way you define them. Business decisions primarily focus on gaining economic rewards, which means there is an assumption that we only engage in transactions that offer the potential to improve our "position." When we choose a course of action, it requires a sacrifice to obtain the reward. In economic terms, this sacrifice is called a "cost." When evaluating alternative choices, a decision maker considers two kinds of costs: the economic cost and the opportunity cost.

An ***economic cost*** is the money spent implementing the decision.

An ***opportunity cost*** is the cost of what you gave up doing when you committed to the course of action you chose.

Everyday life – opportunity cost

Consider being offered two jobs. One offers $10,000 more in base salary but few prospects for promotion. The other offers less money but has more opportunities for promotion and future training. You have two choices: Take the higher paying job, or the lower paying job. The economic cost of taking the second job is $10,000. The opportunity cost of taking the first job is the chance for promotion, future training, and higher pay in the future. In the long run, opportunity costs are often more important than economic costs, but economic costs are generally easier to determine than opportunity costs.

Assessing opportunity costs is important to determine the ***true cost*** of any decision. Opportunity cost can measure anything that is of value. The opportunity cost is not the sum of the available alternatives, but rather the benefit of the best single alternative. If there is no explicit accounting or monetary cost attached to a course of action, ignoring opportunity costs may create an illusion that the benefits cost nothing at all, turning them into a ***hidden cost*** associated with that action. The opportunity cost of a company's decision to build a new plant on vacant land the company owns, for example, is the loss of the land for another purpose, such as using it to build a facility to be leased to another business, or to have access to the cash that could have been generated from selling the land. Only one set of choices is possible. Only one set of benefits is attainable.

Accounting – keeping track of financial outcomes

Every business keeps track of its financial health through accounting. Accounting is a set of rules applied to a company's financial records that allows owners and managers to monitor, analyze, and plan the finances of the business. In short, accounting deals with the business resource of "money" we discussed at the beginning of this chapter.

Whatever business you are in, the stakeholders in your business – and that, as we know, might be owners and shareholders, potential buyers, customers, or even the government's tax office – need to have a consistent frame of reference for assessing the financial health of your company. That consistent frame of reference is provided by the company's financial reports. To understand the financial reports, however, we need to understand some of the basic principles that underpin the rules and principles of accounting.

There are two major types of accounting: ***Financial Accounting*** and ***Management Accounting***.

> **FINANCIAL ACCOUNTING** produces the balance sheets, income statements, and cash flow statements that ensure external stakeholders can access the information they need. These stakeholders are usually people and groups outside the company who need accounting information to decide whether to engage in activity with the company. That might include individual investors; stockbrokers and financial analysts who offer investment assistance; consultants; bankers; suppliers; labor unions; customers; local, state, and federal governments; and governments of foreign countries in which the company does business.
>
> **MANAGEMENT ACCOUNTING** provides vital information about a company to internal users. Because it is for internal use, it does not have to conform to the restrictions of outside regulation and can be expressed in whatever way is most useful for managers. Information can be reported in dollars, units, hours worked, products manufactured, number of defective products, or the quantity of contracts signed. The job of a management accountant is to produce information that is relevant to specific segments of the company's products, tasks, plants, or activities. The goal of that information is to enable managers to make more informed and effective decisions.

The reports a management accountant produces might forecast revenues, predict costs of planned activities, and provide analysis based on those forecasts. By describing how alternative actions might affect the company's profit and solvency, forecasts and analyses help managers plan.

We'll talk in greater detail about financial accounting and reports such as income statements, cash flow statements, and balance sheets in Chapters 4 & 5. More detail will be provided on managerial accounting including budgets, cost analysis, and management reporting in Chapters 2 & 3, which cover marketing and production.

Chapter 1 Review Questions

Business Basics

1. What are the four main business stakeholder groups?
2. What are the primary functions of business?
3. What are the four major activities involved in managing a business?
4. What is the difference between performance effectiveness and performance efficiency?

The Private Enterprise System

5. How would you define supply?
6. How would you define demand?
7. How would define a market?
8. What are the four conditions that must exist for the free enterprise system to exist?
9. What are the implications of the relationship between supply and demand?
10. What are the differences between internal and external stakeholders?
11. What is specialization?
12. How would you illustrate the concept of "uncertainty"?
13. How would you illustrate the concept of "risk"?

Decision Making

14. What is the difference between an economic cost and an opportunity cost?
15. What is the main purpose of the accounting function of a business?
16. What are the differences between financial and managerial accounting?

2 Marketing: how do we identify, entice and add value for customers?

Learning Goals

After reading this chapter you will be able to:

- Describe the role of a marketing manager.
- Describe the key activities of marketing research.
- Discuss the seven steps of information gathering for market research.
- Define and differentiate the "4P's" of marketing.
- Discuss the importance of market segmentation.
- Describe the purposes and goals of marketing strategy.
- Define "diminishing returns" and discuss why this matters to marketing.
- Compare and contrast the concepts of risk, ambiguity, and conformance with regard to marketing.

Overview of Marketing Basics

No matter how good a firm is at offering its products and services, it still has to strive for constant improvement because satisfying the customer is a never-ending process. From buying a bottle of shampoo or ordering a cup of coffee, to choosing a health-care provider or setting up a retirement plan, the abundance of choice in any market makes decision-making increasingly complex for consumers. The same is true for customers in business-to-business markets, like the electronic sensor market.

For any company, understanding the relationship its customers have with the company and its product, and how those relationships develop or deteriorate over time, is critical to the long-term profitability and sustainability of the firm.

Today's customers have access to a wealth of information, as well as many choices in the marketplace. Acquiring and retaining customers can, therefore, be challenging. But a satisfied and/or loyal customer – a "captured" customer – is, in simple economic terms, an asset that yields future cash-flows and contributes to a firm's future growth.

Without unlimited resources, it is impossible for any firm to excel in every aspect of its product: that is, to provide the highest quality, fastest delivery and widest variety at the lowest price. Therefore, firms must make tradeoffs based on what they do best, what their competitors are offering, and what criteria they think matter most to their customers. Managers often struggle to determine the "best" configuration of product-service offerings that will appeal to their chosen target markets and to potential customers.

The Marketing Manager's Role

Ideally, all company activities should satisfy customer needs. The role of a marketing manager is to focus the company's efforts on identifying, satisfying, and following up on its customers' needs - all at a profit. A marketing manager should understand how to:

- Clearly define, describe and forecast the needs of its customers by using data ***(Market Research),***
- Determine how to select specific markets and satisfy customer needs through balancing products, services, and benefits ***(Marketing Mix)***
- Analyze its competitive advantages, plans, and actions ***(Marketing Strategy).***

Market Research

A successful marketing manager cannot afford to implement best-practice initiatives for all possible product offerings to ensure the company can be "everything to everybody." Nor can they use "spray and pray" tactics until they find the most popular product that will stick. With limited resources available, a marketing manager's first step is to view the business from a customer's perspective.

Most marketing managers combine the customer perspective with their sense of the market that comes from experience. However, experience is not always a good thing. Experience may include information acquired over many years that has become outdated and is no longer timely or relevant to today's decisions. Sometimes industry folklore – stories repeated often but without a firm factual foundation – can create misleading impressions that may lead an organization in the wrong direction. Timely market research to ensure you have an up-to-date understanding of your market and customers helps keep decision making on track.

Organizing information

Any research assignment is a systematic gathering, recording, and analyzing of data related to a subject or problem you would like to understand., Market research in particular is simply an orderly and objective way of learning about the group of people who buy from you or who are most likely to do so.

Market research is not a perfect science because it deals with people and their constantly changing likes, dislikes, and behaviors – all potentially affected by hundreds of influences. It is an attempt to learn about markets scientifically and to gather facts and opinions in an orderly and objective way. Market research seeks to find out how things are, not how you think they are or would like them to be, and can define what specific products or services people want to buy, rather than focusing on what you want to sell them.

Market research answers the questions every business must ask to succeed, such as:

- Who are my customers and potential customers?
- What kind of people are they?
- Where do they live?
- Can and will they buy from my business?
- Am I offering the kinds of goods or services they want at the best place, at the best time, and in the right amounts?
- Are my prices consistent with buyers' opinions of the product's value?
- Are my promotional programs working by creating awareness in the market- place?
- Are my sales programs working to create accessibility for my product through the distribution channels?
- What do customers think of my business?
- How do our value propositions (a product or a service that creates value for the customer) compare with those of our competitors?
- Are there specific reasons customers would make the decision to purchase from our business rather than from competitors?

Information gathering

We often engage in information gathering to allow us to systematically organize knowledge. This practice ensures that such knowledge and information is timely and meaningful. Sound information gathering provides what you need to:

- Identify problems and potential problems in your current market that you can solve in a unique manner
- Acquire facts about your market to develop a strategy and implement action plans
- Assist you in making better decisions and correcting problems as needed
- Reduce implementation risks
- Discover unknown opportunities

Many managers conduct informal research every day. In their daily managerial duties, they check returned items to see if there is a pattern of dissatisfaction. They meet a former customer and ask why they have not been in lately. They look at a competitor's ad to see what they are charging for the same products. These activities help provide a framework that enables managers to objectively evaluate the meaning of the information they gather about their business.

A more formal information gathering or research process may include the following seven steps:

1. Defining the problem or opportunity
2. Assessing available information
3. Reviewing internal records and files; interviewing employees

4. Collecting outside data (primary research)
5. Organizing and interpreting data
6. Making a decision and taking action
7. Assessing the results of the action

DEFINING THE PROBLEM OR OPPORTUNITY: Defining the problem or assessing the opportunity is the first step of the research process. This process is often overlooked, but it is the most important step. You must be able to see beyond the symptoms of a problem to get at its cause. Labeling the problem as "a decline in sales" is not defining a cause, but identifying a symptom.

You must establish an outline of the problem that includes causes that can be objectively measured and tested. Look at your list of possible causes frequently while you are gathering your facts, but do not let it get in the way of the facts. To define your problem, list every possible influence that may have caused it. For example, if sales have declined:

- Have your customers changed?
- Have customer tastes changed?
- Have customers' buying habits changed?
- Do our services still meet our customers' needs?
- Is our product still relevant?

ASSESSING AVAILABLE INFORMATION: Once you have formally defined your problem, assess the information that is immediately available. You may already have all the information you need to determine if your hypothesis is correct, and solutions to the problem may have become obvious in the process of defining it. Stop there. You have reached a point of diminishing returns (we'll talk about this term in depth a little later). You will be wasting time and money if you do further marketing research that doesn't offer additional insight.

If you are uncertain whether you need additional information, weigh the cost of more information against its usefulness. This presents a dilemma similar to guessing in advance what return you will receive on your advertising dollar. You do not know what return you will get, or even if you will get a return. The best you can do is to balance that uncertainty against the cost of gathering more data to make a more informed decision.

Everyday Life - available information

Imagine you sell tires. You might guess that sales of new cars three years ago would have a strong effect on present retail sales of tires. To test this idea, you might compare new car sales of six years ago with replacement tire sales from three years ago. What if you discovered that new tire sales three years ago were 10 percent of the new car sales three years before that? Repeating this exercise for previous years reveals that in each case tire sales were about 10 percent of new car sales made three years before. You could then logically conclude that the total market for replacement tire sales in your area this year should be about 10 percent of new car sales in your locality three years ago.

Begin by "thinking cheap and staying as close to home as possible." Before considering anything elaborate, such as market surveys or field experiments, explore your own records and files. Look at sales records, complaints, receipts, and any other records that can help you better understand where your customers live, work, what they buy, and how they buy.

Naturally, the more localized the figures you can find from published sources, the bet ter. For instance, there may be a national decline in new housing starts, but if you sell new appliances in an area in which new housing is booming, you need to base your estimate of market potential on local, not national conditions. Newspapers and local radio and television stations may be able to help you find this information.

Keep in mind that there are many sources of published material and much of it is free. You can find it online, in libraries, newspapers, magazines, and in trade and general business publications. Trade associations and government agencies are also rich sources of information.

INTERVIEWING EMPLOYEES: When you have finished reviewing the available information in your records, turn to that other valuable internal source of customer in formation: your employees. Employees may be the best source of information about customer likes and dislikes. They hear customers' complaints about your products or services, they are aware of what customers are looking for but you are not offering, and can probably supply good customer profiles from their day-to-day contacts whether it's face to face, on the phone, or online.

BEYOND SEARCH ENGINES - GATHERING PRIMARY INFORMATION: Once you have exhausted the basic sources for information about your market, the next step is to collect information not commonly available in published form. Primary research is the collection of original data. Primary research can be as simple as asking customers or suppliers how they feel about your store or service firm, or as complex as the surveys conducted by sophisticated professional marketing research firms. Primary research includes among its tools direct mail questionnaires, telephone or on-the-street surveys, experiments, panel studies, test marketing, behavior observation, and more.

It is critical to ask the right questions and to avoid creating a bias in the responses. If the questions are not carefully crafted, people may answer the way they think they are expected to answer, rather than telling you how they really feel about your product, service, or business.

INTERPRETING DATA: After collecting the data you must organize it into meaningful information. Go back to your definition of the problem, compare it with your findings, and prioritize and rank the data.

- What marketing strategies are suggested?
- How can they be accomplished?
- How are they different from what I am doing now?
- What current activities should be increased?

- What current activities must I drop or decrease in order to devote adequate resources to new strategies?

MAKING DECISIONS AND TAKING ACTION: Prioritize each possible tactic from the standpoint of determining the:

- Immediate goal to be achieved;
- Cost to implement;
- Time to accomplish, and
- Measurement of success.

Research can only take you so far

The Internet makes collecting information for market research easier than ever before. The Internet, however, also makes a clear vision of the future harder to define because of the precarious uncertainties it has introduced for many traditional industries and institutions.

The most research-driven institutions in the world, universities, are watching their entire business model change – and all their expertise in the scientific method cannot produce a clear conclusion about their own future. In the United States for example, Congress, concerned the nation's universities were at risk from a range of forces, asked the National Academies for a full report on the future. The Academies produced a list of 10 actions necessary to secure the university sector including policy, funding, productivity, and partnership priorities in the U.S. It could not, however, predict how a new university sector might look. A recent Ernst and Young report on universities concluded: "the dominant university model ... will prove unviable in all but a few cases over the next 10-15 years" but could not confirm what would take its place.

Innovators in higher education are offering their own solutions. Western Governors University, for example, an online university created by several U.S. state governments, offers competency-based programs that are, unlike existing university programs, low-cost and self-paced. Coursera, an education technology company, gives millions of people access to teaching from highly respected professors through Massive Open Online Courses (MOOCs). Founded by Stanford University professors, Coursera has more than four million users and is working with the American Council on Education to offer the equivalent to university credits.

The traditional news media – newspapers delivered to your door, with television and radio bulletins delivered at scheduled times – also saw its business model collapse as the Internet delivered a 24-hour news cycle and user-generated content. When Amazon's Jeff Bezos purchased the Washington Post, commentators suggested a "back to the future" model would follow in which wealthy, tech-savvy individuals would buy and transform traditional media outlets. The news website BuzzFeed was already offering a new model for news: user-generated content mixed with material by staff journalists and organized by what's "viral" on the web at any moment. Announcing that his company had made its first profit in September 2013, BuzzFeed CEO Jonah Peretti said: "We don't have the trust the traditional news brands have won over the past 100 years, but we are working hard to earn it, and it won't take us 100 years to get there."

But where exactly, is "there"? Universities and news media have total access to information for data-driven decision making. No amount of data, however, can guarantee the future. Information can tell you how things are today, but cannot make the decision for you on what you should do about it tomorrow.

If your market research suggests 10 possible strategies, select two or three that appear to have the greatest potential impact or are most easily achievable and begin there. For each strategy, develop tactics, which may include:

- Staff responsibilities
- Necessary steps
- Budget allocations
- Timelines with deadlines for accomplishing strategic steps
- Progress measurements

Based on this information, make a final decision on the strategies and go to work on the tactics.

ASSESSING THE RESULTS OF THE ACTION: Analyze your progress against success

measures. If adjustments are appropriate, make them. At the conclusion of the time you have allotted for accomplishing your goal, take a hard look at the results.

- Did you achieve your goal?
- Should the decision be renewed on a larger scale?

If you are disappointed in the results, determine why the plan went awry.

The possibilities revealed

Market research should also identify trends that may affect sales and profitability levels in the future. Population shifts, legal developments, and the local economic situation should be monitored to enable early identification of problems and opportunities. Competitor activity should also be monitored. Competitors may be entering or leaving the market, for example. To provide competitive insight, it is also very useful to understand the strategies your competitors have chosen.

Good information about the market is critical. Research provides knowledge that can disclose problems – and a lack of knowledge can easily be remedied through research. The success of any business is based on its ability to build an increasing pool of satisfied customers. Customers buy something because they believe they will be "better off", in some way, because of the transaction. It is critical, therefore, that every business works out exactly who its customers are and how to create value for them. That is the role of Marketing.

The Marketing Mix

The 4Ps of Marketing

Marketing defines your actions for competing in the marketplace. At the simplest level, a high-end vehicle manufacturer such as Rolls-Royce spends its marketing budget enticing high-net-worth individuals, while the value marketing programs of a manufacturer such as Hyundai appeal to a much broader audience. Rolls-Royce and Hyundai do not compete in the same market "segment", which means their customers are looking for cars, but different types of cars. Their marketing programs, therefore, are very different. Hyundai, however, competes with KIA and Suzuki in the same small-vehicle market segment. All three are competing for the same customers, so their challenge is to design marketing programs that make them stand out from the others – to ***differentiate*** their offering in the market.

Traditionally, Marketing covers the 4 P's of ***Product, Price, Promotion*** and ***Place***, and the way a company configures these elements is known as the "marketing mix".

Product

What are you selling and how can you manipulate it to deliver better value for your customers? Does the business concentrate on a narrow product line, developing highly specialized products or services? Does it offer different versions of its products or services to different types of customers? Adjustments to the offerings – through Research and Development, revised designs, new packaging, etc. – are all a key part of the marketing mix.

Price

Price and pricing policies are vital to business revenues. Each product or service must be priced to satisfy customers and deliver on the company's profit target. But pricing also includes determining a credit policy: Do you allow your customer to pay for the product ***after*** they receive it, or do they need to pay for it ***when*** they receive it? The timing of payment by customers will have an impact on the cash available to the business at any given time.

Promotion

No business can expect customers to just stumble across their offering and buy. Each business needs to create awareness for the value proposition they are offering. This can be done by taking advantage of resources such as the Internet, advertising campaigns, sales efforts, special financing deals, or any other creative promotional or sales activities the company can imagine and implement. The cost of these activities, however, must also be factored into the price of the products or services.

Place, or distribution channel

The way you get your product or service into your customers' hands or lives is equally important. Businesses need to make their value propositions accessible. A manufacturer might work through established distributors or agents, for example, to get their products to the right place. A retailer has to consider cost vs traffic flow for their store

– a high-traffic location will have higher rent but a low- cost, low-traffic location will require more expenditure on promotions to bring people in. Online retail requires search engine optimization. Making the product accessible is critical to the marketing mix.

"Place" might be as simple as displaying products that are often bought on an impulse, such as flavored popcorn, candy, or magazines, in a highly visible spot in a high-traffic area of a store (checkout line), or as complex as developing an Internet-based marketing plan to reach customers anywhere around the world.

There are more than four P's to great marketing campaigns, however. Precision, for example – identifying precisely who your customers are and what they want. Preparation is another – doing the careful research and design work to satisfy your customers' needs. And what about pizzazz – getting customers excited about choosing your value proposition over a competitor's? Just like business itself, marketing is much more interesting than its basic definition.

The Four P's go viral

California start-up Dollar Shave Club took on the market powerhouses in the shaving business not just with an alternative value proposition (razors delivered to your door through a monthly subscription), but also with a quirky video ad that went viral on YouTube and won marketing awards for its creativity.

Dollar Shave Club's value proposition started as home delivery of razor blades for as low as $1 a month (plus shipping) then expanded with a range of personal grooming products for men – included wet wipes for (ahem) the other cheeks.

The company's online ad "Our Blades Are F***ing Great" features founder and Chief Executive Michael Dubin riding on a forklift, lobbing stray tennis balls, dancing with a fuzzy bear, and poking fun at the high-priced, complex razor products sold by his competitors. It won Best Out-of-Nowhere Video Campaign at the 2012 Ad Age Viral Video Awards plus two 2013 Webby Awards.

When the company launched publicly in March 2012 it attracted close to $10 million in venture capital. By mid-2015, Dollar Shave was valued at $615 million. Forbes Magazine said: "The company's millions are dwarfed by those earned by Gillette or Schick, but its deft understanding of marketing's 4P's (product, price, place, and promotion) showed that big-name consumer brands are vulnerable."

Some big-name brands, however, have shown they can also play the YouTube game. Dove's "Real Beauty Sketches" campaign had more than 114 million total views in its first month in early 2013 and was labeled the most viral ad release of all time.

In the Dove video, an FBI-trained sketch artist draws women who are hidden behind a curtain, first based on their own self-description, and then based on the way a stranger describes them. In each case, the picture drawn from the stranger's description is more attractive and closer to the way the participants actually look - suggesting women are too critical of their appearance and don't see their true beauty.

Two brilliantly successful marketing campaigns in the personal products market, one from a start-up focused on men and another, from an established brand, for women. Both achieved outstanding awareness thanks to ads on YouTube.

Thinking about the 4 Ps, however, what is the biggest difference between the two campaigns?

Service is another way that an organization can increase perceived value and differentiate itself from competitors offering similar or identical products. Whether it's a free massage when you sign up for personal training, a luxury car dealer offering roadside service, or a mass market retail store with greeters to help customers find what they need quickly, service enhancements are increasingly important in the mix.

Because the resources available for marketing in any organization will be limited, concentrating the company's marketing efforts on one or a few key market segments – or target marketing – is one way to use resources efficiently. Markets can be segmented in several ways:

> **GEOGRAPHIC:** Focusing on understanding the needs of customers in a particular geographical area.
> **DEMOGRAPHIC:** Focusing on the attributes of the market based upon gender, age, income, education, or other measurable factors.
> **PSYCHOGRAPHIC:** Identifying and promoting to people most likely to buy the product based on lifestyle and behaviors. This may be based on interests, fears, behaviors, or actions that can be categorized into groups, e.g., young health-conscious professionals, retired couples on fixed incomes, families with new babies, etc.

Target marketing enables you to identify, access, communicate with, and sell to those who are most likely to purchase your products.

Marketing the key function for online streaming

NETFLIX

Netflix and other online streaming services like Hulu and Amazon Prime – have threatened the business model of cable television by capitalizing on a shift in customer demand to viewing on multiple devices and focusing their efforts on marketing.

Cable subscriptions continue to decline, whereas Netflix told investors in early 2016 that it would reach the 75+ million subscribers around the world in the first quarter, and now operates in 190 countries – excluding China. According to Wall Street research firm Pacific Crest, year over year growth in cable subscriptions, in contrast, went negative for the first time in 2015.

TDG Senior Analyst Joel Espelian says the future of broadcasting is about marketing, not technology.

"Today the clearest example of this phenomenon is Netflix, which doesn't broadcast anything. Nevertheless, the marketing function of broadcasting (i.e., getting new content in front of viewers at a single point in time) is highly relevant to Netflix."

Netflix began offering original content in 2012. At the Emmy Awards for television in September 2013, its popular House of Cards won Best Director, the first television series never seen on a television channel to win an award. In 2015 the Venice Film Festival selected Netflix feature Beasts Of No Nation as a competition selection. It was a controversial choice, not because of its unflinching portrayal of a child soldier facing the horrors of war, but because Netflix launched the film via streaming video at the same time as its cinema release. Many cinemas boycotted the film, arguing for the continuation of exclusive cinema-first releases.

The traditional business model of the cable television business was built on offering a broad range of content to a high number of subscribers. However, customers who were taught by cable to expect content "on demand" now want it all the time, and everywhere – and for a better price!

Marketing Strategy

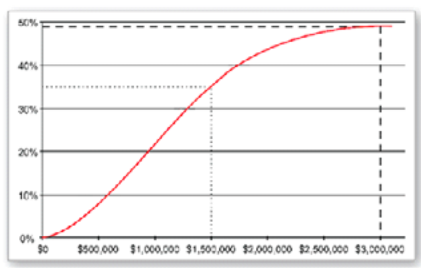
A company's marketing strategy has one goal: to deliver value to customers while making a profit. Business incorporates many trade-offs – balancing one need or demand with another – and this is the most important: delivering just enough value to the customer at a price that allows the business to meet its profit target. The profit target will depend on the type of business. Some businesses focus on selling a relatively small number of products but make a large profit on each one (aircraft engines, for example) while others focus on selling huge volume for a smaller profit on each (canned soda, for example).

Setting a marketing strategy involves identifying customer groups, or target markets, that your business can serve better than your competitors, and tailoring your product offerings, prices, distribution, promotional efforts, and services toward that particular market segment.

Ideally, the marketing strategy should address unmet customer needs that represent adequate potential size and profitability. A good marketing strategy recognizes that a business cannot be all things to all people and must analyze its market and its own capabilities in delivering value. By focusing on a target market that your business can serve best, you increase the effectiveness of marketing activities and provide a better return on the marketing budget.

CAPSIMCore

In CapsimCore Business Simulation the rate of diminishing returns applies to your promotion budget. The first $1,500,000 you invest buys 36% awareness for your product. Spending an additional $1,500,000, for a total of $3,000,000, creates 50% awareness. Therefore, the second $1,500,000 you invest buys only 14% more awareness. The investment beyond $1,500,000 yields a lower return per dollar invested compared to the initial $1,500,000. The return of your promotional dollars diminishes beyond the initial $1,500,000 and will impact your decision regarding spending beyond this amount. Investing beyond $3,000,000 in a single year is just not worth it.



Marketing strategy is most successful when the company overall has a "marketing orientation". A marketing orientation requires managers to constantly gather information about their customers' needs through research, to share that information throughout the firm, and to use it to help build long-term relationships between the organization and its customers.

After marketing program decisions are made, owners and managers need to evaluate the results of their decisions. Standards of performance need to be set so results can be evaluated against them. Sound data on industry norms and past performance provide the basis for comparisons against present performance. Owners and managers need to audit their company's performance on a periodic basis, at least quarterly.

Spending more on marketing programs is not always better. The concept of diminishing returns, or the rate of diminishing returns, states that adding additional investment beyond a certain threshold will not add proportional returns. Spending money beyond this point does not yield as much as the amount spent prior to that point.

Diminishing returns can also be associated with other aspects of business, such as hiring too many employees, or investing in plant and equipment that isn't used efficiently.

Marketing Reality

Irrespective of up or down economic cycles, today's business environment is more competitive than at any other time in recent history. To a certain extent, companies can re-engineer, restructure, and cut costs, but the heart of the business must be a sustainable and profitable business model that nurtures growth. Creating such a business model can prove to be even more difficult than creating a product itself. Many "dot bomb" businesses were able to produce a product, but unable to back it up with a profitable business model.

In such a competitive business environment, managers must have a clear understanding of customer needs and their firm's own capabilities to grow revenue within the constraints of sustainability and profitability. While evaluating various possible market alternatives, managers typically refrain from implementing revolutionary changes in their product or service offerings and instead engage in evolutionary market moves. This makes sense, as it is always easier to modify the "core engine" of a product or service offering by adding one or many "engine variants", rather than introducing a "new core engine" that might capture new markets. With limited resources at their disposal, it is imperative that managers understand the complexities of product or service "drivers" that truly reflect evolving customer needs and competitive activity, so their decisions return the most "bang for the buck."

In other words, to create, capture and maintain demand for their product and service offerings, businesses must perform a balancing act between the external environment (changing customer demands) and the internal environment (the firm's given operational challenges) to maximize growth opportunities. It requires carefully calibrating the company's responses and approach to the following issues:

AMBIGUITY – WHAT DO OUR CUSTOMERS REALLY WANT? Companies lacking a clear understanding of customer choices often take a shotgun approach, hoping that at least one of their offerings will succeed. Unfortunately, this approach is neither efficient nor profitable for most firms. Markets are often flooded with products and services that offer relatively little added value to customers and weaken the seller's bottom line.

RISK – WILL OUR ENVISIONED OFFERINGS BE SUCCESSFUL? Managers face com plex choices when deciding which product-service bundles to offer. Potential product/service drivers (e.g., price or specific product-service features) can have several variants, and managers often use experience, benchmarking analysis, or simply gut feeling to decide what will be attractive to customers. On the one hand, such "informed guessing" might spur new and innovative ideas; it might also lead to depleted profits and chaos.

CONFORMANCE – CAN WE DELIVER WHAT WE PROMISED? Although it is important for companies to understand market value drivers, they must also support customer preferences and align them with effective operations management. Even if firms succeed in identifying and delivering attractive product-service packages, their efforts may prove futile unless they can efficiently deliver on their promises under resource constraints.

In summary, the key questions to determine marketing performance include:

- Do the products and services the company is offering provide value to customers?
- Are existing and potential customers aware of the products and services available from the company?
- Is it easy for the customer to purchase what he or she wants and at a competitive price?
- Do the employees make sure the customers' needs are truly satisfied and leave them with the feeling that they would enjoy coming back?

Profits a greater challenge than marketing for online businesses

The Internet has spawned a wide range of businesses that have overcome the traditional challenge of marketing – ensuring lots of people know about what they offer – but have not overcome the critical challenge of business operations: bringing in more money than the company pays out to deliver their value proposition.

Companies we have already looked at in this text, such as Zynga and Square, have valuations in the billions but are yet to make a profit. Twitter squeaked out its first profit in 2015, but faces concerns about the slow growth in Twitter users, and the high percentage of people who sign up that eventually abandon the service.

Twitter has been outpaced in both size and growth rate by Instagram.

When Facebook paid a billion dollars for Instagram in 2012, the vastly popular photo-sharing site hadn't made a cent. It has been valued recently at $35 billion, but still wasn't making a profit in early 2016 – even though Mark Zuckerberg told investors in 2013 that Facebook would generate "a lot of profit" from Instagram. What he didn't say, at that time, was when.

In late 2013, Pinterest – the online scrapbooking site set up in 2010 – was valued at $3.8 billion. Slate.com said: "That's an impressive feat for a company without any revenue. Note: That's not no profit. That's no revenue whatsoever." By late 2015, that valuation was up to $5 billion, Pinterest had more than 70 million users and had begun to earn revenue, leveraging its loyal consumer base through sponsored content under 'promoted pins' in conjunction with big retailers and the Pinterest Shop.

Pinterest and Instagram both understand the value of information to drive new concepts in the marketplace. They and many other online businesses have Product, Place, and Promotion working for them. However, until they are successful with Price – and can bring in more than they spend – they do not have a true business model.

The Sales Forecast

How will you know how much of your product to produce if you cannot make a reasonable prediction about how much you will sell? One of the most critical aspects of marketing management is to create a sales forecast to predict how many units of a product will sell in the future.

The sales forecast process often begins by assessing how the total market will perform in a given period – one year, for example. From there, using all relevant information, you attempt to assess your performance and what market share your company will realize from that total forecast. This requires speculating on your competitors' performance as well. Forecasting sales is a challenging task due to the multiple variables involved in the process: What will the overall economic climate be like?

- Will consumers make decisions on the same basis they have in the past?
- At what level will our competitors perform?
- Will existing competitors introduce new products, and if so, when?
- Will there be new competitors, or will existing competitors drop out of the market?
- At what price can we sell our products given the many alternative product choices available?

Answering these questions provides insight for making better decisions for production schedules and allocating resources to attract new customers or retain existing customers. You will have the opportunity to practice sales forecasting and build skills in this area several times during the business simulation experience.

However, keep this in mind: What customers ***prefer*** is of interest, but what really matters is what customers ***choose!***

Chapter 2 Review Questions

1. What are the three key responsibilities of a marketing manager?
2. What are the major components of marketing research?
3. What steps should you follow to collect information for marketing research?
4. What are the 4P's?
5. What are some other important factors beyond the 4P's?
6. How can one "segment" the market? Why is segmentation important?
7. What is marketing strategy?
8. When dealing with "marketing reality," what are the three questions that need to be addressed?
9. Why would a company need to forecast sales?

3 Production: how does a business create goods and services to sell?

Learning Goals

After reading this chapter you will be able to:

- Differentiate between operations and production.
- Describe the purpose of production schedules.
- Discuss the importance of inventory control.
- Describe an economy of scale.
- Discuss the five components of supply chain management.
- Discuss why it is important to manage quality.
- Describe how to measure productivity.
- Define the accounting equation.
- Discuss the typical types of managerial accounting reports
- Describe how to calculate contribution margins and why these are valuable.

Production basics

The story so far...

We know that a business exists to make a profit by offering goods and services that satisfy customer needs in a marketplace. We know that there are many types of markets – physical and virtual. We have discovered how to define customer needs and how important it is to promote our products and to make them accessible to customers.

Now let's talk about production: creating something to sell at a cost and level of quality that allows the company to satisfy customer needs and make a profit.

Production is a process that uses resources such as cash, labor, and raw materials – to create a value proposition that is attractive to a particular market.

If "profit" is the answer to "why does a business exist?" and "marketing" holds the answers to "who does the business sell to?" then "production" is the answer to the "how, what, and when" questions about a business.

Let's begin with an overview of production management. A production process can be defined as: any activity that increases the similarity between the pattern of demand for goods and the quantity, form, and distribution of these goods to the marketplace.

Inputs to outputs

Production is the act of making products that will be traded or sold commercially based on decisions about what goods to produce, how to produce them, the costs to produce them, and how to optimize the mix of resource inputs used in their production. Production information is combined with market information such as demand to determine the quantity of products to produce and sell at an optimal price point.

A business needs a production process whether it provides products or services. The production process involves planning, procuring goods and/or expertise to produce the product or service, as well as assigning and organizing tasks to get the products or services to the market. It is important to differentiate "production" from "operations" in the business context.

> **OPERATIONS** describe the full range of management activities that enable a company to be profitable and sustainable.
> **PRODUCTION** involves the actual process of creating goods and services.

Production can take the form of mass production, where a large quantity of standard products are created in a traditional assembly line process; it can be a very specialized process with individual or small quantities of a good being created; or it might involve running the logistics necessary to deliver a service efficiently. Inputs, therefore, can be raw materials like steel and chemicals; human inputs like specialized computer programmers, designers, or engineers; and/or money, from a few thousand dollars to start a home-crafts business, to millions of dollars for sophisticated manufacturing equipment. The concepts are the same whatever the business may be.

Core functions in production management

Production management seeks to develop an efficient, relatively low-cost and high-quality production process for creating specific products and services. Good pro duction management is important if business goals, whether for manufacturing or service-oriented companies, are to be met. The profit and value of each company is determined, to some extent, by its production management process.

The primary resources that firms use for the production process include:

> **HUMAN RESOURCES:** employees and their skills as applied to the production process.
> **RAW MATERIALS:** the cost of all the goods needed to create the products or services.
> **CAPACITY:** the annual production capabilities of the facilities, technology, machinery, and equipment.

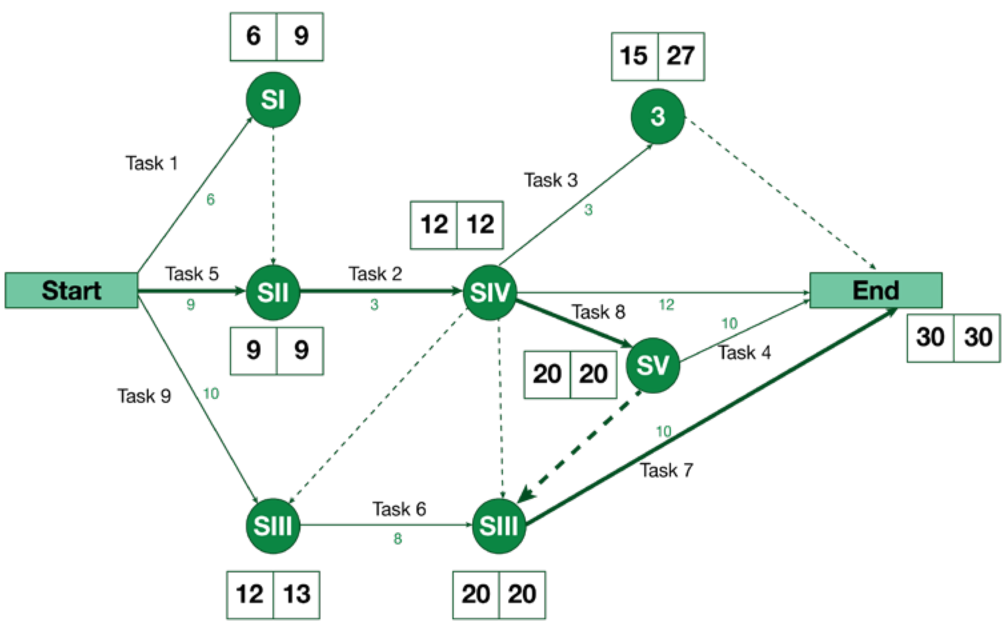
Each of these resources costs money. Employees need to be paid, materials must be purchased, and there are buildings, production facilities, and computer systems that require time and money to be maintained for ongoing production. The objective of production management is to use these resources in the most efficient manner possible. This will enable the organization to take advantage of higher production levels by producing more units at a lower cost per unit.

Whatever the business is selling, its production process is the conversion of inputs (e.g. skills and raw materials) into outputs (goods or services) as efficiently as possible. The process can include sourcing, manufacturing, storing, shipping, packaging, and more. Because it is based on a flow concept (the steps must flow in a logical order to get the product or service ready for sale) production is measured as a "rate of output per period of time."

In any manufacturing environment – and your CapsimCore Business Simulation is in the manufacturing business – it is the Production Manager who has responsibility for scheduling the production sequence, type of product to be produced, and the volume of production. The three elements of management we discussed in Chapter 1 – planning, organizing, and controlling – are clearly necessary for production management. Following are some key concepts you will need to understand, along with some of the functions performed in the production department.

Scheduling production

A ***master production schedule*** determines when the products will be produced and in what quantities. Dates must be met, specified quantities must be produced on time, and costs controlled to ensure this process goes smoothly and meets commitments. One tool to help with this process is a PERTchart. ***PERT*** stands for "Program Evaluation and Review Technique." This is a graphical representation that tracks production events and their time frames from start to finish. A PERT chart maps out the production process, which can help to identify problems before the process even begins.



Inventory control

As goods are produced, they also need to be managed. Inventory control is the process of efficiently managing those goods. It is important to have enough products to sell, but not to have too many products unnecessarily sitting in the warehouse tying up cash. An efficient inventory control system minimizes the costs associated with inventory.

Companies must manage inventory even while it is in the process of being built. This is described as work-in-process inventory, or products that are only partially completed but have required an investment of resources. Products cannot be sold until they are complete, and monitoring the status of products still involved in production is important.

Another cost directly associated with inventory is carrying cost. ***Carrying cost*** is the cost of maintaining completed products. Inventory ties up space, cash, and human resources. A popular method for reducing carrying costs is the just-in-time (JIT) inventory system. This system is based on having just enough products on hand to satisfy consumer demand. Product should always be available, without overstocking on what might be needed for the future.

The JIT system is often associated with a materials requirement planning system that ensures materials are available when needed. A ***materials requirement planning*** system or ***MRP*** helps determine when the materials to produce the product are needed to meet production deadlines. As a firm develops a forecast of the demand for its products, it determines the time at which the materials need to arrive at the production site to meet the anticipated market demand.

Economies of scale

An ***economy of scale*** occurs when the cost of each good produced decreases as the volume produced increases. This reduction in cost per unit occurs because the initial investment of capital is shared with an increasing number of units of output. Variable costs (those that change with the number of goods produced) and fixed costs (costs that do not change regardless of volume) are monitored throughout this process. As output increases, fixed costs remain the same, and variable costs on a per-unit basis decline.

Economies of scale are particularly critical in industries with high fixed costs such as manufacturing. With an initial fixed investment in machinery, one worker, or unit of production, begins to work on the machine to produce a certain number of goods. If a second worker is added to the production line, he or she can produce an additional number of goods without significantly adding to the factory's cost of operation. If the number of goods produced grows significantly faster than the plant's cost of operation, the cost of producing each additional unit is less than the unit before, and an economy of scale occurs. This is one important reason why businesses always want to grow: Growth means you can reap the efficiency rewards offered by economies of scale.

Can Tesla achieve economies of scale and keep its promise?

Electric vehicles were first popular in the late 19th and early 20th centuries – before Ford Motor Company developed the production technologies to mass produce gasoline-fueled cars with internal combustion engines. For the next century and more, gas-powered cars ruled the highways with high-volume manufacturing providing the economies of scale to make them affordable. In the late 20th century, high oil prices, environmental concerns, and advances in battery technology brought electric cars back into the mainstream.

Most traditional car companies, including Ford, GM, BMW, Toyota, Honda, and Nissan, have released electric or electric/gasoline hybrid cars. By 2013, however, it was an automotive start-up, Tesla Motors from California, not only winning all the awards but also proving it had a profitable model for electric cars that might challenge the traditional car companies. Tesla opened a "new" market segment: luxury electric cars, with a longer battery life and range of up to 300 miles (480 kilometers), designed for discerning motorists and sold not through dealerships but their own, branded stores. It wasn't offering the battery version of a gas-powered car with fewer extras, but a new sought-after trend in upscale motoring.

When Tesla made its first profit in 2013, CEO Elon Musk said his company's goal had always been to mass-produce fully electric cars at a price affordable to the average consumer, and would do it "within five years." Musk was standing by his product life-cyle strategy – entering at the high end where customers will pay more, then driving down costs and building volume.

Developments in Tesla's favor include improving battery technology and range which will lower costs; parts vendors demonstrating they can revamp their own production and reduce the cost of parts; as well as more efficient manufacturing – the company says it is steadily cutting the number of worker hours necessary to build each car, and it is fast expanding capacity, pumping money into a Gigafactory and additional production capacity.

The major car makers, however, are not sitting by while Tesla muscles into their space – battery technology is replicable, and these brands already have experience in mass manufacturing. Perhaps Tesla's biggest advantage is the incredibly strong support it enjoys from its investors. By mid-2015 Tesla's market cap was $33 billion with sales of around 55,000 cars that year. GM's market cap was $58 billion, less than twice Tesla's, and it sold 10 million cars. As 247wallst.com said, "something is wrong with this picture."

Forbes called Tesla's share price "a cult-like valuation", and critics suggest that without generous U.S. Government loans and subsidies the company will not survive. However, 2020 has seen Tesla's share prices rise at breathless speed. Trading Economics reported that Tesla has achieved the $500-billion mark with its shares soaring 547% this year. According to reports by Bloomberg, Tesla's shares have touched an all-time high of $543.17.

Supply chain management

The collection of partners – manufacturer, wholesaler, distributor, retailer, on-line sales site – is referred to as the "supply chain." Efforts to improve the relationship between a company and its suppliers are referred to as ***supply chain management (SCM).*** The objective of SCM is to manage the connections between different businesses in the supply chain to enhance efficiencies and reduce costs.

Supply chain management involves these five basic components:

PLAN: The strategic plan to manage all the resources needed to meet customer demand for your product or service

SOURCE: The selection of the supplies that will deliver goods and services (e.g., suppliers that can offer parts faster and/or cheaper)

MAKE: The manufacturing step involving scheduling, testing, packaging, and preparing for delivery

DELIVER: The logistics and timing of getting products and/or services through the relevant channels to the customer

RETURN: The "soft" link in the chain that supports customers who are returning products or have had problems with their product/service experience.

Everyday life – economies of scale

You are setting up a small business in your local area and need a business card. The cost to print 50 business cards is $25, which is 50 cents per card. However, if you were to place an order for 500 business cards, the total cost is $50, reducing the cost to 10 cents per card. The more business cards printed in each print "run," the lower the cost per individual business card. The cost for the printing company is in setting the job up; the small additional cost in ink and paper to run a larger print run is marginal, so the cost per unit comes down.

Quality control and Total Quality Management

Quality is the degree to which a product or service meets the company's internal or external standards ***and*** satisfies customer expectations. Quality control is the process of testing to ensure the product or service meets the organization's standards before it is sold. Techniques to monitor quality may include sampling, monitoring customer/user complaints, and planning to correct deficiencies.

National or international authorities often set standards in business. The International Organization for Standardization (ISO), founded in 1947 and made up of representatives from many national standards organizations, is one such authority that sets international quality standards. The ISO 9000 family of standards was designed to help organizations ensure they can meet the needs of customers and other stakeholders. The ISO 9000 standards are focused on a company's quality management systems. Certification requires a company to meet all requirements and pass a series of audits from independent certifiers. The benefits of compliance include internal management efficiencies – quantified by substantial research – and access to new business from companies that will work only with ISO-certified suppliers.

Companies are often required to adhere to standards set by national agencies or industry associations. In the United States, for example, standards agencies include the Food and Drug Administration (FDA) and the Consumer Products Safety Council (CPSC). The standards imposed by these entities affect design, performance, durability, safety, and many other attributes relating to performance and function. Quality is also used as a competitive advantage to provide "perceived excellence" compared with other choices in the market.

Several techniques are used to improve quality within an organization. ***Quality Circles*** are small groups of employees who meet regularly to attempt to identify and solve problems involved in quality improvement. A more formalized process is the concept of ***Total Quality Management (TQM).***

Total Quality Management is the process of monitoring and improving the quality of products and services produced. This concept is primarily based on the work of W. Edwards Deming, an American statistician, professor, author, lecturer, and consultant. He is perhaps best known for his work in Japan. Beginning in 1950, Deming taught top management in Japan how to improve design and service, product quality, testing, and sales through the application of statistics and other methodologies. Deming offered 14 key principles to managers for transforming business effectiveness in his book ***Out of the Crisis.*** Although Deming does not use the term in his book, Deming is credited with launching the Total Quality Management movement. His work followed these objectives:

- To provide managers and other employees with the education and training necessary to excel in their jobs
- To encourage employees to take responsibility and to provide leadership
- To encourage all employees to search to improve the production process

Whispers from the supply chain suggest a bullwhip

Apple Inc. is well known for extreme secrecy – particularly around new product offerings – but the company's silence creates an information vacuum that rumors race to fill. And Apple rumors are extremely popular on news websites, blogs, and in the general consumer and tech media.

A major source of information is Apple's supply chain – the many manufacturers that feed product components into the devices the world loves to buy.

A month after Apple released its new high-end 5S iPhone and lower end 5C iPhone in 2013, suggestions that the 5C was not selling as well as projected came from the supply chain. According to the Wall Street Journal, Taiwan-based iPhone manufacturers Pegatron and Foxconn both reported a cut in orders for the 5C. Retailers were reporting a much large inventory of 5C phones than 5S and some were cutting prices.

The lower than expected customer demand may have caused a "bullwhip effect" in the Apple supply chain. The bullwhip effect occurs when a change in customer demand for a product causes an increasingly large effect on suppliers the further along the supply chain it moves. Whereas Pegatron's order for the 5C phone was reportedly cut by 20% and Foxconn's order by around 33%, "a component supplier was notified that the order for iPhone 5C parts would be cut by 50%, a source said." Apple discontinued the 5C iPhone in 2015.

Information from the supply chain also suggested that Apple would revamp its device displays with new technology in 2014. NPD DisplaySearch, a company that provides analysis of the supply chain for computer displays, released data to suggest Apple "intends to count on display technology for new product innovation".

The information was based in part on the way Apple had approached various suppliers regarding samples and testing. A DisplaySearch analyst described the company's research method, which is to track "the broadest bits of information throughout the supply chain and evaluate them .. to see what can be weeded out so what is left is detailed, and hopefully, accurate indications of what is happening from a manufacturing and production standpoint."

In 2020, Apple's Iphone X was the company's first OLED phone.

Many firms create teams of employees to assess quality and to offer suggestions for improvement. This creates a form of cross-functional teamwork in which employees with different jobs, responsibilities, and perspectives work together to improve the production process through enhanced quality.

Benchmarking

The process called ***benchmarking*** is another quality improvement technique. Benchmarking describes a method of evaluating performance by comparing it with another specified level achieved by another entity. Often, benchmarking involves studying highly successful companies in other industries. For example, Ford Motor Company in the US studied and used the customer service performance levels of the American clothing company Eddie Bauer to improve its customer relations process. Benchmarking may also be used in conjunction with a TQM process.

Technology

Many production processes have been automated, and robotics has become a significant factor in manufacturing throughout the world. Machines and robotic equipment reduce the labor required in the production process. Good planning is required to make certain that the automation process, often requiring a substantial up-front investment in equipment, accomplishes the desired goals. This involves a thorough assessment of the required costs, savings, and benefits that may be realized, and the degree of "fit" within the organization and production process.

In the simulation, similarly to real life, automation is expensive and as you raise automation levels, it becomes more difficult for new product designs to be quickly created and produced. This effect mimics the difference in flexibility between a human laborer and a machine that needs to be retooled and reprogrammed to change what it produces. However, increasing automation always carries the benefit of decreasing the labor costs associated with production.

Improving Productivity

Productivity is the ratio of output to inputs in production and is a measure of the efficiency of production. A common measure of productivity is dollars of output per hour worked. Production faces the standard challenges of increasing labor, material, and opportunity costs. It also must address the impact of uncertain world events, technological change, and the global labor market.

Interrelationship between production and accounting

Accounting, as we discussed in Chapter 1, is the process that tracks, summarizes, and analyzes a company's financial position. Accounting provides information in a standard format so that stakeholders have a consistent frame of reference for assessing the company's financial health. Recall that we discussed two types of accounting.

FINANCIAL ACCOUNTING produces three key financial reports (the balance sheet, income statement, and cash flow statement). These three reports ensure that external stakeholders can access the information they need. External stakeholders might include investors and bankers; stockbrokers and financial analysts who offer investment assistance; suppliers; labor unions; customers; local, state, and federal governments; and governments of foreign countries in which the company does business.

MANAGERIAL ACCOUNTING provides vital information about a company to internal users. Because it is for internal use, it does not have to conform to the restrictions of outside regulation and can be expressed in whatever way is most useful for managers. Information can be reported in dollars, units, hours worked, products manufactured, numbers of defective products, or the quantity of contracts signed. The overall purpose of this information is to enable managers to make more informed and effective decisions.

There is another key difference between financial accounting and management ac counting – financial accounting is always historical; it records past transactions in and through the company. Managerial accounting, however, is often forward-looking, using historical information to predict future outcomes and set expectations. For example, the reports a management accountant produces might forecast revenues, predict costs of planned activities, budget the amount of money the company will spend on various activities, and provide analysis based on that information. By describing how alternative actions might affect the company's profit and solvency, the information and analysis helps managers plan for the future.

Because managerial accounting pertains specifically to improving internal decision making, it has special relevance to a company's production-related activities. So, it is important to introduce you to some basic accounting concepts related to managerial accounting. We will look carefully at the reports related to financial accounting (balance sheet, income statement, and cash flow) in Chapters 4 and 5.

The Accounting Equation and Managerial Accounting

Two key elements of the production function that you will practice in CapsimCore are increasing and reducing the capacity of production lines based on the sales fore casts for various products, and maintaining or increasing automation based on the technological advancement of products and how quickly the company can get them to market. The production department, therefore, builds up assets (production equipment) and accrues liabilities (loans to buy the equipment).

In reality, a production department is doing much more than simply dealing with assets and liabilities. It is managing staff, equipment, productivity, quality control, software, and so forth, but all the accounting department of the company is interested in is the way all those activities can be distilled into numbers that conform to accounting rules.

The Accounting Equation – which can be applied to every business – is:

Assets = Liabilities + Equity

In a corporation, "equity" means the money the owners have invested in it. As the accounting equation dictates, the equity must always be equal to the value of the company's assets, minus the value of its liabilities.

Everyday life: the accounting equation.

You accidentally spill a complete can of soda onto your laptop – a disaster because you are in the middle of a busy semester and need your computer! Luckily you have everything backed up in the cloud. Someone offers you an almost-new computer – just the model you want – for $1,200 in cash. But you don't have the cash on hand. A good friend is willing to lend you $500, so you use that, plus $700 from your own savings, and buy the computer. In terms of the accounting equation, your assets are now $1,200: your liabilities $500 and your equity $700.

$1,200 (assets) =
$500 (liabilities) + $700 (equity)

Companies typically use managerial accounting reports that fall into two broad categories:

BUDGET REPORTS: Budgeting is the process of quantifying managers' plans and showing the impact of these plans on the company's operating activities (remember, the goal of operations is to make a profit.) Managers present this information in a budget (a "forecast"). Once the planned activities have occurred, managers can evaluate the results of the operating activities against the budget to make sure that the actual operations of the various parts of the company achieved the goals established in the plans. For example, a company might report a budget showing how many units of product it plans to sell during the first three months of the year. When actual sales have been made, managers will compare the results of these sales with the budget to determine if their forecasts were "on target" and, if not, they will investigate the discrepancy. Budgets are powerful planning and control devices.

COST ANALYSIS REPORTS: Cost analysis is the process of defining the costs of specific products or activities within a company. A manager will use a cost analysis to decide whether to stop or to continue making a specific product. The cost analysis shows a product's contribution to profitability at different levels of sales. Assigning (or defining) costs to products and activities is a complex activity. Every decision maker in the company must be familiar with the way relevant costs are assigned in order to make appropriate decisions. Consistency in this reporting process is critical to ensure the information is accurate and understood by a company's various decision makers.

Management accounting reports, therefore, are produced to help managers monitor and evaluate the company's operations, in order to determine whether its planned goals are being achieved. They can also highlight specific "variances," or differences from plans, indicating where corrections to operations can be made if necessary.

Contribution Margin- a key to profitability

Contribution margin is the amount of money left over from the sale of your product after you have paid all the costs of producing that product. This money "contributes" to the running of the business.

Contribution margin = Price – Variable costs

Calculating the contribution margin from each product line a company produces is a critical element of cost analysis. In CapsimCore Business Simulation, contribution margin is one of the key indicators for success in your business, demonstrating how important this managerial accounting calculation is to your company's success.

3D printers changing the production paradigm?

3D printers use additive manufacturing techniques in which products are built up from a digital plan rather than pieced together as in traditional manufacturing.

Many companies, including General Electric, Lockheed Martin, Airbus, and Siemens, that traditionally incorporate mass production throughout their operations, incorporate 3D printer manufacturing techniques.

3D printing makes mass customization possible, a valuable benefit in areas like health care where patients are individuals. For example, 3D Systems, a market leader in 3D printing, makes individual hearing-aid shells from scans of patients' ears, and transparent plastic "aligners" to progressively straighten teeth using molds from a patient's mouth. The disadvantages of additive manufacturing include the high price of many materials used for printing (from light-sensitive liquids to metallic powders) and the time it takes to produce individual items.

The advantages, however, as Richard A. D'Aveni suggests in the Harvard Business Review, may "change the world". "Industrial 3-D printing is at a tipping point," he said, "about to go mainstream in a big way." Additive manufacturing allows for local or on-site manufacturing, reducing the value of centrally located plants offering mass production, and economies of scale. The higher cost per unit at a local 3D plant may be offset by lower transport costs. Printing on demand means inventory can be carefully managed. Repair shops can produce spare parts on-site.

D'Aveni says: "McKinsey recently reported that 3-D printing is "ready to emerge from its niche status and become a viable alternative to conventional manufacturing processes in an increasing number of applications." According to the Market Research report published in January 2020 as well as Fortune Business Insights, the market size for global 3D printing stood at $8.58 billion in 2018 and is expected to grow to $51.77 billion by the year 2026 with a compound annual growth rate (CAGR) of 25.8%. Presently, at 38%, the U.S. holds the highest market share in the global industry of 3D printing. A research report "U.S. 3D Printing Market Outlook 2020" by MarketResearch.com anticipates the U.S. 3D printing industry to value $17.2 billion in the forecast period of 2016–2020.

The equation above can help you work out how you might manipulate the contribution margin, by increasing or reducing the price and the variable costs of your products. When we say "costs" – as discussed earlier – we usually refer to either variable costs or to fixed costs. Costs that differ depending on how many products you produce (e.g., if you are producing a lot, you'll need more raw material and more labor so your costs will be higher) are called "variable" costs. Costs that don't change no matter how much you produce (whether you build one product or a million products you'll still have to pay the rent, the Corporate Office expenses, and other bills) are called "fixed" costs. The contribution margin represents the amount of money that is left over after your products have been made and sold, to contribute to paying your fixed costs. The higher the contribution margin, the more profitable the business can be.

Actively monitoring the contribution margins of your various products will helps ensure your CapsimCore company is profitable and competitive. In the simulation, there are several ways to improve your contribution margin, but each comes with trade-offs. For example, you can:

RAISE PRICES: But fewer people will purchase at a higher price.
LOWER MATERIAL COSTS: This may make your product less attractive because it would need to be bigger, slower, or less reliable.
REDUCE LABOR COSTS: Increasing automation will cost money and can increase the length of time needed to update your products.

Chapter 3 Review Questions

Production basics

1. What is the difference between production and operations?
2. What are the primary resources used in the production process?
3. What does "economies of scale" mean, and why is that concept relevant in the production process?
4. What benefits does TQM offer an organization?
5. What does benchmarking accomplish?
6. How does supply chain management impact the production process?
7. What are the potential benefits of effectively managing quality control?

Linking Production to Accounting

8. Who relies on accounting information?
9. What is the accounting equation?
10. What is cost analysis?
11. What are some ways to increase your contribution margin?

4 Accounting: how do we keep track of the money?

Learning Goals

After reading this chapter you will be able to:

- Describe the three categories of cash in a cash flow statement.
- Discuss the types of activities that add or subtract cash flow from operating activities.
- Define working capital and the working capital cycle.
- Discuss the importance of managing the working capital cycle.
- Differentiate between production cycle, accounts payable lags, and accounts receivable lags.
- Calculate accounts receivable.
- Discuss the importance of a credit policy for a company's cash flow.
- Discuss the importance of managing inventory for a company's cash flow.
- Calculate inventory turnover rates, inventory turnover days, and ideal inventory.
- Describe the kind of information found on a company's income statement

Accounting basics

Cash is King

We have discussed why we use accounting – to summarize and report on a company's financial position – and the difference between Managerial Accounting (to provide information for internal stakeholders) and Financial Accounting (to provide information for external stakeholders).

In practice, there are three key financial statements that provide financial accounting information about a company: Cash Flow Statements, Income Statements and Balance Sheets. Together they provide information managers can use to make better decisions in all areas. Analyzing your competitors' financial statements will provide intelligence on their operation;the better you know your competition, the better prepared you are to compete. In this chapter we focus on cash flow statements and income statements. In Chapter 5, we turn to balance sheets.

We know that one goal of business is to make a profit – it's a critical point that has been made several times. Here is another critical point: ***Profit does not equal cash.*** Profit, as discussed in Chapter 1, is the difference between what it costs to make and sell a product and what the customer pays for it. Profit does not equal cash for several reasons.

First, cash is moving in and out of the business constantly and depends a lot on timing: When did you pay your suppliers? Have your customers paid you yet? When is the interest payment due on your loans? How much money is tied up in products you haven't sold yet?

Second, the numbers on the income statement (the accounting statement that shows whether you are making a profit) are entered according to standard accounting rules in order to maintain consistency, not necessarily to reflect the reality of where the cash in the business is tied up at any given point.

Third, because of the above, it is possible for a company to be showing a profit on its income statement but to become bankrupt because it has completely run out of cash to keep the operation running.

To really understand it all, we will start with the Cash Flow Statement because that's your go-to statement to ensure you have the cash to operate your business in every round of the simulation.

CAPSIMCore

If cash is king, what happens when you spend it all?

When a company is out of cash to continue its day-to-day operations, the company is bankrupt. In your CapsimCore Business Simulation – if you make a few poor decisions – you could find yourself bankrupt at some stage. In the spirit of "all experience is good experience", it's certainly better to learn the hard lessons of running out of cash in a simulation rather than in the real world! If we let you go bankrupt and drop out of the game, however, you lose the opportunity to learn a hundred other useful lessons about business.

So, if you go bankrupt, we save you with an emergency loan. If your company be comes insolvent, the loan will kick in immediately to allow you to continue your operations. That's the good news. The bad news is that the money comes at a very high interest rate: 7.5% above your cur rent short-term debt rate. There will still be some pain, but you will be able to stay in the game and turn your company around.

The Cash Flow Statement

It is important to keep track of the cash moving through your business so you can be sure that you'll have enough to continue to run the company's operations. It is the Cash Flow Statement that identifies how much cash is available for use in a given period. Good business managers update their Cash Flow Statements regularly to keep a consistent eye on their available cash reserves.

The Cash Flow Statement records how your cash position has changed between the present and the last period you measured. In general, financial accounting reports strive for consistency, based on standards or guidelines. For example, the International Accounting Standards Committee works to unify accounting rules around the world, as many countries have their own accounting standards and associated agencies. In the United States, for example, it is the Finance and Accounting Standards Board, or FASB, which sets the GAAP rules.

Underlying Principles in Accounting – Rules that Keep the Information Manageable

To understand the financial reports, we need to understand two of the basic principles that underpin the rules of accounting.

The reports you'll work with during your business simulation adhere to GAAP (Generally Accepted Accounting Principles). GAAP accounting is a set of rules used to generate financial reports. These rules look back at a given time period, typically one year, and are used to produce reports based on the principles of Historical Cost Accrual Accounting. These principles have two key elements: Historical Cost, and the Matching Principle.

Historical Cost requires the company to record the original price paid for an asset, and then to write off part of the value of that asset each year according to a fixed schedule of depreciation. For example, if a company buys a laptop computer for $2,000, the company will list the laptop as an asset worth $2,000. The next year, the company reports a lower value for the same laptop. That's the way the financial records describe the fact that the laptop – like most assets the company owns – is getting older and wearing out.

If the depreciation schedule is a straight five years (i.e., 20% per year), a $2,000 laptop will be reported as worth $1,600 the following year, and $1,200 the year after that.

The Matching Principle says a business must match all revenue to the costs associated with generating that revenue, at the same time. At the time you sell a product, you put into your books the cost of the materials and labor required to produce it.

It does not matter if you bought the materials some time before the product was sold, or that you've already paid your workers for their labor: You can only report the cost of those inputs at the time you make the sale. This is important because it helps you to match up what you earn from a product, or from a service, with what you spent. That way, you can figure out if you are making a profit.

Accounting helps keep track of a business's finances, but it doesn't represent exactly what is happening day-to-day. If the numbers tried to perfectly represent reality, they would be messy, unmanageable, and inconsistent. The accounting rules are simply the accepted, legal way of capturing all the action in a business in an orderly fashion.

Under FASB guidelines, there are three categories of cash in a Cash Flow Statement. The statement shows:

CASH FROM OPERATING ACTIVITIES: your day-to-day business activities.

CASH FROM INVESTING ACTIVITIES: e.g,, selling or buying plant and equipment.

CASH FROM FINANCING ACTIVITIES: from stock transactions, loan repayments etc.

Let's take each of these cash categories one at a time.

Cash from Operating Activities

Cash from Operating Activities traces money from the sale of a company's goods and services. To get a number for Cash from Operating Activities, you start with your ***Net Profit*** and then adjust it by eliminating everything that does not represent cash.

First you subtract non-cash items like Depreciation. Put simply, Depreciation is a reduction in the value of an asset over the passage of time. Depreciation is a consistent way of expressing wear and tear on the things the company owns.

The next step in calculating Cash from Operating Activities is to look at changes (be tween reporting periods) in the Assets and Liabilities that impact cash flow, -- accounts such as Inventory or Accounts Payable. The up or down change in these accounts is recorded in the Cash Flow Statement as either a use of cash (which means your cash goes down), or a source of cash (in which case your cash goes up).

For example, if your last Cash Flow Statement identified $100,000 in inventory, and today you have $125,000 in inventory, that's an additional $25,000 in cash tied up in inventory. That change is what is recorded on the Cash Flow Statement – negative $25,000 in cash, because you are using more cash than last year..

Similarly, if your Accounts Payable last period was $100,000 and this period it is $125,000, that's $25,000 more in cash this period over last period. The Cash Flow Statement records a positive $25,000, or a positive use of cash.

So, once your Net Profit is adjusted for non-cash items like Depreciation, and for changes in Assets and Liabilities in areas such as Inventory and Accounts Payable, you get Net Cash from Operations.

Cash from Investing Activities

The second category of cash is Cash Flow from Investing Activities. The Cash Flow Statement calculates the difference between what you spent or received due to investment activities that occurred between the last statement and this statement. Investments include things like the purchase or sale of land and buildings, or plant and equipment. Whether those investments provided cash or used up cash, the difference is totaled to give you ***Net Cash from Investing Activities.***

Cash from Financing Activities

The third category tells you what cash came in and what went out via financing activities. That includes both short-term borrowing/lending such as loans from the bank or loans to other parties, as well as long-term investing such as stock transactions and the purchase or retirement of bonds. The change in your overall cash position – based on the three categories of cash above gives your Change in Cash position, which can be either negative or positive.

In CapsimCore, your financial statements are updated for every decision you make. You'll find the amount of cash available for operating your business right now on the last line of your Cash Flow – Closing Cash Position.

The following table describes the cash flow activity and how each of these entries may result in cash coming into the business, or cash flowing out of the business.

Cash Flow Activity

	Cash Flow In *Positive Cash Flow: Bringing cash in*	**Cash Flow Out** *Negative Cash Flow: Taking cash out*
Cash Flows from Operating Activities		
Net Income (Loss)	Net income was higher than the previous period.	Net income was lower than the previous period.
Depreciation	Adds back to net income a deduction made in the income statement that was not a cash expense.	Does not apply.
Accounts Payable	Accounts payable was greater compared to the previous period.	Accounts payable was less compared to the previous period.
Inventory	Inventory levels were less than the previous period.	Inventory levels were greater than before.
Accounts Receivable	Accounts receivable was less compared to the previous period.	Accounts receivable was greater compared to the previous period.

Now that we have discussed the three categories of cash found on Cash Flow Statements and outlined the types of activities that add or subtract from a company's overall cash flow, let's take a closer look at factors that specifically influence Cash from Operating Activities. We will discuss the factors that influence Cash from Investing Activities and Cash from Financing Activities in Chapter 5.

Cash and the Working Capital Cycle

A company turns cash into products or services, and then turns these back into cash through sales. At any time, a company will have bills to pay (accounts payable) and customers who owe money (accounts receivable). And while the cash is flowing in and out of the business, managers must ensure there is enough available cash at any time so the business can continue to operate and to meet its obligations. ***Working capital*** is the cash that is available to run day-to-day business operations.

Working capital management is concerned with day-to-day operations rather than with long-term business decisions. In general, long-term financing needs – such as buying a new plant – are best met through long-term sources of capital such as retained earnings, sale of stock, and the sale of long-term debt obligations (bonds). Working capital management policies address short-term problems and opportunities – "short term" meaning issues that generally occur within one year.

At its core, working capital management requires that business leaders effectively manage what is known as the "working capital cycle." The working capital cycle – also called the cash flow cycle – is a concept based on the time cash is tied up (in raw materials, for example) and therefore unavailable for other uses by the business.

Effectively managing working capital involves overseeing the working capital cycle to get the time lag between accounts payable and account receivable down to a minimum. This requires attention to a company's accounts receivable, inventories, accounts payable, and short-term bank loans. We will look at these one by one.

Working Capital Cycle: The Importance of Time and Timing

The working capital cycle includes all the activity that occurs between the time cash is spent producing a product and the time that payment is made on the product's sale. Therefore, the first step in the working capital cycle is when the company orders and receives the raw material, generating an '"account payable". The final step is when you receive the money owed to you from the sale of the product on credit – when the "account receivable" is paid off.

The working capital cycle is ***the length of time between the payment of the payables and the collection of receivables.*** During the cycle, some of the company's funds are unavailable for other purposes. Short-term financing may be needed to sustain business activities during the cycle, and because there is always a cost to such financing – interest to be paid, for example – a goal of any business should be to minimize the cycle time.

To achieve that goal, three terms must be clearly understood:

> **PRODUCTION CYCLE** refers to the length of time from the purchase of raw materials, through the production of the goods or service, and to the sale of the finished product
>
> **ACCOUNTS PAYABLE (A/P) LAG** is the time between the purchase of raw materials on credit and the cash payments made for the resulting accounts payable.
>
> **ACCOUNTS RECEIVABLE (A/R) LAG** is the time between the sale of the final product on credit and collection of cash payments for the accounts receivable.

Let's look at examples with different payable and receivable time lags. In both examples, assume it takes 40 days after an order is received to process the raw material into finished product – this means the production cycle is 40 days.

> **30-DAY A/P LAG:** In one example, the accounts payable lag is 30 days, and the receivables lag is 45 days. Your company receives the materials and starts to process them. Within 30 days after receiving the material, you have to pay your supplier (A/P lag); 40 days after receiving the material, you have inventory to sell. For 10 days, then, your cash is tied up in inventory that is not available for sale. If you deliver it to your customer on the 14th day of the production cycle, your customer has 45 more days to pay for it. On that day, your cash has been tied up in inventory for a total of 55 days (10 days before inventory was ready for sale and 45 days after).

> **45-DAY A/P LAG:** A second example has the accounts payable lag at 45 days, and the receivables lag at 30 days. Your company receives the materials and starts to process them. Within 40 days after receiving the material, you have inventory to sell. Within 45 days after receiving the material, you have to pay your supplier (A/P lag), For 5 days, you have inventory

available for sale with none of your own cash tied up. If you deliver it to your customer on the 40th day of the production cycle, your customer has 30 more days to pay for it. On that day, your cash has been tied up in inventory for only a total of 25 days. (You didn't have to pay your supplier for 5 of the 30 days after delivery).

To recap, the working capital cycle represents the time in which working capital is "tied up." If business managers can shorten the cycle, there will be less need for external financing, which means smaller interest payments and higher profits.

Managing Accounts Receivable and Accounts Payable

We have seen how A/P and A/R lags can affect cash flow and that there is a need for a policy that balances the company's need for readily available cash, the need to offer credit to customers, and the need to pay suppliers.

One way a business can attract customers and increase sales is to "sell on credit'" – to allow the customer to have the product before paying for it. However, there are costs to extending credit. Selling product without receiving cash generates an account receivable. You are "loaning" your customer the money to buy your product. Normally, a loan generates some value, usually an interest payment. An account receivable "loan" usually generates value through increased sales, not a cash interest payment. The total dollar amount of receivables is cash that is "tied up" and thus unavailable for other uses. This amount is determined by the volume of sales and the average length of time be tween a sale and receipt of the full cash payment:

Accounts Receivable = Credit sales per day x Length of collection period

For example, if a business has credit sales of $1,000 per day and allows 20 days for payment, it has a total of $1,000 x 20 or $20,000 invested in receivables at any given time. Any changes in the volume of sales or the length of the collection period will change the receivable position.

A ***credit policy*** refers to the decisions made about how to grant, monitor, and collect the cash for outstanding accounts receivable. Four factors must be considered in establishing an effective credit policy:

1. Creditworthiness standards – Can your customers pay you back?
2. Credit period – How long do they have to pay?
3. Collection policy – What will you do if they do not pay?
4. Early payment discount - Do you give them a discount if they pay early?

Purchasing equipment and raw materials represents a large portion of total operating expenses. A small manufacturing firm may spend in excess of 70% of total sales purchasing raw materials and converting them into finished goods (Cost of Goods Sold or COGS is 70% of sales, and gross margin is 30%). In this type of business, accounts payable become an important source of financing in the short term. In essence, you are borrowing the use of the materials from your suppliers to create products. When you sell the products, you will have the required cash to pay back your suppliers.

As we covered earlier, however, the amount of time you can use the materials "on credit" is the A/P lag. As your A/P gets larger, your suppliers become reluctant to provide more materials and, if you don't have materials, you can't produce products. Managing prompt payments of accounts and keeping repayment cycles as short as possible make the company an attractive customer.

Managing Inventory

Because a company's profitability depends on its ability to sell its products, it must have enough inventory to meet demand. So, the same important question we discussed in the marketing section (Chapter 2) remains – how much inventory is needed? The answer begins with the sales forecast, but because the sales forecast depends on many factors outside the control of a business, inventory management is challenging. Less inventory than what is needed will cost the company in lost sales. Holding inventory in excess of what is needed will also cost the company because of storage and insurance costs. In addition, as we discussed earlier, holding inventory ties up cash so that it cannot be used for other purposes. So, we need sufficient inventory to cover our expected sales, but we may also want to prepare for potential sales increases by holding some level of "safety stock." The amount of safety stock is determined by comparing the cost of maintaining the additional inventory to the cost of potential sales losses due to not having adequate levels of inventory.

The following ratios are used to determine the optimal amount of each product to keep in inventory:

Inventory Turnover Rate = Cost of goods sold / Inventory

Inventory Turnover Days = Number of days in a period / Inventory turnover rate

Ideal Inventory = Cost of goods sold/ Industry average turnover rate

For example, last year your business sold goods that cost $100,000, and your average inventory for the year was worth $10,000. The inventory turnover rate for last year was $100,000/$10,000, or 10 times.The company's inventory turnover days were 360 days/10, or 36 days. These numbers indicate that during the past year, your inventory turned over 10 times and, on average, it took 36 days to sell the entire inventory. When compared with industry averages, the relative strength of your inventory management can be revealed. A low inventory turnover rate could indicate overstocking, whereas high inventory turnover days can represent slow sales.

If the average industry turnover rate is 12 times, the ideal inventory levels for your company for the year should have been $100,000 / 12 = $8,333.

This figure may be used as a guideline for determining inventory levels during the current year.

The total costs associated with inventory include the time value of capital tied up in inventories, storage and handling expenses, and insurance, taxes, and costs relating to unsold inventory. These costs are generally referred to as the inventory carrying costs. These carrying costs increase as inventory levels rise.

CAPSIMCore

One of the major reasons CapsimCore companies go bankrupt (and receive an emergency loan) is because the company is holding too much inventory. Sales forecasts were not met and the company's warehouse is full of stock that is tying up cash – leaving nothing left to run daily operations. Pay close attention to honing your forecasting skills and improving them with every round of the simulation as you become more comfortable with the calculations and more attuned to your competitors' strategies.

The Income Statement

The Income Statement records all the company's revenues and expenses, compares them, and calculates the difference between them. The difference between your revenues and expenses is your profit – or loss – for the period. If you want to know whether a business is making a profit on its goods and services, simply look at the Income Statement, also called a Profit and Loss Statement.

One way to think of the Income Statement is as a movie of what's happening in the business. It shows all the activities related to getting your products and services into your customers' hands – from the purchase of raw materials all the way through to delivery.

Here's how a traditional income statement is organized:

The first line is your total sales for the period, or net sales/revenue. It's net revenue because it reports how much the company has received after discounts or other allowances you gave your customers have been deducted from the total (gross) sales number.

From that number, net revenue, we deduct the ***Cost of Goods Sold*** (COGS). The Cost of Goods Sold is just as it sounds – a tally of all the costs associated with the production of the goods and services you provide. That number gives us a Gross Profit, which is also called Gross Margin.

Gross Margin is simply the Net Sales minus all of the direct costs of making your products or services – costs that include materials and labor plus depreciation on the plant and equipment you use.

Moving down the Income Statement we get to ***Selling and General Administration Expenses*** or ***SG&A***. That accounts for all the administrative costs of doing business such as marketing, salaries for your staff at head- quarters, insurance policies, legal advice, and more.

The next line, ***Non-Operating Items***, includes miscellaneous expenses that must be accounted for but are not part of the company's regular business activities. Let's say, for example, a computer company sells a building it doesn't need. The profit or loss from the sale is recorded in this section so it does not distort the picture we're building of the core operations of the business.

Once all the expenses and Non-Operating Items have been accounted for, we get down to ***Earnings Before Interest and Tax***, or ***EBIT***. What comes next is the ***Interest*** we paid our lenders on money borrowed, and the ***Taxes*** we pay various governments for the privilege of doing business.

After those two final costs are deducted, we get to ***Net Profit*** (also called earnings).

Your CapsimCore Income Statement

In the Simulation, we use a variation of the traditional Income Statement that allows you to calculate a Contribution Margin rather than a Gross Margin for each of your products. As we discussed in Chapter 3, Contribution Margin is calculated by deducting Variable costs from Sales.

As explained earlier, a business has two classes of expenses – Period or Fixed costs, and Variable costs.

Variable costs vary with sales volume in the business – with the number of goods or services you sell. Take material costs, for example If you're selling more products, you are spending more on materials to make the products. Or look at labor. If you're making more products, you are spending more on labor either by increasing the size of your workforce or by paying your existing workers overtime.

Fixed costs, however, stay the same -- within a fairly large range -- no matter how much or little operational activity takes place during the year. They are fixed for that period.

These costs are often called your "overhead." Fixed Costs include research and development, interest payments and depreciation, and office expenses like rent and electricity. Whether you sell one product or a thousand products, the fixed costs still have to be paid.

In a traditional Income Statement, as we discussed, we would deduct all the Fixed and Variable Costs from the Net Revenue to give a Gross Margin. In a Period and Variable Costs Income Statement, we first deduct just the Variable Costs to give a Contribution Margin, and then we deduct the Fixed Costs. By calculating the Contribution Margin, you discover how much income from each product line is left over after production costs are taken out to contribute to your fixed costs.

In your CapsimCore Income Statement, under each product name the first line is Sales. Then we deduct the Variable Costs -- labor, materials, and inventory carrying costs respectively – which gives us the Contribution Margin.

Next, we deduct the Fixed Costs (Depreciation and the Selling, General & Administration or SG&A costs) which gives us a Net Margin.

The benefit of separating Period and Variable Costs is that it helps us, as managers, to focus on the variable costs of production and to develop tactics to minimize them. The higher the Contribution Margin – the more money left from each sale to pay for overhead and go into profit – the better your bottom line will be.

This chart will help you understand the various lines of the Income Statement.

Income Statement	
Revenue	*Funds that come into the company from the sale of goods or services. These can be sales that are in cash or on credit.*
Variable Costs	*Costs that vary with the level of activity - the more products you make, the greater the total cost.*
Material costs	*The cost of the materials (raw material and component parts) that were used in the products you sold.*
Labor costs	*The cost of the labor (human resources) used to produce the products sold. This can encompass payroll but also hiring expenses, etc.*
Inventory carrying costs	*The costs (warehousing, insurance, etc.) of having inventory available for sale but not yet sold.*
Total Variable Costs *Cost of Goods Sold (COGS)*	*This is the cost of making the products sold.*
Contribution Margin	*The difference between the revenue brought in by sales and the cost of making the products for sale. This difference is what is left over to cover fixed costs and, finally, to generate a profit. Those costs that are fixed over a given period of time. These do not vary with the level of activity.*
Period Costs	*Those costs that are fixed over a period of time. These do not vary with the level of activity.*
Depreciation	*This figure recognizes the amount of value that operating a business "uses up" in the plant (factory) and equipment.*
Research and Development (R&D)	*The investment the company makes in developing new products or improving existing ones.*
Marketing expense	*The investment the company makes in advertising, selling, and distributing products.*
Administrative expense	*The cost of running a business; legal expenses, accounting services, etc.*
Total Period Costs	*The costs of operating your business over a given period.*
Earnings Before Interest and Taxes (EBIT), or Net Margin	*Revenues minus variable costs (contribution margin) minus period costs.*
Interest expense	*The fee you pay to use other people's cash. This is the expense of your financing strategy.*
Taxes	*The revenue you pay to the government as a citizen of a society.*
Net Income	*Revenues minus variable costs minus period costs minus interest expenses and taxes. This is synonymous with profit, earnings, "return," and "bottom line."* *Creating net income for its owners is the reason a business exists.*

Recognition of Transactions

As soon as an agreement is made between a company and its customers or suppliers, the transaction should be recognized on the books. In other words, it is recorded when it occurs and not when the cash is exchanged. Often a company's income statement might show a company is profitable, yet the company has run out of cash anyway. This can happen in a phase when the company is investing in its growth, but does not have the cash available to pay its debts because it still has products in development that are not ready for sale.

All of these occurrences are captured in the company's financial statements according to the rules that underpin accounting such as historical cost and the matching principle. They key message from this chapter is that it is critical for a company to manage its cash flow first, and then to focus on managing its profitability over the long term. Run out of cash, and there is no long term.

Doing deals with accounting, a recipe for disaster

Groupon, the company that made a multi-billion-dollar business out of offering cheap deals online, went from being the darling of online business investors to what one venture capitalist and tech business expert called "a complete fiasco" in less than a year. Many of Groupon's problems stemmed from poor financial reporting.

Launched in 2008, Groupon immediately attracted strong investment, and launched an IPO in 2011. A few months before the offering, however, Groupon had to restate its financial reports, correcting errors in the way it reported its results, reducing revenues from $713.4 million to $312.9 million. The problem was non-traditional accounting methods the Wall Street Journal called "financial voodoo". Time Magazine said the culprit was "a funky financial metric it called Adjusted Consolidated Segment Operating Income (ACSOI)." ACSOI excluded marketing costs, which represented the majority of the company's expenses, making Groupon's financial results seem better than they were. Groupon had flagrantly ignored the matching principle, which says expenses (the cost of the sale) must be reported at the time the revenue (money from the sale) is reported.

In April 2012, Groupon restated its earnings once again to reflect a larger quarterly loss after its auditor found "material weakness in internal controls." Scrutiny from the U.S. Securities and Exchange Commission followed, along with lawsuits from investors. Right up to the firing of Groupon's founder and CEO Andrew Mason in February 2013, Groupon's accounting practices were in the spotlight, with the company's audit committee and the competence of its accounting staff under severe criticism.

Groupon's challenges were bigger than accounting, however. Rapid growth as it expanded to 45 countries and increased staff from a few people to 10,000 in less than five years made adequate internal control difficult to manage, plus it faced tough competition from Amazon and Google with their own deal programs.

Former CEO and founder, Andrew Mason, told the Seattle Times in 2015 that Groupon was a "stupid, boring idea that just happened to resonate." That's a bitter pill for Groupon investors to swallow. As USA Today reported: "It's hard to find a worse technology investment over the last three-and-a-half years than the Groupon IPO." By mid 2015, investors had lost 76%. The company's market cap plummeted from $16.6 billion to $1.7 billion in early 2016.

And Groupon was still using non-GAPP accounting.

Chapter 4 Review Questions

Cash and The Cash Flow Statement

1. Describe the difference between profit and cash.
2. What are the differences between cash from operating activities, cash from investing activities, and cash from financing activities?
3. What is depreciation and what does it do to cash flow?

Cash and the Working Capital Cycle

4. Why is it important to understand working capital?
5. How does working capital relate to the Cash Flow Statement?
6. What is the working capital cycle and why does it matter?
7. What might be the ramifications, financially and from a marketing perspective, of increasing the accounts receivable lag time?
8. What are the tradeoffs of selling products on credit?
9. What is the Inventory Turnover Rate and how is it measured?

The Income Statement

10. What is the benefit of separating Period and Variable costs on the Income Statement?
11. What does a Contribution Margin represent?
12. What is the relationship between Revenue and Net Income on the Income Statement?

5 Finance: how do we raise funds, reward shareholders, and manage our assets?

Learning Goals

After reading this chapter you will be able to:

- Discuss the importance of a financing strategy to a company's performance.
- Define the role of risk with regard to investment decisions.
- Differentiate between the two types of transactions used to gain access to additional funds.
- Describe the similarities and differences between loans and bonds.
- Describe how the bond market impacts bond value.
- Discuss how to evaluate the quality of bonds.
- Differentiate between common stock and preferred stock.
- Discuss why a company would choose to pay dividends.
- Describe the purpose of the Balance Sheet.
- Discuss the kinds of information found on the Balance Sheet.
- Differentiate between assets and liabilities.

Cash does not equal net profit

In Chapter 4 we took a good look at money moving through the business, how we keep track of cash on a Cash Flow Statement, and how to keep an eye on profit with the Income Statement. We also looked at some of the accounting rules that businesses are required to follow when they report their results to external stakeholders.

A point that has been made several times is that cash does not equal profit. All the ***Net Profit*** number in the Income Statement shows is whether the "movie" of your business is going to have a happy ending or not. That is, if your products and services are making an overall profit.

All the decisions managers make in running a business either cost the company money or make the company money. If the company brings in more money than it pays out, then management is running a profitable business! It sounds simple, but as you already know, making money involves many individual decisions in different areas of the business, and all these decisions need to be coordinated.

Financing your CapsimCore Company

In CapsimCore – just as in the real world – if you don't have enough cash or don't bring in enough revenue from the products or services you sell; if you have too much money tied up in unsold inventory; or if you don't supplement your sales income with borrowing to cover your investments, you may become bankrupt.

The simulation ensures that a bankruptcy doesn't put you out of the game, but the emergency loan that will see your company through comes at an interest rate of 7.5% above your current rate.

To ensure you don't run out of cash, you need to do two things every round of the game: manage your cash flow and decide how to fund your investments. In the previous chapter we discussed managing your cash flow from operations. In this chapter we turn our discussion to managing your cash from investment and financing activities.

CapsimCore gives you the opportunity to manage your investments and financing in a variety of ways. You will need to answer important questions. What's the best financing option for the investments you want to make? Short-term loans? Bonds? Do we increase or decrease stock holdings? Do we pay our shareholders a dividend this year?

The Finance screen in the simulation shows that you need to make decisions in four areas:

Current debt (short-term loans – how much will you borrow?)

Bonds (long-term loans – will you maintain them or pay them off?)

Stock (should you issue more or buy some back?)

Dividend policy (do you share profits with your owners this year?)

How much cash does a business need?

The important question for managers is: How much cash does the business need? Managers must be sure they have enough cash available to cover the company's day-to-day transactions, and that is called the ***transaction balance.*** However, they may want to keep some extra cash on hand to take advantage of special bargains (a supplier's clearance sale of raw materials, for example), or to take advantage of discounts offered by suppliers for early payment of your bills (accounts payable), or as a precaution against emergencies (any unexpected expense). The cash held for such purposes is called the ***speculative cash balance.***

There are many advantages to having enough cash on hand, and many problems when you don't have enough. Cash, however, does not work ***for you***. Cash does not earn an explicit return. If you have too much cash on hand, you are not using your assets effectively and your cash is not being used in the most productive manner.

Answering "how much is enough" is a critical management skill. As an alternative to holding large cash balances, many companies hold part of their liquid funds in short-term marketable securities. These instruments earn interest and can be very easily converted to cash. In the United States, for example, there are several types of short-term marketable securities such as:

TREASURY BILLS (T-BILLS), short-term loans secured by the US Government with a denomination of at least $10,000 and that mature in less than one year. Sold at a discount, the buyer pays an amount less than the face value of the T-Bill, but still receives the full amount when the bill matures.

COMMERCIAL PAPER is an unsecured loan to a large corporation with good and well-established credit ratings. These loans usually mature between 15 and 45 days (but it can be anywhere from 1 to 270 days).

CERTIFICATES OF DEPOSIT (CDS) are popular short-term instruments issued by commercial banks. CDs are issued in denominations up to $100,000 and may be traded in the secondary market. The Federal Deposit Insurance Corporation (FDIC) insures CDs.

Investment Financing: getting cash to grow your business

Growing companies need money to fuel their growth. They need money to develop new products, to buy new equipment, to launch new promotion campaigns, and to take advantage of opportunities in the market as they emerge.

Individuals or organizations that might provide money to allow you to grow your business want something from you. It is an economic transaction that follows the rules of all economic transactions; people will only participate if they are made better off through the transaction.

There are basically two kinds of transactions that allow you to get access to additional funds: (1) taking on debt (loans or bonds); and (2) taking on new owners (stockholders). Both transactions have one thing in common: they provide cash to help the business thrive. In all other ways, however, they are quite different. Before we get into the details of these types of transactions, however, it is important to discuss the concept of "risk" because it underlies all investment and financing activities.

Risk

Put simply, risk is the possibility of losing some or all of an investment. In other words, risk represents the chance that an investment's actual return will be different than what is expected. If you have money to invest, that money represents wealth that you have created in the past and not yet consumed. You could have used that wealth to buy tools that would allow you to create something of value that you could take to the market. This investment in yourself would then give you a greater ability to create wealth in the future. However, if you are not going to purchase tools to create wealth directly, you still want that money to do as much work for you as possible. One way to do that is to let others use your money to create wealth that will come back to you in some form.

If you are a person who has money to invest in others, what do you want out of the transaction? You want the highest return you can get for your money, and you want to be sure that you do not lose your money. The degree of certainty (or uncertainty) that you will get your money back is the risk. In a market system, you have a lot of choices about how to put your money to work.

You might be attached to your money and only want it to work in a safe and secure environment. If that is what you want, you only "rent" your money to people who are going to use it conservatively. Maybe you rent it to the government, which can guarantee its safe return. The problem is that everything else being equal (which it isn't), there are a lot of people willing to put their money out for safe use. When there is a lot of money competing to be put to safe use, it is easy for those "safe users" (for example, electric utilities or governments) to get the use of that money cheaply. For the person investing the money, therefore, the "return" is expected to be low.

On the other hand, you might be willing to risk your money in the hope of high returns by giving it to someone who will use it in a venture that might not work out, but, if it does, will provide a very high return. That's your risk.

To rent your money or attract interest, these high-risk projects have to offer you a high return on those funds. The common rule is:

The hope and the risk of new cancer treatments

Announcing he would be ringing the closing bell at the Stock Exchange on January 4, 2016, Sandesh Seth, Executive Chairman of biotech firm Actinium, said, "Actinium expects 2016 to be a transformational year."

Actinium went public in 2013 after demonstrating success with its drug treatments and "alpha particle therapy" to target and kill cancer cells. Clinical trials for Actinium's drugs are focused on therapies for types of leukemia and lymphoma and the company has strong support from the key medical experts in the bone marrow transplantation and acute myeloid leukemia specialties.

When the company launched its IPO, the President and CEO said: "As we are expanding our ongoing clinical trials and adding new ones, it is very important to have access to public markets and provide liquidity for our investors who helped us reach this stage in the clinical development of our drug candidates." The company's market capitalization was reported to be $13.17 million, in Q3 of 2020 with its current stock price at $11, just above its starting price at around $1.80. While it has a valuable pipeline of drugs and therapies, the company doesn't seem to have been able to thrill its investors.

Perhaps that's because of the risks in biotech companies. According to the smarteranalyst.com, " To make really big money in biotech, one must take a gamble and try and pinpoint those small-cap companies which have the best chance of bringing a significant drug to market."

As Genetic Engineering and Biotechnology News site genengnews.com adds, "Clinical trial failures can kill biopharma companies." And they might just have similar consequences for the patients! "Just look at TeGenero," genengnews says, "a company that filed for insolvency in 2006 after its disastrous Phase I clinical trial of TGN1412 nearly killed its first human subjects."

Large and established drug companies may be able to absorb drug test failures, but clinical trials cost many millions of dollars, and the risk of failure – and the loss of those funds if the tests go badly – is the risk borne by investors in companies such as Actinium.

The higher the risk, the greater the expected return.

Now that we have discussed the concept of risk and introduced broadly the ways a company can gain access to cash (e.g., taking on debt and/or new owners), let's turn our attention to the accounting instrument used to record a company's financing activities – the Balance Sheet.

The Balance Sheet: documenting assets and liabilities

In Chapter 4 we called the Income Statement a financial "movie" that shows how money moves through the business over time. The Balance Sheet, in contrast, is a financial snapshot of a business' assets and liabilities at any one point in time. It's a "freeze frame," giving you the exact financial position of a company's assets and liabilities at a certain point in its history. Keep in mind that the difference between all assets minus all liabilities is the value of the company that is retained for its shareholders: ***the equity.***

Financial snapshot

A Balance Sheet snapshot of a business can be produced at any time, for shareholders or for potential buyers for example, but is always produced for shareholders at the close of the financial year. The financial (or fiscal) year for most companies in the United States ends December 31st but in other parts of the world, the financial year may end on June 30th. It really doesn't matter when a financial year starts or ends, as long it is always equal to 12 months.

A business, of course, is dynamic and thus changes not just day-to-day but in many cases hour-by-hour. Because of this, it's important to remember that a Balance Sheet represents just one point in time and, like the other financial statements, is a way of presenting a company's financial information in a uniform way.

There are three parts to a Balance Sheet. On one side are the company's ***Assets*** (what you own). On the other side are ***Liabilities*** (what you owe) plus the owners' ***Equity*** in the business. Owners' Equity is known by several names such as Stockholders' Equity, Shareholders' Equity, and Net Worth.

Whatever you call it, Owners' Equity means the same thing – it is what is left over after you deduct what you owe (your liabilities) from what you own (your assets). Put the opposite way, if you add your Owners' Equity to your Liabilities on one side of the Balance Sheet, you'll get a figure equal to the value of your Assets on the other side, because the ***Balance Sheet always balances.***

There are two categories of assets on the Asset side of the Balance Sheet and they are ***Current Assets*** and ***Long-Term Assets.***

Current Assets are things that can be converted into cash in less than a year such as cash itself, accounts receivable, and inventory.

Balance Sheet	
Assets	This includes the "stuff" or economic resources that the company has use of and from which it can expect to derive future economic benefit.
Current Assets	Assets that can (will be) converted to cash within the year
Cash	Currency readily available to the business.
Accounts receivable	The amount your customers owe because they purchased from you on credit.
Inventory	The value of the products (merchandise) that have been acquired for sale to customers and are still on hand.
Total current assets	These are the assets used to operate your business–an important part of working capital.
Fixed Assets	Assets that have a long-term use or value, including land, building, and equipment.
Property, plant and equipment	The purchase price that you paid for the land, buildings, and equipment that you use to create your products or services.
Accumulated depreciation	How much of the value of your plant and equipment you have used up while operating your business over time.
Total fixed assets	The net value of your property, plant, and equipment.
Total Assets	The value of all of the assets (stuff) of your business.

Liabilities	These are "loans," or debt contracts.
Current Liabilities	The loans that have to be paid back within a year.
Accounts Payable	The amount that you owe your suppliers for materials (inventory) that you purchased on credit.
Current debt	The loan payments (part of a long-term loan) to be made this year.
Total current liabilities	The debt that you have to pay back within one year.
Long-term liabilities	The loans (or debt contracts) that have to be paid back at some point in the future (in more than a year's time).
Total liabilities	The amount of other people's wealth you are renting the use of, as if you were using their money on contract.
Owners' Equity	The value of the owners' investments in the company.
Common Stock (paid-in capital)	The value of what the owners "paid in" as a direct investment in the company. (n a corporation, the sale of stock)
Retained earnings	The portion of owners' profits that they choose to reinvest in the company.
Total owners' equity	This is the owners' claim against the assets of the business - or the value of owning the business.
Total Liabilities and Owners' Equity	This will always equal Total Assets - as liabilities and owners' equity account for where the money came from to acquire the assets.

Long-Term or Fixed Assets are things in which your company has a long-term investment such as land and buildings, or plant and equipment.

On the other side, Liabilities are also divided into two categories, ***Current Liabilities*** and ***Long-Term Liabilities.*** Current liabilities are debts you have to pay within a year such as accounts payable, accrued expenses – that's expenses you owe but have not yet paid – and short-term debt such as a loan you took out to cover your working expenses. Long-term liabilities are debts that you have more than one year to pay, such as mortgages or bonds.

Owners' Equity also has two major accounts – ***Common Stock*** and ***Retained Earnings.*** Common stock is the value of the company stock owned by shareholders. Retained earnings represent the profits the company chooses to reinvest, rather than pay out as a dividend.

Balance Sheet 'Infrastructure'

Sometimes you'll hear people talk about the "infrastructure" on a company's balance sheet. That refers to how the Assets of the business are supported – whether they are funded more by Liabilities or debt, or more by Owner's Equity.

If the Liabilities portion of the Balance Sheet is really high, that means most of your Assets are financed through debt. In that case, the Owners' Equity portion will be quite low. In this case, the company would find its investors and debt holders asking serious questions about why the management of the company is getting so deeply into debt. If debt gets too high, it threatens the company's viability and hence the owners' investment. It is important that managers work to build up the equity in the business so the business can grow.

On the other hand, if the Assets are financed mostly by Owners' Equity, then the company's debt will be proportionally very low. In this case investors are equally concerned but asking a different question. Now they want to know why the managers are using their Equity, rather than third-party borrowing, to fund the Assets.

Getting the "infrastructure" on the Balance Sheet right – so that it satisfies investors and the day-to-day needs of the business at the same time - is a constant management challenge. The only way a business can grow – the only way you can have a bigger company this year than you had last year – is if the Owners' Equity portion of the Balance Sheet is growing over time. The following chart summarizes the lines on a Balance Sheet.

Now that you understand Risk and the Balance Sheet, let's discuss some specific types of transactions that can be used to secure additional funds to run your company.

Loans

A loan is a form of a rental agreement. When you borrow money from someone, you are renting the use of that person's money. The amount borrowed is the ***principal*** of the loan. The lender gives you the money for a certain period (term of the loan) and you pay them a fee called interest for the use of that money. In almost all business situations, the fee for using other people's wealth is a ***percentage*** of the money you are renting and is called the ***interest rate.***

In business, every company experiences risk. The level of risk might be a function of the industry you are in, your strategy for competing in that industry, and your experience in serving the market. Your financing strategy, or the way you go about getting the money you need to grow your business, also influences your risk. The more debt you have, the more risk you are exposed to. Debt involves a contract whose terms you must meet. If you do not meet your obligation (make your payment), the contract usually specifies a remedy. This may include that your creditor can force you to sell your assets until you can meet your contractual obligations. When this happens, you are in the process of going out of business. The greater the percentage of assets you acquire by debt, the greater the possibility that you could be forced to sell key assets to meet your obligations.

Borrowing money increases the total value of your company and infuses cash into the business, ***but this money is not income.*** The transaction involves increasing the balance of your cash account and increasing the value of the appropriate liability account. Paying back the loan reduces the balance in your cash account (and the value of your company) and the balance in the appropriate liability account.

It's important to point out that paying down the principal of a loan is not an expense. However, the interest that you pay to use or "rent" the money is a legitimate business expense. Interest expenses reduce the balance in your cash account and the balance in your retained earnings account. Because interest payments come out of retained earnings, they are part of (and expensed on) the income statement and reduce your net profits. The more you borrow, the higher the interest rate and the higher the interest payment. Additional payments against the principal reduce both the principal amount due and the interest payments.

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All companies in CapsimCore face the same level and type of market risk. Therefore, the proportion of your assets that is financed by debt determines your risk level.

Your company's risk is measured by the debt-to-assets. We will look closely at the many ratios companies use to measure different elements of their financial results in Chapter 5. The debt-to-assets ratio, however, measures a company's financial risk by determining what proportion of the company's assets has been financed by debt. It is calculated by adding the company's short- term and long-term debt and dividing it by total assets.

When your debt-to-assets ratio approaches 80%, banks will not lend you additional funds, and they will charge you the highest interest rate possible. Keeping your debt-to-assets ratio at an acceptable level - below 80% in this case - will allow you to have access to more-affordable capital that you can use to operate and expand your business.

$$\text{Total Debt To Total Assets} = \frac{\text{Short Term Debt} + \text{Long Term Debt}}{\text{Total Assets}}$$

Short-term bank loans

Short-term loans are loans that need to be paid back within a year. Banks will lend funds to a business over the short term if they feel the business has a reasonable risk profile.

Whether it is a savings bank or a commercial bank, the most important point to keep in mind when dealing with a bank is that bankers seek to avoid risk. Their primary concern is always the safety of their funds. Therefore, the company will not only need to fill out an application, but provide documentation of financial history (past balance sheets and income statements) and submit a business plan to assess future potential financial success. This information allows the bank to assess risk.

Bonds and the bond market

A bond is a form of long-term financing. When you borrow money from a bank, you sign a debt contract to use the bank's money for a certain period of time and to pay a specific rate of interest. You might have to pledge specific assets as security, or collateral, for the loan. If you miss payments, the bank can force you to sell those assets and use that money to retire the loan.

Companies and government entities can develop a similar debt contract, but instead of borrowing money from a bank, they can borrow money directly from investors. These debt contracts are called bonds. Bonds are referred to as ***securities*** because they represent secured (or asset-based) claims for the investors. Stocks are another type of security. These are secured or asset-based claims against the company. Both stocks and bonds are traded in ***securities markets.***

The debt contract is called an "indenture" and contains the critical information of a loan including answers to these questions:

- Who is borrowing the money?
- How much money is being borrowed?
- For what period of time?
- At what rate of interest?
- How and when is the loan going to be paid off?
- How will the loan amount be secured?

When you borrow money from a bank, you provide information in the loan application that helps the bank determine how likely you are to meet the terms of the contract. The bank uses this assessment to determine whether or not to loan you the money and how high an interest rate they should charge. The higher the risk of non-payment, the higher the interest rate you have to pay.

It is impractical for every investor who might want to buy a bond (loan some money) to assess the risk of the company (or government entity) that is issuing the bond. Instead, a few well-established companies, such as Moody's and Standard & Poor's, will assess the company and the bond issue and assign it a risk rating. The ratings range from AAA, which is excellent, to D, which indicates the organization presents an exceptionally high level of risk.

Bond ratings progress from a rating of "excellent" to "very poor" in the order indicated in the table below.

Excellent		**Low Risk**
	AAA AA A	
	BBB BB B	
	CCC CC C	
	DDD DD D	
Very Poor		**High Risk**

The lower the bond rating, the higher the interest rate the issuing company will have to pay in order to attract investors. Companies get very concerned when their bond rating is degraded. It communicates a negative message to the financial community and to the market in general.

In the U.S., a company that wants to issue a new bond has to get permission from the Securities and Exchange Commission. The company then typically goes through an ***investment bank.*** An investment bank is a financial institution that specializes in issuing and reselling new securities such as stocks and bonds.

The company's financial managers and the investment bankers evaluate the reasons for the bond issue (what the money will be used for), the length of the loan, how much money they want, and how much interest they expect to pay. The investment bank then works to market the new bond issue. They contact big investors – such as banks, insurance companies, and pension funds – to determine the willingness of the market to buy the bonds and to create a distribution network for the bond issue. The investment bank also ***underwrites*** (buys) a significant portion of the bond issue. This first sale of the newly issued security takes place in the ***primary securities market***

Because bonds are a secured claim, investors who own them can buy and sell them to other investors. These transactions occur in the ***secondary securities markets*** (or ***exchanges***) or the "bond market." In the bond market, the bond (debt contract) can trade above or below the face value of the bond. In general, bond prices move in the opposite direction of interest rates - as interest rates fall, bond prices go up, and as interest rates rise, bond prices drop.

A bond is an investment whose return is specified in the debt contract. Consider a very simple example: A $1,000 bond that pays 10% interest per year for 5 years.

As an investor, you view investments as shown in this.

YEARS	"Bond A"
Year 1	$100
Year 2	$100
Year 3	$100
Year 4	$100
Year 5	$100 + $1,000
TOTAL	**$1,500**

Because this is a contract, the return on your investment does not vary at all. Suppose as an investor, you had the opportunity to choose between buying the 5-year, 10% bond or a new, 5-year, 15% bond (assume equal risk or bond rating). If the two investments involving $1,000 looked like this, which would you choose?

YEARS	"Bond A"	"Bond B"
Year 1	$100	$150
Year 2	$100	$150
Year 3	$100	$150
Year 4	$100	$150
Year 5	$100 + $1,000	$150 + $1,000
TOTAL	**$1,500**	**$1,750**

The rational investor would pick the investment with the higher return: "Bond B" paying 15% interest. However, if the investor who owned "Bond "A" was motivated, she might offer to sell it at $980. If she attracted no buyers, she might offer it at $960, then $940, and then at some lower price. The potential buyer would then be as well off buying "Bond A" as "Bond B." As the return on the alternative investment (interest rate of the other bond) goes up, the trading price of existing bonds goes down.

Consider the same scenario, but the alternative bond offers a 5-year, 5% return as shown in this table.

YEARS	"Bond A"	"Bond B"
Year 1	$100	$50
Year 2	$100	$50
Year 3	$100	$50
Year 4	$100	$50
Year 5	$100 + $1,000	$50 + $1,000
TOTAL	**$1,500**	**$1,250**

The rational investor would want to buy "Bond A". The current owner of "Bond A" faces a situation in which motivated buyers are competing to buy his investment. The owner would then bid the price of a 10% bond higher than the face value ($1,000) because the return is better than any alternatives. At some price, say $1,120 for discussion purposes, the two investments would be equally attractive and would generate buyers. A $1,120 price for a bond that pays $1,500 would be about as attractive as a $1,000 price for a bond that pays $1,250.

Bonds are bought and sold every day on the bond market. At the end of a trading day, the information about the outstanding bonds, the value of their issue, their trading prices, yield, and the bond ratings of the companies are published in the financial press.

Stocks and dividends

When you sell shares of stock, you are selling ownership rights to a corporation. Owners, or stockholders, never have to be paid back, and you do not have to pay them interest on the money that they are investing in the company. However, owners have a claim against the company's assets and the wealth that is created in the form of net income, earnings, and profit by the company, plus they have a say in the management of the company. The stockholders' ownership claim ***never ends*** as long as they hold the stock.

Stock market

When you own a stock, you are actually a part-owner of a corporation. As a shareholder, you have a "say" in how the company operates, although your voice may be just one among thousands of other shareholders and the strength of your voice is usually affected by the percentage of shares you own.

Companies initially issue stock to raise capital to run their businesses, often motivated by the fact that they need more money. A corporation sells shares to investors in an organized fashion called a public offering, the first of which is its ***Initial Public Offering***, or ***IPO***. After the company's IPO, investors are free to sell their shares and buy more, but not from the company directly. Instead, shares are traded on organized stock markets like the New York, London, or Hong Kong Stock Exchanges.

A company can issue common stock or preferred stock. ***Common stock*** represents a simple share of ownership and each common stock share has one vote to cast when electing the corporation's board of directors. If the company were to go bankrupt, the corporation would have no financial liability to common shareholders, and those shares may become worthless.

Preferred stock, a form of stock that is traded at a far lower volume than common stock, does have privileges. Preferred shareholders, often those having some kind of history or relationship within the company, may receive higher dividends and have a first claim to as- sets if a company should go bankrupt.

Shares of stock are traditionally represented by a piece of paper called a stock certificate. Since shares of stock trade electronically, you may never actually see a physical certificate for the share that you own. The brokerage holds the shares on your behalf in what is known as a "street name" which is nothing more than a method of bookkeeping and has no effect on your ownership of the stock. Owning shares in street name is much more efficient and convenient, especially when it is time to sell the stock.

Like a bond, stocks are secured investments. They have a claim against the assets of the company. The company sells new shares of stock to potential owners through the ***primary securities market*** in a process similar to the way new bond issues are sold. The company meets with an investment banker who reviews the business strategy and specific plans for the money that is to be raised. The investment bank underwrites, or buys, markets, and distributes the new shares. Under-writers charge commission and make money by holding some shares until the price per share rises.

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Dividends should be paid from the profits of the business. When you are managing your CapsimCore company, it is generally not a good idea to pay dividends in a year in which you are borrowing money. Owners and the market for potential owners interpret this as borrowing money to pay the dividend. The owners give the managers of the company their money to grow their wealth, not for the managers to take out loans in their name. Owners do not like managers to hold "excessive" cash balances. It is the owners' money, and they expect those funds to create more wealth. Cash does not earn any significant return. Owners think that if you do not have a productive use for their cash, you should give it back to them by paying a dividend. A "productive use" is to invest it in new products, make facility improvements, or take other actions that will put that cash to work for the business.

Again, once stock has been issued, owners can buy from and sell to others on the ***secondary securities markets (exchanges)*** or stock markets around the world. The company itself receives no cash for shares that are sold in the secondary markets, and every corporation wants to see its stock price in- crease for the benefit of its shareholders and the financial reputation of the corporation.

If you are a potential investor in a company (someone who is thinking about purchasing shares of stock in a company), you have choices about which company's shares you might want to purchase. You want to invest your money in a company that is going to create as much wealth for you as possible.

There are two ways in which owning stock increases your wealth - when the value of your shares increases as the stock price goes up; and when the company distributes to owners some of the profits it has created in the form of cash payments called dividends.

Paying dividends

When a company creates profit, the profit belongs to the owners. There are only two things that can happen with that profit: it can be kept in the company as retained earnings; or it can be distributed to the owners in the form of a cash disbursement or payment. If it is paid out to the owners, it reduces the amount of cash on hand.

Value and stock claims

Interactions between buyers and sellers determine stock price. A potential buyer might consider three things in determining how much to pay for stock in a particular company:

1. The value of the stock's claim against the assets of the company
2. How much profit the company makes per share of stock
3. How much of that profit is distributed to owners (as a dividend)

The value of this claim is determined by dividing the total owners' equity from the balance sheet by the number of shares outstanding. For instance, if the value of the owners' claim is $100 million and there are 2 million shares of stock issued and outstanding, then each share has a claim against the assets of the company worth $50. This is called the ***book value*** of the stock.

There are two ways to increase book value:

1. Increase the value of total owners' equity
2. Reduce the number of shares out- standing (buy back stock)

The easiest way to increase owners' equity is to make a profit to reinvest, or retain it, in the company, which increases the value of the "retained earnings" account. If you sell more shares to increase the value of the common stock account, you have increased the value of total owners' equity, but you have also increased the number of shares you have to divide it by in order to get book value. In general, current owners would prefer that you borrow money to grow the company, if you can afford the interest payments, rather than dilute the value of their claim.

CAPSIMCore

Cash Flow from Investing & Financing Activities in CapsimCore

In Chapter 4 we looked in detail at the first category of cash on the Cash Flow Statement, cash flows from operating activities including depreciation, accounts payable and receivable, and inventory. The two other categories of cash – from investing and financing – are linked to the issues we have discussed above.

The second category of cash, cash flow from investing activities, includes the changes in plant and equipment we discussed in Chapter 3 – such as adding capacity and increasing automation levels, or selling off your unused production capacity.

The third category tells you what cash came in and what went out on financing activities. That includes both short-term borrowing such as loans, and long-term investing such as share transactions and the purchase or retirement of bonds.

Your CapsimCore simulation updates your financial statements every time you make a decision. Now that you understand the Balance Sheet, you can use it plus the Cash Flow Statement to discover exactly how much cash is available for operating your business right now. Just take the Change in Cash Position from your Cash Flow Statement and add it to the cash line on your Balance Sheet.

Here's an example. If your balance sheet showed $10 million in cash on December 31st last year, and your cash flow statement shows a change in cash position of -$3 million today, you have $7 million left in cash to run the business today.

Recap: cash flows, financials and company performance

Now is a good time for a quick recap of what we have covered. In Chapter 4, we introduced the three types of financial reports that are typically used to summarize a company's financial standing and spent quite a bit of time talking about the Cash Flow Statement and the Income Statement. In this chapter we reviewed the ways a company can gain access to additional cash to run its operations and to grow its business. We also introduced and discussed the information found on a company's Balance Sheet. All three financial statements provide important information for your decision making as a manager:

- The Cash Flow Statement helps keep track of cash and ensure you always have enough on hand to keep business operations running smoothly.
- The Income Statement shows where you are (or are not) making a profit and, therefore, which parts of the business require more attention.
- The Balance Sheet demonstrates the way you – as managers of a business – are working the owners' investment in the business.

Financial Ratios

One way to measure whether you are operating a sustainable and profitable company is to keep a close eye on measures called financial ratios. These are terms you may have heard during discussions about business and include:

- ROE (return on equity)
- ROA (return on assets)
- ROS (return on sales)
- Asset Turnover

The above ratios are all "profitability ratios" because they compare various numbers (for example sales or assets) with the profit the company is generating. However, you can also measure success using "market ratios" such as overall Market Share or Market Capitalization that demonstrate how well the company is performing in the marketplace, compared with its competitors.

Profitability Ratios

We know that a business exists to make a profit – so profit is a very clear measure of success – but we also know that how much profit represents a "good" result and how much a "bad" result is a function of the type of business you are in. We balance other elements - such as sales or assets - against the profit number to give more information about the ***quality*** of the result for the business we are measuring.

In accounting, the word "return" means the company's profit ***compared with*** another element of the company's financial results. Below are the key profitability ratios and how to read them.

RETURN ON EQUITY

$\frac{\text{PROFITS}}{\text{EQUITY}}$ Return on Equity (ROE) compares the equity that the owners of the business have tied up in the business with the business's profit.

You'll remember from the Balance Sheet that Owners' Equity or Net Worth is common stock plus retained earnings - the accumulation of net profits over the years that were not paid back to the owners in dividends. To assess the return on that equity, we take net profit for the year and divide it by shareholders' equity to get Return On Equity.

RETURN ON ASSETS

$\frac{\text{PROFITS}}{\text{ASSETS}}$ Return on Assets, or ROA, gives us a different perspective on a company's returns in relation to its assets. ROA is a way of looking at the stewardship of a company. It compares profit with the total assets of the business. We have a value for our assets - that's how much we have tied up in the business. ROA tells us how much profit the managers of the business – the stewards of those assets – are able to make on those assets.

We calculate ROA by taking net profit and dividing it by the assets on the balance sheet. ROA is a vital measure for assessing the health of asset-heavy businesses with lots of money tied up in plant and equipment, raw materials, and inventory.

ROA is an excellent measure of both the effectiveness and efficiency of the operations side of the business. A high ratio indicates good utilization of company resources.

RETURN ON SALES

$\frac{\text{PROFITS}}{\text{SALES}}$ Return on Sales (ROS) compares profit with sales. ROS looks at the revenue or the sales dollars we've generated from our products and services to see what percentage of that goes all the way to the bottom line, into net profit.

Think of ROS as an efficiency measure. It answers this question: Of every dollar that comes into the business, how many cents does the business get to keep? What percentage of your sales ends up in Net Profit?

For example, if the total sales for a business are $2 million and the profit $200,000, we divide $200,000 into $2 million for an ROS of 10%, meaning10 cents in every dollar is profit.

Is 10% ROS a good result or a poor result? That all depends on the type of industry and the type of company we are looking at. In a commodity business – like a supermarket, for example – ROS will be low because only a few cents from each item makes it into profit. These businesses focus on large volume sales, not profits on individual items to drive their profits. A 4% ROS for a supermarket, then, would be excellent. However, for a company in high tech electronics where volumes are low but the company makes a high margin on every sale, 4% would be a dismal ROS.

ASSET TURNOVER

$\frac{\text{Sales}}{\text{Assets}}$ Asset Turnover compares sales with the company's assets. Asset Turnover doesn't look directly at profit but it implies something about profit. It is a measure of how effectively we've used our assets in generating revenue.

Asset Turnover is calculated by taking sales for a given period divided by the asset base on the Balance Sheet. How often can your sales match the value of your assets in that period? How often can you make your assets earn their keep or how often have you "turned over" the value of your assets?

If, for example, you have assets of $1 million and your sales during the year are $1.5 million, then your asset turnover is 1.5, $1.5 million divided by $1 million.

MARKET RATIOS

Market ratios assess a company's health according to its stock price and other relationships in the stock market. These ratios, of course, are only relevant for publicly traded corporations, such as your CapsimCore company.

EARNINGS PER SHARE

Let's start with Earnings Per Share. EPS is reported for a publicly traded corporation every quarter, and is viewed as a critical number in terms of assessing the value of a company's stock.

EPS is calculated by taking net profit for the quarter or year in question, and dividing it by the number of shares outstanding – or the number of shares held in the marketplace. Predictions over whether EPS will be up or down – higher or lower than estimated – have a great deal of immediate impact on stock price.

In some ways, that impact is misleading. Over the long term, it is more than the profitability of a business that drives its success, as we learned with the Balanced Scorecard. Net Profit, as we have also discussed, is not cash flow. Companies that show a profit can still become bankrupt if they don't manage their cash flow – and EPS ignores how much cash a company has, or does not have, to run its operations.

As a qualifier, then, analysts and business people will often discuss the "quality of earnings" to suggest their confidence that those profits reflected in the EPS will turn into cash. In this way they are high quality rather than virtual or imagined profits created by accounting tricks.

PRICE TO EARNINGS

The next market ratio is the Price to Earnings ratio. P to E is calculated by taking the stock price at a given point in time and dividing it by Earnings Per Share. This usually results in a large positive number. For example, the stock price might be 10 times the earnings per share or 20 times the earnings per share. This number is often referred to as the "multiple" instead of the Price to Earnings ratio – simply because it's a multiple of EPS.

Managers will often discuss the relative size of their P to E ratio, at times bemoaning the fact that it's too low: "Our stock price should be worth more than 10 times our earnings per share!'' Unfortunately, while that may be the manager's assessment, it's not the market's assessment.

On the other hand, sometimes you'll hear analysts say that the P to E multiple is too high, suggesting over-valuation of stock on the market. A correction usually follows.

DIVIDEND YIELD

When a company pays a dividend, that dividend is often compared to the trading value of the stock price in the stock market in a ratio called the Dividend Yield.

Dividend Yield is calculated as the Dividend divided by the stock price.

The Dividend Yield is the percentage of returns we are generating compared with the stock price. This is similar to the interest on your bank account. When you assess that interest, you compare it with the capital tied up in the account. The Dividend Yield tells you what your ''interest'' is on the money you have tied up in a stock.

In Chapter 6, we will look at some other ways to assess a company's performance and the importance of aligning all the decisions that are made about how to run the business with the company's overall strategy.

Chapter 5 Review Questions

1. How does a company's financing strategy impact its operations and performance?
2. What is risk and how does it affect decisions about investment?
3. What is the primary difference between financing through loans versus stock?
4. What is a loan and how do interest rates affect a company that takes out a loan?
5. In what ways are bonds different than loans?
6. How can we tell the difference in the quality of different bonds?
7. How are common stocks different from preferred stocks? Why would a company offer preferred stocks?
8. Why would a company choose to pay dividends?
9. What is the purpose of the Balance Sheet?
10. What is the difference between assets and liabilities?
11. What are the accounts that make up Shareholder's Equity on the Balance Sheet?
12. What are the main profitability ratios? What are the main market ratios?

6 Strategy: how does it all work together?

Learning Goals

After reading this chapter you will be able to:

- Discuss the factors that influence strategic choices.
- Describe the components of a SWOT analysis and the common questions that are asked in each component.
- Explain how a SWOT analysis informs business strategy. LO4: Describe the linkages between goals and strategy.
- Discuss the five characteristics of effective goals.
- Compare and contrast the three groups of customers that are important to growing and sustaining a business.
- Compare and contrast operational effectiveness and strategic positioning.
- Define competitive advantage and the kinds of business resources that create it.
- Describe the "five forces" that drive competition in an industry.
- Compare and contrast the two generic strategies of cost leadership and differentiation.
- Discuss ways a company can pursue a cost leadership strategy.
- Discuss ways a company can pursue a differentiation strategy.
- Describe the four quadrants of the Balanced Scorecard.

Alignment, coordination and Evaluation – critical factors

Sporting analogies are common in business because – just like team sports – business is competitive and requires the efforts of people with different expertise all working together.

Former sports coaches have built lucrative second careers teaching leadership to business people, our business-speak is peppered with sporting analogies from "don't drop the ball" to "it's a marathon, not a sprint," and any sales team securing a big contract may well whoop as loud (and celebrate as hard) as a team winning a championship!

There are two key areas in which team sports and business are alike: Both require the coordinated efforts of people with different skills, and their success is measurable on a score-board. We'll cover both of these issues in this chapter.

The comparison to sports, however, may stop there. In all other areas, according to Octavius Black, CEO of Mind Gym - a performance training consultancy - sports and business have very little in common.

> *"Athletic sport is primarily about completing a single task to an exceptionally high standard. Business is invariably a multi-task, multi-layered affair. The single-mindedness of the brilliant fly half would be catastrophic for the corporate high flyer. They would be marked down for lack of big picture thinking and sent to back office processing.*
>
> *"Sport is all about beating someone else. There are no win-win solutions, you can't increase the size of the market in victories and you don't need to watch out for new entrants who play by different rules." (The Sunday Telegraph, July 15, 2012)*

In the world of business, things are not as clear-cut as in sports. There is no simple rule-book and the competition can, and at times does, change the game entirely. In this complex environment, therefore, how do we co- ordinate and align our efforts, stay ahead of our competitors, and measure our success?

Managing Resources under Pressure

Irrespective of up or down economic cycles, today's business environment is more competitive and fluid than at any other time in recent history. To a certain extent, a company can reengineer, restructure, and cut costs, but ongoing success requires the ability to grow revenue and margins. Therefore, management must align and coordinate its resources consistently in order to nurture growth. Creating the process of aligning and coordinating resources, however, can prove to be as tough and ruthless as surviving a reality-based television show.

The process becomes more and more challenging when management has to make its decisions in a competitive environment. Competitors in an industry scrutinize any realignment of resources by another player in context of the choices now available to them. For example, in our CapsimCore simulation if Andrews realigns its market offering, the management teams of Baldwin, Chester, Digby, Erie, and Ferris will attempt to identify and understand Andrews' actions and attempt to initiate counter measures.

Searching for alternatives

As we discussed in Chapter 2, because of resource constraints, it is virtually impossible for any firm to excel in all functional aspects of business all at once. Management, therefore, needs a clear understanding of customers' needs to find ways to satisfy them within their firm's capabilities.

While evaluating various possible competitive alternatives, managers typically refrain from implementing "revolutionary" changes in their market offerings; instead, they engage in "evolutionary," or incremental, market moves. This is understandable, because the underlying problem in predicting future market shifts is that customers often make purchasing decisions based on many different criteria simultaneously, including brand, quality, performance, price, and service.

It is frequently easier to modify the "core engine" of a product or service offering by adding one or several "engine variants" rather than introducing "the new thing" that might capture new customers and market segments, but, at the same time, potentially risk the firm's market position and profitability. The choice is even more challenging in an environment where a competitor can make similar moves, or simply copy your every step. Think about Samsung and the way it copied Apple's playbook until it was stopped by legal action in various courts around the world. Whenever we make decisions that have multi-year, lasting impacts on a firm's operations, they should be well planned. We refer to these critical firm-level decisions as strategic choices.

Making strategic choices: where are we now?

In order to make strategic choices, a company must understand the challenges, opportunities, and future trends, both inside and outside its chosen industry and markets. This requires a company to clearly define the industry and markets in which it exists as well as how it would like to operate within this context. The clear understanding that comes from defining the industry and markets is necessary for making choices about where to direct and use human and financial resources.

At the same time, a company has to be always ready and able to respond to industry and market changes. These changes can be triggered by shifts in the external environment, such as a recession or labor strikes, or can be caused by the internal environment, such as not meeting customer requirements for product features, quality, or price. A company's competitors can also force changes within the broader marketplace, or even force the company to exit particular markets. For example, think about the way Apple's smartphone grabbed most of the mobile phone market share of Blackberry, Motorola, and Nokia.

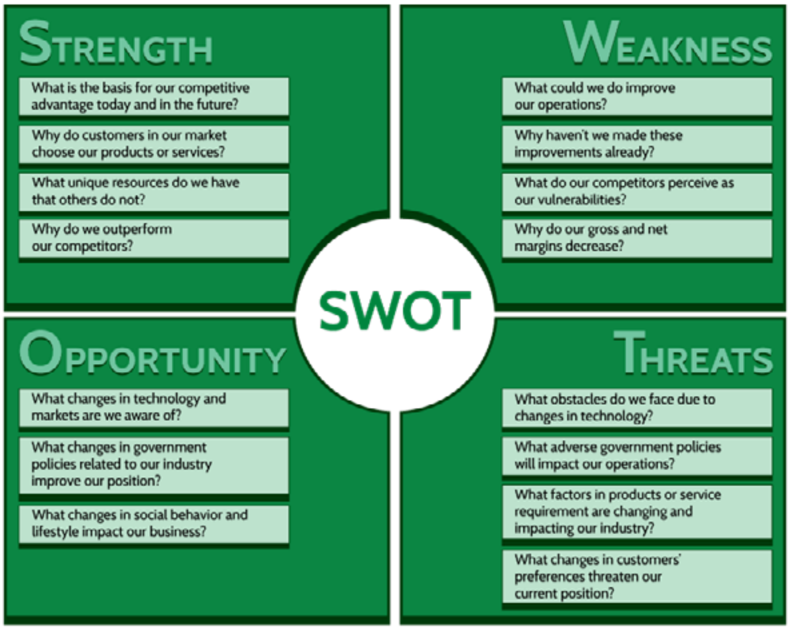
In order to develop a systematic understanding of the important issues a company faces, we have to look to the pros and cons of all potential forces that might impact our chosen strategy. As a starting point for this discussion, many organizations use a SWOT analysis – Strengths, Weaknesses, Opportunities, and Threats. A SWOT analysis focuses on both internal and external factors:

INTERNAL FACTORS: Strengths (Pros) and Weaknesses (Cons)
EXTERNAL FACTORS: Opportunities (Pros) and Threats (Cons)

Setting goals: how do we get there?

After a thorough SWOT analysis, senior executives can summarize the company's top-level goals and create a concise description of their focus. The next step is to deter- mine how to align skills and capabilities the company has, or needs to acquire, to achieve success.

The Four Quadrants of the Balanced Scorecard



The company's ***vision*** is an aspirational description of what the leaders of the company want to accomplish. It outlines core activities, but is typically far broader than the available resources and competencies the company possesses. If well understood and executed, it will allow the company to reach the desired market leader position. The vision underpins the company's ***mission,*** which reflects the corporate values and fundamental beliefs a company has adopted. In communicating the company mission to employees, customers and other stakeholders, a company clearly defines its corporate responsibilities.

Once an organization has set a strategic direction and outlined how it intends to operate in its chosen industry and markets, the next step is to determine how to marshal its resources to reach its goals. Put simply, the company needs to move from understanding and defining its strategy to determining the kinds of actions that will facilitate successful implementation. In addition, these actions must be continuously monitored to ensure that they are effectively moving the company towards its strategic goals.

A company needs firm goals so it can monitor the success of the tactics it chooses to implement its strategy. This is typically, but not always, done on a yearly basis as a company sets annual goals, monitors progress toward those goals, and then at the end of the year evaluates whether or not the goals have been met. For any goal to be most effective and useful it should have the following "SMART" characteristics:

S – Specific (clearly described and detailed)
M – Measurable (includes aspects that can be assessed)
A – Achievable (challenging, but attainable)
R – Relevant (important to the chosen strategy)
T – Time-bound (linked to a certain deadline and milestones)

Whenever a company develops its annual plan for its operations, including the various SMART goals tied to operations, it is also important to consider how these goals link to the company's management systems and structures. To ensure success - or to assess failure - a company must put in place the organizational structures, management tools, procedures, and policies necessary to facilitate the implementation of its goals. Questions that need to be addressed include:

- What has to be accomplished to meet our goals?
- What resources are required to meet our goals?
- Who will be responsible for each goal?
- What does goal success look like?
- How will we adjust to slower than expected progress toward our goals.

Growing the Business: How do we sustain the momentum?

In theory, growth is quite simple: Increase both "topline" (revenue) and "bottomline" (profit) performance by choosing a strategy that seems right, and learn everything you can about what is necessary to make it work. Experience suggests, however, that it can't be that simple. If it were, stories of failed companies would be extremely rare. Think about the following questions:

- Why did Sony miss the chance to invent a product like the iPod?
- Why doesn't AT&T own the Internet?
- Why was Sotheby's, the world's premier auction house, upstaged by eBay?
- Why didn't the Encyclopedia Britannica organization start Google?

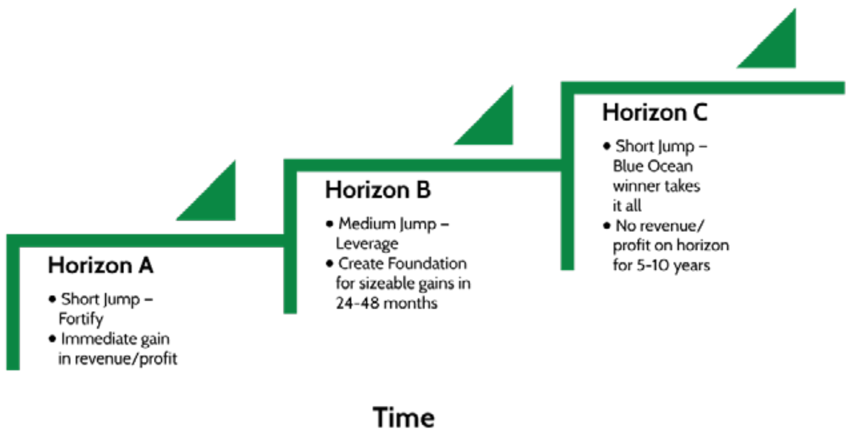
Even very successful companies get it wrong. If business were simple, there would not be over 20,000 books on corporate and business growth and more than 35 million Internet search results on the topic. Clearly, growing a business is difficult and challenging. Nevertheless, when you analyze the literature on business growth and sustainability, common themes emerge.

First, a company can bring better or cheaper products to ***existing customers.*** Here, a company typically introduces products or services at the low end (i.e., for customers who earn low wages, or companies that have major budget constraints) of the market. This tactic often disrupts the strategies of its competitors. Perhaps companies such as Dollar General, Wal-Mart, Costco, Tesco, and Target illustrate this approach by selling cheaper, but still with quality, products, and services that are acceptable to the marketplace, thereby challenging established department stores (such as JCPenney, Bloomingdale's, Neiman Marcus) and general grocery stores.

Alternatively, a company can offer products to the ***"overserved"*** customers, which includes customers who see a given product as "good enough" and/or tend not to fully use or care about new product features. Here, companies might reduce investments in additional product improvements and extra features. Discount airlines are an example of companies that offer services to these kinds of overserved customers. Apparel companies such as ZARA or H&M use the same approach in the fashion industry, offering fashionable clothing at substantially lower prices than established brands such as Chanel or Prada.

The ultimate, strategic move that disrupts a marketplace is to reach out to ***"non-customers"*** with relatively simple, convenient, and customizable products and services. For example, companies like Facebook, LinkedIn, and Twitter appeal to all segments of the market with easy-to-use, customizable social network services.

Overall, fostering a growth-oriented organization in practice is often more difficult than simply focusing on existing and new customer relationships. One of the biggest challenges, beyond managing internal and external resources and opportunities, is the timing of a strategic move. Being in the right place at the right time matters. What this means is that it is critical to develop your growth strategy and consider all of the potential tactics you may choose within the designated "time horizon." Time horizons in business typically fall into three categories:



When thinking about how to best formulate, implement, and time the execution of a strategy, keep in mind a simple adage: ***The best strategy badly implemented is like having the worst strategy brilliantly executed.*** In the early 1990's Apple launched the Newton, a product that was essentially an early version of the iPad or iPhone. It completely bombed in the marketplace. Today, the iPad and iPhone dominate the marketplace and have disrupted entire industries. It took the company some time to align strategy, implementation, and timing but eventually it had a good strategy, implemented well.

Operational effectiveness versus strategic positioning

Whenever companies search for an advantage in the marketplace, we commonly refer to it as "competitive advantage." However, when planning for competitive advantage it is important to distinguish between operational effectiveness and strategic positioning. ***Operational Effectiveness*** means performing similar activities better than your rivals. ***Strategic Positioning*** means performing different or similar activities from your competitors in different ways.

From an operational-effectiveness standpoint, a challenger will benchmark and attempt to outperform the dominant company following a similar value proposition (i.e., an appeal to the marketplace). On the other hand, strategic positioning by a company will deliver a unique value mix. This unique offering will be in tune with the company's own resources and competencies, making it more difficult for a competitor to respond.

However, keep in mind that identifying the best strategic position in the market is irrelevant if you fail to execute it operationally within your company. Of course, the opposite is also true. Companies that encounter such "asymmetry" between operational effectiveness and strategic positioning are doomed to fail in the long run – even emergency loans or government interventions cannot save them. Look, for example, at Blackberry and Nokia who both dominated the mobile phone market for almost two decades, but missed the importance of smartphones and the opportunities offered by the millions of user applications humankind could develop. All in all, a company must offer greater value to a customer to attain competitive advantage over its rivals.

Trading off costs and benefits

Opportunities and options, constraints and choices – these are the forces that affect business strategy. And no matter what course of action we choose, there will be tradeoffs – costs and benefits that result from our choices.

It is important to recognize that coordination and alignment are interdependent. In other words, to realize success, strategic choices and resource allocation must work in tandem. Of course, coordination and alignment can be a complex process when we don't clearly see the direction we are moving. However, as long as you pay attention to details, understand your capabilities, and effectively execute the choices you make, you will be able to successfully compete in your industry and targeted markets.

Just one more thought: The more people involved in making coordination and alignment decisions, the more difficult it will be to reach a consensus quickly and to choose the best path forward. Think how long it takes to reach a consensus on a venue for dinner when your entire family is in town. Usually, someone has to take the lead and make the decision for everyone when no agreement can be reached.

The same happens in a business. Typically the company's board of directors appoints the "Commander" or the Chief Executive Officer (CEO). Though we often hear only about the stellar compensation and golden parachutes that CEOs receive, every day CEOs have to make complex, difficult, and far-reaching decisions in order to maintain a continuously growing, profitable, and sustainable company. Let's take a look to the basic four buckets of a CEO's responsibilities:

> **PLANNING PROCESS:** A CEO is required to understand the interrelationship of all business functions such as marketing, product development, production, finance, and human resources, and how they affect the value chain of the company.

BUSINESS MODELS: It is critical to an organization that its CEO understands all the attributes of the business that affect revenue streams. In other words, the attributes of the organization that influence the internal cost structure, the customer value proposition, business performance, and how innovation can shape its business environment. Remember, when we refer to revenue streams, we are talking about "top-line", versus the "bottom-line" which is the profitability of the business.

COMPETITIVE ADVANTAGE: Before a CEO commits a company to a specific path, it is crucial that the management team identifies the available resources and assesses how different market factors in its industry will impact business performance The better the company's capabilities and the bigger the gap between its own and its competitors' capabilities, the better the chances the company will succeed in implementing its mission.

STRATEGIC CHOICE: This is actually the best part of being CEO. Once the CEO has analyzed the topics and issues from the three buckets outlined above, the company is ready to take action. In other words, the CEO chooses the direction and sets the operating agenda. Jim Collins, a renowned management guru, makes the point: It's not doing many things well, but instead doing one thing better than anyone else in the world that leads to success.

Creating Competitive Advantage

Up to this point, we have discussed the planning process, different business models, and strategic choices. It is now time to focus on the ultimate outcome of any business strategy: creating sustainable competitive advantage. Put simply, a sustainable ***competitive advantage*** occurs when a company uses its resources in a way that allows it to gain a better, often more profitable, long-term position in the markets in which it offers products and services.

There are many different ways to look for competitive advantage. It is almost like arguing if a glass of water is half-empty or half-full. To identify a competitive advantage, it is helpful to ask some simple questions:

- What are we best at today and in the future?
- What can our organization do better than any other organization today and in the future??
- How do we reach our customers today and in the future?
- What skills or capabilities make our organization unique today and in the future?
- Where do our profit margins come from today and what about in the future?

Typically, the search for competitive advantage begins with gaining a deeper understanding of potential customers, products, production and delivery processes, as well as geography – all of which are factors discussed in previous chapters. When examining these factors it is useful to focus on the field of companies that share the primary business activities of your company (manufacturing sensors, for example, in the case of CapsimCore). This field is commonly referred to as an industry. Industries can be further broken down into industry sectors (motion sensor or pressure sensor sectors, for example). The reason for doing all this work is to analyze a cluster of similar companies that are your "competitors." This allows you to understand the strengths and limitations that a company might have in terms of its successes (profits) and failures (losses), current market position, and of course, the resulting competitive advantage.

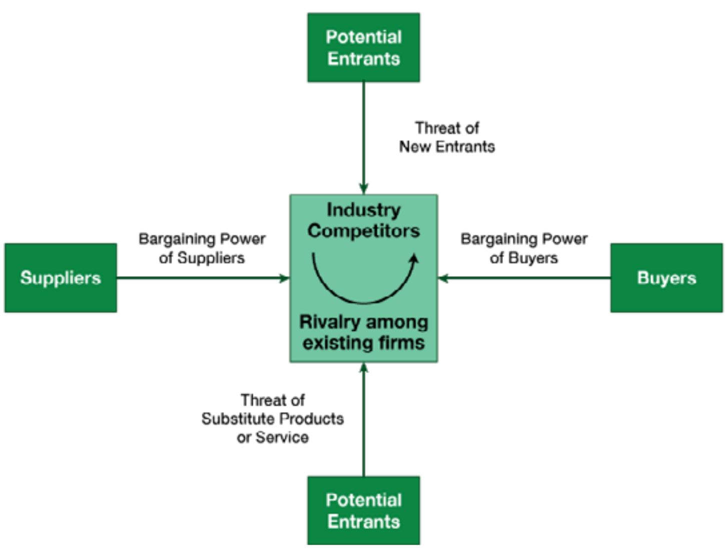
Sustainable competitive advantage ultimately comes from how the company's management coordinates and aligns the firm's resources. These resources include all its financial, technological and human resources. Generally speaking, the extent to which any of these resources can result in competitive advantage will differ depending on three characteristics. Simply put, is the resource:

> **RARE?** Meaning that it is unique in the marketplace; you have it and no other companies (or very few) do.
> **NOT EASILY IMITATED?** Meaning that it is not easily copied or replicated by others.
> **NON-SUBSTITUTABLE?** Meaning that something else cannot be used or substituted in its place; e.g., machines substituting for people or an outsourced company providing manufacturing capacity.

The driving forces of competition

In his groundbreaking work in the 1980s, Michael Porter developed a framework for how we understand the driving forces of competition within an industry. In his analysis Porter identified five factors that naturally act together:

1. Threat of new entrants to a market
2. Bargaining power of suppliers
3. Bargaining power of customers
4. Threat of substitute products
5. Degree of competitive rivalry



Depending on the characteristics of the industry, each of the factors might be more or less important.

To illustrate this model, let's consider the companies in the CapsimCore Simulation. As you know, there will never be more than six competitors, so no new competitor (a seventh company) will ever enter the industry. It is often helpful to first look to the "center of gravity" of the five forces, the ***degree of competitive rivalry.*** In particular, we need to determine the nature of the rivalry, which reflects the intensity of competition in the industry. This allows us to choose the most effective strategy. Rivalry depends on many factors, but the following seven issues are critical:

Issue	Impact
Number of competitors	*Competitive rivalry will be higher the more competitors are in the market.*
Market size and future growth	*Competition will be most intense when markets decline or stagnate.*
Product differentiation and customer loyalty	*The greater the customer loyalty and/or the higher the product differentiation the less intense the competition.*
Availability of substitutes	*If customers can choose among substitutes or similar alternatives the intensity of competition will increase.*
Capacity utilization	*Any existence of excess capacity will increase the intensity of competition*
Cost structure	*Intensity of rivalry will increase if companies' fixed costs are a relatively high percentage of their total costs because profits will depend primarily on manufacturing output.*
Exit barriers	*If there are no purchasers for companies that attempt to exit the industry or it is difficult to sell their assets, intensity of competition will stay at least constant.*

Even though in the CapsimCore Simulation there cannot be more than six companies, it is still important to understand how a ***barrier to entry for a potential entrant*** can affect your strategy. In CapsimCore, new entrants can appear in a sub-segment of the market. For example, a competitor may begin to focus on either the low tech or high tech end of the market. In addition, any new product offerings or entry by a competitor into a market segment can increase the level of rivalry among the competitors. Finally, companies that are already in an industry or sub-segment of the market hold stronger positions if the barriers to entry are higher and vice versa.

In the next table, there are some examples of barriers to entry you might want to consider in the CapsimCore Simulation.

The remaining two forces, the power of suppliers and customers and the possibility of substituting products and services, can still threaten the strategic position a company has obtained within an industry. Although these forces are not really a threat in the CapsimCore Simulation, we will briefly discuss them because they certainly influence the real world of business.

Examples of Barriers to Consider in CapsimCore

Barrier	Potential Consequence
Financial investment	*High capital requirements might mean that only companies with sufficient financial resources can compete. For example, if your CapsimCore company does not have the financial resources to invest in automation or capacity, you will have a competitive disadvantage in relation to your competitors in the long run.*
Economies of scale	*The higher the quantities you produce, the lower the unit costs will eventually be, thus making it difficult for your competitors to break into the market and compete effectively. For example, a CapsimCore company that produces a million sensors will have lower per-unit manufacturing costs than a company that manufactures 10,000 sensors. The higher the production level, the more likely the company will develop process experience and utilize technology more efficiently so it can offer lower prices.*
Differentiation	*Whenever a company can create a strong relationship (i.e. loyalty) to its products, and/or make them more easily available, and/or offer a unique customer value proposition, it makes the market more difficult for competitors to sustain or gain share in the long run. For example, in your CapsimCore company you can make investments in R&D to create products with different value-driver extensions, or focus more heavily on accessibility and awareness compared to your competitors.*
Access to suppliers and distribution channels	*A lack of access to suppliers (e.g. materials, equipment) and/or distributors (e.g. sales organizations) will make it difficult for competitors to enter the market. For example, in your CapsimCore company it would be difficult to develop new products if your Research & Development department did not exist because you would not have access to this expertise even outside your company.*
Price-based competition	*Just the threat of a potential "price war" can discourage your competitors from entering a market. Though predatory pricing is not legally permitted in many regions of the world, often companies find ways to circumvent it. For example, in your CapsimCore company you cannot lower your price below a certain price level.*
Regulatory constraints	*Though this will not be a problem in your CapsimCore company, patents often act as a barrier to enter an industry.*

A ***substitute product or services*** can be more easily realized if a company is able to provide an alternative service or product that satisfies the same need. For example, the need for news can be met with printed media content like newspapers and magazines or with online sources such as websites, blogs, and social media. The more credible a substitute to a company's offering, the more it will limit the price that can be charged. This reduces the company's profit margins and subsequently lowers the potential profit pool of the entire industry.

The ***power of suppliers*** and the ***power of customer***s operate in a similar manner because suppliers and customers are basically operating from the opposite marketplace perspectives (one group is selling, the other group is purchasing). The level of power these groups have follows some general rules. First, both groups are typically more powerful when there are only a few of them around. Second, their power further increases when supply is limited or when a single customer purchases a significant portion of an industry's output. Third, power is high when customers and suppliers are reluctant to switch to a competitor. This is typically the case, for example, when customers have a high degree of loyalty, often established through brand, availability, and accessibility.

All in all, the various forces a company faces in an industry will always encourage management to add as much value as possible to the products and services a customer is willing to pay for. Thus, most companies have developed sophisticated tools to help understand where potential value can be added to their core processes and support activities (***the value chain)***, in order to differentiate themselves from competitors on expertise and ultimately on cost.

Generic strategies

You may have noticed two concepts threading throughout this chapter. Companies often focus their strategic efforts: (1) on providing their products and services based on a low cost approach and/or (2) on differentiating their products and services from competitors in order to manage their costs by setting different prices.

Though there are many shades of gray to the low cost and differentiation approaches, both concepts apply to any company and to any industry. Thus, we often refer to them as "generic strategies." We briefly describe these generic strategies below.

Cost Leadership

A company embracing a cost leadership strategy maintains a market presence in a well-defined "niche" (a specific market segment) or operates broadly across all segments of the market. Such a company gains competitive advantage by keeping R&D, production, material, and labor costs to a minimum. Lower costs enable the company to compete on the basis of price and volume. Consequently, the prices of their products and services will typically be below the industry average.

When well executed, a company focusing on cost leadership will cycle its products through an entire "lifecycle" in order to maximize profitability. For example, the electronics industry (e.g. smartphones, television panels, Blu-ray players, etc.) begins with product offerings at the high end of the market and then trickles them down over time to all other customer segments (customers with very limited budgets, for example). This product lifecycle continues until the product matures and has saturated the market (i.e., only a limited amount of potential new customers exists).

Another low-cost approach is for companies to go in the opposite direction and begin in the low end of the market. This approach is generally less frequent. Volkswagen is a good example. The company started out with a very affordable car (the "Beetle") intended to be widely available. In fact, the name "Volkswagen" means the "people's car." Today, Volkswagen manufactures many higher-end cars such as Audi, Porsche, Bentley, Lamborghini, Bugatti, and many others.

Closing the gap on the cheap seats

EasyJet – the British low-cost airline that launched in the mid-90's with the slogan 'flights as cheap as a pair of jeans' – announced its fifth consecutive year of record profits in 2015. Southwest Airlines, the US low-cost airline that started it all in the 1970's – with hostesses in orange hot pants and white go-go boots – topped a billion dollars in profits in 2015 – its 43rd consecutive year-end profit.

The low-cost carrier (LCC) market has matured, but as analysts point out, the gap between LCC and legacy airlines services has narrowed significantly in latter years. As the legacy airlines saw their markets erode, they cut costs and services in an attempt to meet the competition. As the no-frills airlines became successful, they had more money to introduce a few small ruffles.

EasyJet, for example, now markets to business travellers and has introduced allocated seating. Ryanair, its major European competitor based in Ireland, has followed suit. The sector is also growing aggressively in new markets. According to the Center for Asia Pacific Aviation, the capacity of LCCs in Asia Pacific increased more than four-fold over the past 10 years – from approximately 130 million seats in 2008 to nearly 600 million seats in 2018.

Low-cost carriers developed a new profit model for air travel. They cut costs in myriad ways. They cut fleet costs by hedging gas price contracts to smooth fuel costs and using one type of aircraft with minimal additions (Ryanair's seats, for example, did not recline or have seat back pockets, in order to reduce weight and maintenance costs). They cut labor costs by hiring less experienced staff at lower pay grades. They cut passenger amenities to the bone, offering no in-flight entertainment and charging for each service, including food, beverage, luggage, pillows, blankets – even debating the merits of charging for bathroom use. They cut airport fees by ensuring planes spent minimum time on the ground, using secondary airports instead of major hubs and avoiding jetways that attract high usage fees. The result was an ability to cut prices – sometimes to as low as zero (excluding taxes and charges) – with simple fare structures such as one-way fares priced at half return fares and seat prices that increase as flights fill.

According to the Economist, however, "the cost gap between traditional and budget airlines has fallen by an average of 30% in six years, partly because legacy airlines have abandoned old differentiators like free baggage and in-flight catering on short-haul flights. "The service being offered by low-cost and legacy carriers is now more or less the same," says one analyst."

The result may be the end of zero-plus-fees airfares. "In America, where Continental, Northwest, Midwest and AirTran have all merged with other carriers, average fares have risen by 13% since 2009. The days of cheap flights are over and, as usual, passengers will foot the bill."

As in the real world of business, you have the opportunity to drive down manufacturing costs in your CapsimCore company. In addition, you are able to increase the automation levels of production, which can also improve margins and offset costs such as overtime for employees on second shift.

Differentiation

With this generic strategy, companies seek to provide customers a very different, and often extremely unique, experience in order to differentiate their products or services. Sometimes the experience is considered a luxury in and of itself. Other times the unique experience could be derived from technology. Of course, a combination of both can be used as well. For example, think about a car. A car in its simplest form is just a mode of transportation to get you from point A to B. However, the experience that a Rolls-Royce seeks to provide is much different than a Ferrari, or a Volkswagen, or a Ford for that matter.

A company gains competitive advantage through differentiation by distinguishing its products with excellent designs, high awareness, easy accessibility to customers, and new products offered regularly. Consequently, such companies seek to develop a highly skilled R&D function that keeps designs fresh and exciting. Products will keep pace with market changes by offering improved features, such as size and performance (e.g., smaller, faster smartphones). Even when costs are managed very well, companies pursuing differentiation with product design will often end up with a price above industry average and thus need to closely link production capacity to a higher market demand.

Puttin' on the Ritz

A barman at the Ritz-Carlton in Marina del Ray, California was told the young couple he was serving had canceled their honeymoon in Hawaii because the groom had been diagnosed with cancer. A little while later, the night manager appeared with two tropical drinks, a cheery "Aloha" and escorted the couple back to their suite where "orchids carpeted the floor, Japanese lamps glowed, and seashells and sand were scattered across the room. Pictures of the happy couple in "Hawaii" were presented as a memento of their stay."

This is one of many in a montage of Ritz-Carlton moments collected on the company's website, where it promotes its above-and-beyond-the-call-of-duty style of service. There is the wheelchair-bound gentleman heard to bemoan the fact he couldn't go down to the beach with his wife, who the next morning discovered a timber ramp built from his room to the beach. The businesswoman whose birthday breakfast tray included a webcam bringing her husband and daughter into her hotel room. The guest whose luggage combination lock mysteriously stopped working until the hotel staff called the bag's manufacturer in Germany for help.

The Ritz-Carlton, part of the luxury sector of the Marriott hotel group, is a top-tier hotel management company that manages individually owned hotel properties for their private owners.

Its motto is "we are ladies and gentlemen serving ladies and gentlemen," and its many service success stories are shared at the daily 15-minute lineup meetings most of its 40,000 employees attend. In its manifesto "I am Proud to be Ritz-Carlton," the first of its "service values" is "I build strong relationships and create Ritz-Carlton guests for life." That repeat business is fostered by ensuring all employees are given responsibility for solving problems on behalf of guests. First-line employees are authorized to spend up to $2,000 per incident (for everything from Japanese lamps and seashells to custom built ramps!)

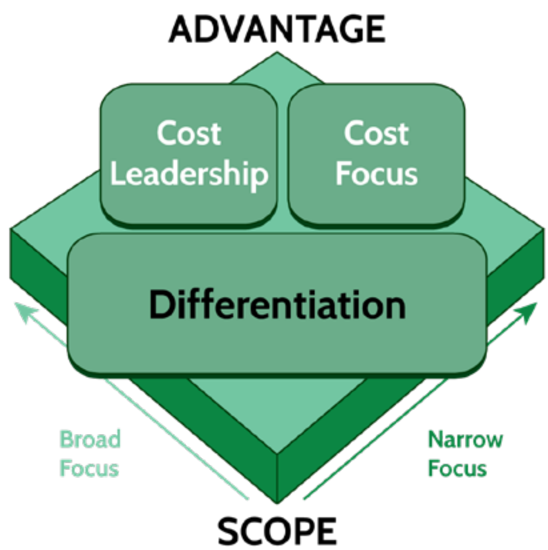
Simon Cooper, then President and COO told Forbes that Ritz-Carlton hired just 2% of the people who apply for jobs. Those who succeed receive more than 100 hours of training. "Training is really important, because it nurtures the careers of our ladies and gentlemen."

Mr. Cooper said the company did not think of itself as a hotel chain. "A breakthrough in our thinking was understanding that we are not a hotel brand but a lifestyle brand," he said.

"More than 3,000 people have bought in for several million dollars each, and to me those people are brand devotees for life. Of course, all strategies are sensitive to significant market turns, but from the longterm perspective of growing a customer base that is absolutely married to the brand, it has worked out extremely well."

Instead of focusing on new designs of a given product in a particular market segment, another differentiation strategy can be accomplished by maintaining a presence in ***every*** segment of the market. For example, the French luxury goods manufacturer LVMH provides champagne and wine as well as fashion products to the market. The Italian fashion design conglomerate, Armani, offers furniture and hotel services. Some companies execute such strategies by focusing on broader product categories across market segments, like Nike (shoes and apparel) or Sony (electronics). Certainly, companies will strive to run their product and service offerings across their product lifecycles as we already discussed in the Cost Leadership section. However, doing so using a differentiation strategy is very challenging to implement.

In summary, competitive advantage can be achieved by either focusing on cost leadership or on differentiation. The activities used to implement these generic strategies can be narrowly focused or broadly scoped, but they will always focus on reducing cost or increasing differentiation in order to achieve a competitive advantage.



Recall that we discussed that choosing a strategy always results in making tough choices about who a company wants to be, who it wants to serve, and how this will be accomplished. This also means there will be trade-offs, advantages, and disadvantages in any strategy. Given that companies focus only on one of the quadrants shown in the figure above, any chosen strategy that seeks to build competitive advantage through cost leadership or through differentiation bears the risk that:

- Competitors imitate another company's business activities
- Differentiation becomes less important to customers and buyers
- Demand disappears
- Customers choose only companies that provide a broad portfolio
- Technology changes over time
- New customer segments emerge requiring completely different value drivers than currently offered.

CAPSIMCore

Evaluating your CapsimCore Company

In CapsimCore, you are scored on a five star rating. One star each for Sales, Profit, Stock Price, Contribution Margin and Emergency Loan.

It's simple: you get a star this round if your company improved on its result from last round. No improvement, no star. The scoring is based loosely on Morningstar Ratings that have been used for more than 30 years to help investors understand the risk profile of various investment funds. However, awarding a star for improvement over last year is a reflection of what happens in the real world. If your company performs better this year, then you are making progress and will be rewarded. This means no external criteria are imposed on you, potentially disadvantaging you vis-à-vis other companies in your industry. For example, if the simulation was to use a measurement like market share to evaluate each company, it would be great for a firm selling cheap, commodity products, but not relevant to a company aiming for the high end market.

You can see your projected results on the five star rating under 'proforma' in the top menu bar of your simulation. Remember, however, the proforma offers projected results, based on your forecasts, not actual results which will vary depending on the accuracy of your forecasts and your competitors' activities. Your goal is to do better each year on:

Sales: *Whether you are selling a lot of low tech products or a lower number of upscale, high tech products, your goal is to ensure you are selling more, each year, than you did last year. Success will depend on your ability to analyze the market, forecast sales and deliver the right products, in the right quantities to the right customers.*

Profit: *Profit, as we discussed in Chapter 1, is the difference between everything it costs the business to offer a product or service and what it makes in sales. Losses are usually the result of insufficient margin, when business costs are too high and prices too low to cover them. Profit can also suffer from excessive expenditures in selling and advertising, heavy interest payments on debt, and losses on liquidation (scrapping) of inventory when retiring a product line.*

Stock Price: *Stock price is affected by performance, asset base, debt, dividend policy, and number of shares outstanding. In a year of aggressive investment in plant expansion and automation, you would expect that the necessary debt load would cause some uneasiness on the part of shareholders. If your stock price dips more than $15.00, however, it may be a warning sign of too much debt. The stock price can also suffer in profitable years. For example, liquidation of plant brings in cash, but makes shareholders wonder about the long-term competitive ramifications. Paying dividends in excess of profits, or needing an emergency loan, will also have a negative effect on stock price.*

Contribution Margin: *Your contribution margin is defined as sales minus (direct labor + direct materials + inventory carrying costs), divided by sales.*

Your star rating is calculated on an aggregate contribution margin over your entire product portfolio. A good benchmark for contribution margin is 30%.

Emergency Loan: If *you are out of cash at the end of the year, your company is given an emergency loan to bail you out. However, it comes at a very high interest rate. In the real world we often refer to emergency loans as "a liquidity crisis", "Chapter 11", or simply "Bankruptcy".*

Measuring success: the importance of a balanced approach

Measuring success in business is critical, but long before that we need to know what success ***means*** for your particular business. This flows from your company's mission and its strategy – whether it is to provide the most exclusive handmade chocolates, deliver the best pizza in town, or build the world's most luxurious supersonic jet.

Alignment and coordination are all enhanced, as we have discussed, when a business has a clear strategy. Measuring how well the company is achieving its strategy also depends on the strategy itself because that determines what is important to measure.

A company's strategy points to the benchmarks used to indicate a company's success. For example, a discount retailer like Wal-Mart doesn't measure its success using the same benchmarks as a luxury retailer like Chanel. They are in the same industry (retailing), but are very different businesses using very different business strategies.

In the real world of business, companies select their own, key benchmarks based on their unique company strategy and/or important industry benchmarks.

The Balanced Scorecard

One 'big picture' approach to how a company is performing is the ***Balanced Scorecard***. More than a grouping of financial measures, the Balanced Scorecard is a strategic assessment tool that can accurately portray a business or business unit's overall strategic progress.

The Balanced Scorecard asks managers to consider their business from four different perspectives. ***The critical point is that all four perspectives are equally important in measuring success – the scorecard is "balanced."*** For instance, only one perspective focuses on the financial metrics. The implication? Focusing only on financial assessments of performance is not enough to improve an organization.

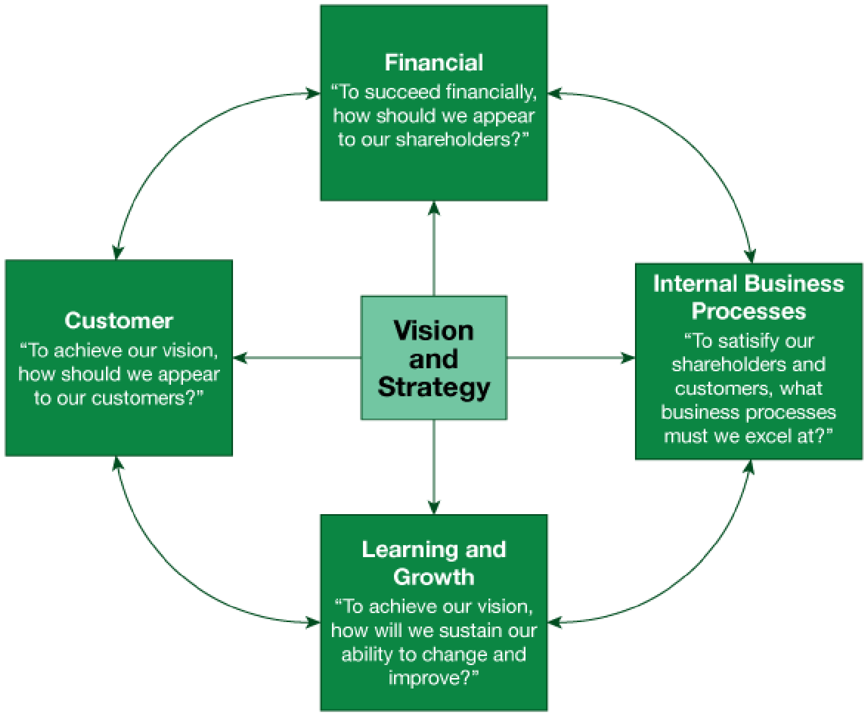
The four perspectives (or "quadrants" of the scorecard) are:

1. The Customer
2. Internal Business Processes
3. Learning & Growth
4. Financial

CUSTOMER PERSPECTIVE. The customer perspective asks the question: ***"how well are we satisfying our customers' needs?"*** Robert Kaplan, one of the originators of the Balanced Scorecard, says customers' concerns can generally be broken down into four areas: Quality; Performance; Time and Service.

Within each of these areas there are a number of sub-elements. Take the area of "time," for example. A customer might be concerned with the amount of time a manufacturer

The Quadrants of the Balanced Scorecard



takes to introduce new designs, or how quickly the manufacturer can deliver a product (the production cycle). One of the goals in this perspective is to be perceived as the most innovative supplier to the industry. Clearly then, new product introduction cycle time is a vital statistic, as is the portion of revenues generated by products or services that are less than two years old. Innovators would not want the additional perception of a low-cost leader, for example, because low cost is inconsistent with innovator's goals.

In CapsimCore for example, your score in this quadrant – if you were using the Balanced Scorecard, might look at measures such as customer awareness, customer accessibility, customer satisfaction and your company's market share.

INTERNAL BUSINESS PERSPECTIVE. The internal business perspective asks the question: *"What do we need to correct within our own business to ensure we deliver the value propositions the market needs and expects?"*

For example, a manufacturer that sets its strategy to be the low price leader in the marketplace needs to focus very carefully on driving down all internal costs for making and selling its products. It takes strict discipline. To meet this goal, the manufacturer would need lower labor and material costs than its competitors. Even marketing costs would have to be reduced. Questions about the internal business perspective need to be uncompromising. What do we want to be best in the world at, and what do we have to do to get there?

In CapsimCore, for example, a Balanced Scorecard rating in this quadrant would include measures such as your contribution margin, plant utilization levels, and days of working capital.

LEARNING AND GROWTH PERSPECTIVE. Nothing in business is static; the innovation and learning perspective asks, ***"How do we develop and grow in order to continue to create value?"*** In 1903 the economist Joseph Schumpeter said companies needed to engage in "the creative destruction of capital" to succeed. He was referring to the need for corporations to be willing to pull apart their existing processes and systems, reconfigure them, and then move forward with new, different, and more highly developed value propositions as the markets in which they operate change. The more rapidly markets change, the more important this reinvention is, and businesses that cannot "creatively destroy" will inevitably give way to businesses that can.

FINANCIAL PERSPECTIVE. In this perspective, the question is: ***"How is our strategy and tactical execution translating into profitability and economic viability?"*** Some might feel there is no need to review financial measures, because by carefully watching the other measures of the Balanced Scorecard, financial success will naturally follow. This may be true in some cases, but it is not always true. For example, low cost companies might watch their cash position all but evaporate if there are not enough buyers for their products–no matter how efficiently they are produced. Therefore, the financial perspective asks two distinct questions:

1. Are we making a profit in the activities in which we are engaged and therefore growing the company/increasing shareholder value?
2. Do we have the appropriate levels of cash to operate both in the short term and the long term?"

In CapsimCore, you'll watch a few key financial measures – profit and stock price – each round via your dashboard. The Industry Report provides a wide range of financial results on both your own, and your competitors' companies.

A final note on how it all works together

From the relatively simple building blocks of ideas, people, and capital with which we began our discussion in Chapter 1, we have seen over the course of this journey that businesses can develop in very different ways and that they have quite complex interactions with internal and external stakeholders. All of these interactions matter to the success and sustainability of a business.

As we discussed in this chapter, it is vital that every business, in whatever market it operates, sets a very clear strategy and keeps a close eye on the operational execution of its chosen strategy. Critical to this process is how success is measured and monitored relative to the firm's strategy and the performance of its competitors. In the next chapter we are going to broaden our horizon to the community and culture in which the business operates and think about how good business decision making needs to be underpinned by sound ethical principles.

Chapter Review Questions.

1. What factors influence the strategic choices a company will face?
2. What does S.W.O.T. stand for and how does a SWOT analysis matter to business strategy?
3. What are the common questions that are asked in each of the components of a SWOT analysis?
4. What is the importance of goal setting to business strategy?
5. What are the characteristics of effective goals?
6. What are the differences between the existing, overserved, and non-customer categories? How does one grow or sustain a business in relation to each of these categories?
7. What is operational effectiveness?
8. What is strategic positioning?
9. What four basic decisions are generally the responsibility of the CEO?
10. What is competitive advantage and what kinds of question can we ask to help identify sources of it?
11. What are the characteristics of business resources that promote competitive advantage?
12. What are the "five forces" that drive competition in an industry?
13. What are some ways to create "barriers" in the CapsimCore Simulation?
14. What are the differences between the two generic strategies of cost leadership and differentiation? What are the goals and actions that are associated with each?
15. What makes the Balanced Scorecard "balanced"?
16. What are the four quadrants of the Balanced Scorecard? What is the central question that is asked in each perspective of the Balanced Scorecard?

7 Ethics: doing it right – social responsibility and ethical decision making

Learning Goals

After reading this chapter you will be able to:

- Define what represents an ethical issue.
- Describe the ethical decision-making process.
- Define social responsibility.
- Compare and contrast concepts such as triple bottom line and corporate philanthropy.
- Discuss the four steps of the ethical decision-making process.
- Describe the five major approaches (theories) of business ethics.
- Differentiate between primary and secondary stakeholders.
- Apply the ethical decision-making process to business situations
- Incorporating Ethics into Strategy

The Broader Context of Business

Business, by its very nature, cannot operate in a vacuum. Instead business requires constant interaction with a wide range of stakeholders, and each of these stakeholders is impacted by the actions a business takes. As we discussed in Chapter 1, business stakeholders are both internal (e.g., owners and employees) and external (e.g., suppliers, bankers, customers, etc.). And every day, while businesses are operating within their commercial, physical, and community environments, their activities are constrained by laws, regulations and in some cases culture. Within that web of interactions and restrictions, however, there are gray areas – areas where human behaviors, lack of clarity, and conflicting rules and expectations can lead to problems that need to be solved not by financial or managerial logic, but by ethical reasoning. This is the domain of business ethics.

An awareness of ethical principles in general helps to determine the standards of behavior that guide us in our daily life. These principles shape our relationships at home, at work and within our chosen profession, our community and society at large. Such considerations are at the heart of how we structure our organizations: our schools, our businesses, our community and non-profit groups, our places of worship as well as our governments, the laws we enact, and the systems we provide to our citizens such as health care, energy, transportation, and taxation.

We make ethical decisions every day, often without thinking about them: whether to slide through a stop sign when we don't notice any traffic; whether to cheat (just a little) on expense reports or taxes; whether to download music we didn't pay for; or even how we deal with a coworker or classmate who doesn't contribute their share of the work.

Ethical principles also come into play in nearly every decision we make when running a business. The difficult part, however, is being able to first recognize the "ethics" in a given decision and then to follow a thought process that more fully informs the decisions we ultimately make. The main goal of this module is to help paint a clearer picture of business ethics, why they matter, and what we can do to improve our ethical decision-making skills.

Business ethics basics

To understand the broad implications of business ethics, we should start by defining a few terms. Put simply, an ***ethical issue*** is one where a person's actions, when freely performed, may either harm or benefit others or both. Therefore, ***ethical decision making*** is the process through which you determine what course of actions you will take. This process necessarily involves making choices while considering the possible consequences of those choices for the business and its stakeholders.

Typically, a decision is deemed "ethical" when it is both legal and morally acceptable to the larger community and is based upon careful consideration of the facts. Sometimes what is legally acceptable in a business context may not be considered "morally acceptable" to the broader community. In these and many other circumstances the application of ethical decision making is critical to avoid adverse consequences either

Legally correct but what about the ethics?

Walmart

In 2000, Wal-Mart employee Deborah Shank was driving her minivan when it collided with a semi-trailer. The accident left her with permanent brain damage, confined to a wheel chair and living in a nursing home. Deborah's husband and family were awarded a $700,000 settlement for damages from the trucking company which, after legal costs and expenses, left $417,000 to be put into a trust for Deborah's ongoing care.

Six years later Wal-Mart, which provided Deborah's health insurance, sued her for the $470,000 the insurer had paid for her medical expenses. The legal action was entirely valid because there was a clause in Deborah's health insurance contract that said any money won in damages by an employee could be recouped by Wal-Mart. The court, therefore, ruled in Wal-Mart's favor.

Over the following years, her husband had to rely on Medicaid and social security payments for her care, her 18-year-old son was killed in Iraq while fighting in the U.S. army and the Supreme Court declined to hear her appeal to the earlier court ruling. It took a news story by CNN in 2008, followed by a public outcry and calls for a boycott of Wal-Mart's stores, for the company to reverse its decision.

Most importantly Wal-Mart – the world's largest retailer, with revenues of nearly $524 billion in 2020 according to the Fortune Global 500, – changed the clause in its health care plan to allow for "more discretion" in individual cases where damages are awarded following accidents. "Occasionally, others help us step back and look at a situation in a different way. This is one of those times," Wal-Mart Executive Vice President Pat Curran said in a letter.

to stakeholders or to the business itself. We will return to a discussion of the ethical decision making process later in this chapter.

Ethical practice relies on rational thought to inform us how we "ought to act" in such matters as fulfilling our obligations and duties, being compassionate and fair, respecting the rights of others, and contributing to the greater good of society. It is important to point out that simply believing that you are "an ethical person" is no guarantee that others will view you this way. In fact, it is the actions we take (our behaviors) that are most often what is ultimately judged to be "ethical" or "unethical."

Business is essential for a prosperous society and we rely on businesses to act ethically by not putting their own interests above those of the society at large. In other words, we need those who lead businesses to consider the impact of their activities on the rest of us. Business ethics, however, aren't just relevant to chief executives who make major decisions. Ethical issues come up at every level of business. Start work in any type of business at all and you are likely to encounter job-related ethical conflict.

Ethics and social responsibility

Business ethics operate on two levels. At the individual level, decisions with ethical considerations need to be made in all areas of business. The company as a whole, however, also bears a social responsibility. After all, it is society at large that makes the operations of ***any*** business possible.

The pressures on organizations to act in responsible and ethical ways come from a variety of stakeholders, including a firm's, customers, employees, industry groups, etc. Laws and regulations also frame the types of actions seen as "acceptable" in a given society customers, employees, industry groups etc. Laws and regulations also frame the types of actions seen as "acceptable" in a given society. However, as we have said, compliance with the law is often not the same thing as acting in a responsible or ethical manner. One way to view business ethics is as a part of the ***"pyramid of social responsibility."***

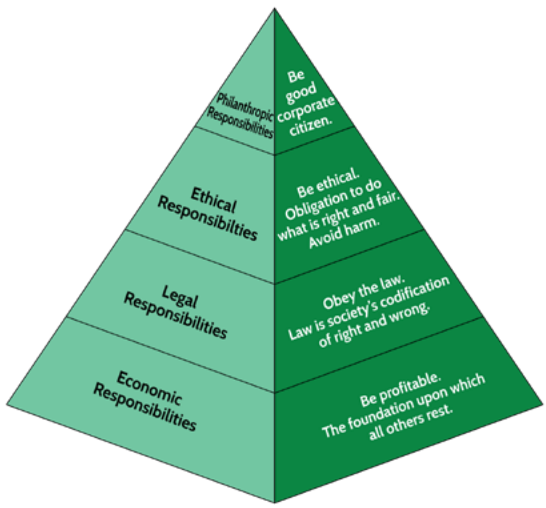
Everyday life - but no one's going to notice......

Ethical breaches can lead to blatantly illegal activities that destroy businesses, families, fortunes ... but the seeds of unethical behavior can seem insignificant, even acceptable because "everybody does it" or "no one will even notice." Some examples are sneaking food out from the restaurant you work for, a boss promising an employee a day off to reward them for additional work then not following through, someone taking credit for someone else's work, doing a fake online review of a friend's business, calling in sick to go to the beach, sliding a personal purchase into a business expense account, copying a piece of software from work onto your home computer. How many more examples can you list, from your imagination or your experience?

Social responsibility is an ethical or ideological theory that holds that an organization or individual has an obligation to society at large. Sometimes this is referred to as the "social contract" between business and society, and includes the informal expectations that the public holds for business practices.

In its simplest form, social responsibility in business involves four steps that begin at the base on the pyramid:

1. Be profitable (required)
2. Obey the law (required)
3. Be ethical (expected)
4. Be a good corporate citizen (desired)



Triple Bottom Line

TBL measuring and driving business development

When actress Jessica Alba launched The Honest Company to make nontoxic baby products, her vision included management according to the Triple Bottom Line: profit, people and planet.

The concept of the TBL has been embraced by private, publicly listed, and publicly owned corporations. Michigan-based Cascade Engineering, for example, describes how TBL integrates into its management and reporting systems:

> *"We think of the concept of sustainability as the three interconnected gears in motion. Each category is an interdependent, innovation-enabling mechanism. The three gears … cannot exist independently; each in turn, provides momentum and innovative thought to the next. To drive one forward is to drive all three forward; the result is a sustainable system where innovation begets innovation."*

But TBL is not only for smaller companies. General Electric uses the principles of TBL in its annual "citizenship report", summarizing the company's commitment "to finding sustainable solutions to benefit the planet, its people and the economy." Plus, many public enterprises use it to plan and monitor economic development projects including industrial parks, cultural precincts, and rural economic networks.

Pressure to act in a more socially responsible way has led many businesses to focus on more than just profits and to adopt a broader view of business success. This viewpoint has been called the ***"triple bottom line" (TBL)*** and involves businesses evaluating success in terms of financial, environmental, and social performance – sometimes referred to as a focus on "people, planet, and profits."

Corporate philanthropy

Efforts to increase social responsibility also can be found in corporate philanthropic activities, as companies seek to improve the communities and societies in which they reside and operate.

A recent report from the Committee Encouraging Corporate Philanthropy in New York, an international forum of CEOs and Chairpersons, said 84% of corporate executives believe "that society now expects businesses to take a much more active role in environment, social and political issues" than ever before. The report, based on research by McKinsey and Company, notes:

> *"Successful philanthropy today is not simply writing checks to the local charity. Philanthropic pursuits are becoming an important way for most corporations to communicate with stakeholders, gauge their interests and satisfy their elevated expectations. By choosing the right philanthropic programs – those that yield social benefits and address stakeholder interests companies can build a good corporate reputation. And a good reputation is both a source of tangible value and a reservoir of good will to be tapped if a company runs into trouble."*

The report concludes that the most successful philanthropic programs are those that are operated using the principles of sound management applied elsewhere in the company: a clear strategy, good teamwork (harnessing the talents and capacities of a variety of people), and constant, ongoing measurement against goals or standards.

"By treating giving as a business unit," the CECP report says, "the philanthropy team is empowered to contribute to the wealth of the company just as the rest of the business does."

Not just a few bad apples

Of course, we more often hear about organizations that fail to act ethically and responsibly. These tend to be the situations that make the news headlines and rightly so, considering the costly consequences of many ethical breaches. Engineers at Thiokol had safety concerns about the cold weather performance of a space shuttle part – the O-ring – but did not ensure that this information was communicated to key officials. The Space Shuttle Challenger exploded on launch on a cold morning in 1986, killing all seven crew members.

BP's Deepwater Horizon oil rig continued drilling even through its blowout preventer was defective, faulty software was causing rig systems to crash, emergency alarms were disabled, and a relatively inexpensive acoustic trigger (which could have shut down a damaged well), was not installed. Eleven BP employees were killed, 17 more were injured, and nearly 5 million barrels of oil leaked into the Gulf of Mexico.

News Corp. executives were caught in a phone hacking scandal that was thought to involve eavesdropping on politicians, celebrities, and members of the Royal Family but was later discovered to include private citizens - including crime victims and the relatives of soldiers killed in action. The scandal, including accusations of police bribery and improper influence, led to the closure of the ***News of the World*** newspaper after 168 years.

The failure of American International Group in 2008, due to under-collateralizing one of its credit products, had a devastating effect on the world economy, precipitating a global financial crisis. These and other sensational business stories involved unethical business behavior that eventually affected thousands.

These examples certainly point out that the consequences for acting unethically or irresponsibly can be severe and long-lasting for organizations. Yet organizations don't make decisions, people do. It was ***individuals*** in these organizations who decided on the particular courses of action that ultimately led to negative outcomes.

To be clear, this does ***not*** mean that poor decisions are the result of one or two "unethical" employees (so-called "bad apples"), which is the common explanation that is given in these situations. Nor does this mean that corporate work environments have little influence on ethical decision making. To the contrary, an organization's culture –

It seemed like a good idea at the time…

When the Duchess of Cambridge was hospitalized during her early pregnancy in 2012, hosts of the Hot30 Countdown radio program in Sydney, Australia, were able to get private information about the Duchess's condition by calling the hospital pretending to be the Queen of England and the Prince of Wales.

The call was made around 5:30 a.m. London time and – with no switchboard operator on duty at the private hospital – the nurse answering the phone, Jacintha Saldanha, transferred the call directly to the nurse treating the Duchess, who gave details of her condition. The goal of the hoax was to get the Duchess on air and had been cleared by the radio station's lawyers. It appeared to be a very successful stunt, until – three days later - Jacintha Saldanha was found dead in the nurses' quarters. She had hanged herself and left several suicide notes, one blaming the radio presenters.

The consequences of the "hoax" were far reaching. Advertisers boycotted the radio station, which then donated $500,000 to a memorial fund in support of the victim's family. A street demonstration was held in front of the British High Commission in New Delhi and there were calls for further protection for Indians working abroad (Saldanha was a native of India). The radio program was canceled and the pranksters lost their jobs. Legal action followed in Britain and Australia, but the British Crown Prosecution Service eventually determined no laws had been broken because: "however misguided, the telephone call was intended as a harmless prank." What difference do you think ethical decision making, using the guidelines discussed next, could have made to the outcome?

the social aspects of its work environment – can have an effect on the way people think and act, especially in regard to ethics and social responsibility. For example, the seeds of an ethical crisis often go unrecognized. A series of small, even unrelated, decisions can culminate in "the perfect storm." A person who is normally honest and virtuous in their personal life may justify unethical behavior at work as "just business" or "that is the way things are done around here." Perhaps that person put personal success and the financial security of his or her family before his or her responsibility to society at large, or felt compelled to act against his or her better judgment due to pressure from an authority figure, a corrupt organizational culture, or an organizational culture that offered no clear expectations about how to act.

What doesn't make the news, but is more common, is this type of scenario: A mid-level advertising executive pressures a new hire to "fudge" a routine advertising spending report provided to their client, a brand manager of skin care products with a large pharmaceutical company. The executive suggests, "it's just the way it's done around here." Against better judgment, the new hire complies and numbers are massaged to misrepresent the agency's spending of client funds. The client's brand manager detects the fraud and notifies the entire corporate chain of command, sparking a crisis of confidence between the client and the advertising agency.

When the situation is reviewed at the agency's senior level, whose job and career will be on the line in an effort to appease the client and save the business relationship? The account supervisor with years of experience in the skin care market, or the most recent addition to the account team?

Certainly developing an ethical consciousness might have helped the young recruit in the example above. However – and this is part of the paradox of business ethics – it might not have had any impact on the outcome for the individual. Acting ethically and refusing to fudge the numbers may have led to the same result. The new recruit might have lost his job for not being a good "fit" for the position. The client might have fired the agency for poor results. The only ***guaranteed*** reward for the ethical actions is the knowledge that everyone had acted ethically.

With some understanding of basic ethical principles and training in how to approach ethical problems, however, we can be less vulnerable to undue or untoward pressure in the workplace and better able to help shape a company's ability to be a good corporate citizen on the world stage. Understanding how to use ethical decision-making tools, therefore, may be as important to understanding business as understanding the disciplines of marketing, finance, and operations.

Ethical decision making process

Trying to engage in an ethical decision making process presents several challenges. The first challenge with being an ethical decision maker is that many problems do not scream, "Look at me! I'm an ethical issue!" That is, ethical dilemmas are not always clear-cut cases of "right versus wrong." In fact, many ethical dilemmas involve situations that are "right versus right," where choices entail deciding on truth versus loyalty, short-term versus long-term effects, or individual versus community. A second challenge is that ethical decision making requires effort, perhaps even more effort than we typically give toward other decisions. A third challenge is that ethical decision making requires that we avoid our natural tendency to make snap judgments or use quick solutions.

To help meet these challenges, it is important to follow a deliberate and systematic process. Generally speaking, there are four steps to the ethical decision-making process:

1. Investigate the ethical issues
2. Identify the primary stakeholders
3. Increase the number of alternative courses of action
4. Inspect the consequences of the alternatives

While proceeding through the steps above may take more time and effort, there are several benefits. A multi-step process encourages discussion with others and may uncover additional viewpoints as well as revealing how these viewpoints are similar or different. It allows fair evaluation of conflicting perspectives, each of which may involve what appear to be "good" or "right" reasons. By considering multiple courses of action, decision makers may reject a proposed action as inappropriate, even if it was originally widely supported. A multi-faceted evaluation can highlight which option may be the best choice, and can build consensus regarding that decision, particularly as key decision makers consider public reaction to their choice. Finally, a multi-step process provides a structure to use to evaluate the decision after action has been taken, and to deter- mine what practical knowledge the situation provided.

Now, let's walk through each of these steps in more detail.

Step 1: Investigate the Ethical Issues

The first step in the ethical decision-making process is to gather relevant information about the situation and to use that information to identify the ethical issues involved. This means you need to collect the facts and define the ethical dilemma or problem that you face.

Information that is "relevant" can be revealed by asking questions such as:

- What are the potential legal issues? What laws or regulations are related to the situation?
- Has the organization faced this situation before? If so, what actions were taken previously and why?
- Who has the final authority to make a decision?
- Are there organizational rules, policies, or regulations that govern the decision?

Once you've gathered all the relevant facts, it is time to use those facts to define the ethical issues involved in the situation. At the broadest level, there are several categories of ethical problems that help identify ethical issues. For example, does the situation present a case of bribery, an abuse of resources, a conflict of interest, or a form of discrimination? These ethical problems can occur in any function of business.

A useful tactic for exploring the ethics of a situation is to apply different ethical theories or perspectives. The value of applying different perspectives is that it forces you to see the problem from multiple viewpoints, which is ***absolutely essential*** to the ethical decision-making process. Doing this helps reveal aspects of the problem that you might not have considered, and can often suggest the best way to carry out a decision.

There are many specific ethical theories or perspectives that can be applied. However, the majority of these fall into five general approaches:

UTILITARIAN. This approach assesses a possible action in terms of its consequences or outcomes. For a company that is the net benefits and costs to all individual stakeholders. The goal of this approach is to achieve the ***greatest good for the greatest number*** while creating the least amount of harm or preventing the greatest amount of suffering. In a business context, a utilitarian approach might rely on a statistical analysis of probable outcomes, a classic costs/benefits assessment, or consideration of the marginal utility (the added value) of a consequence for various stakeholders in the group.

INDIVIDUAL RIGHTS. This approach focuses on respect for human dignity, which comes from our ability to choose freely how we live our lives, and our moral right to consider others to be free, equal and rational people, and to respect their choices. The goal of this approach is to avoid actions that infringe on the rights of others. In a business context, an individual rights approach might rely on determining whether an ac-

Some examples of ethical breaches common to business functions

Accounting and Finance	*Compensation issues, such as excessive payments made to senior executives.*
	"Creative" accounting, misleading financial analysis or reporting.
	Bribery, kickbacks, and facilitation payments, which, while perhaps beneficial for the short-term interests of a company, can be anti-competitive or offensive to societal values.
Marketing and Sales	*Price fixing, price discrimination, and price skimming.*
	Attack ads, subliminal messages, sex in advertising, and products regarded as immoral or harmful.
	Specific marketing strategies such as green washing, bait-and-switch, shill, viral marketing, spam, pyramid schemes, and planned obsolescence.
	Unethical marketing to children, such as marketing in schools.
Production and Operations	*Defective, addictive, and inherently dangerous products such as tobacco, alcohol, weapons, motor vehicles, chemicals and drugs.*
	New technologies and their potential impacts on health (e.g., genetically modified food, mobile phone radiation, etc.).
	Impact of production processes on the natural environment.
	Product testing ethics: animal rights and animal testing, or use of economically disadvantaged groups (such as students) as test participants.
Human Resources	*Discrimination on the basis of age, gender, race, religion, disabilities, weight, or attractiveness.*
	Issues affecting employee privacy such as workplace surveillance and drug testing.
	Occupational safety and health.

tion would infringe on the rights of an employee (or other stakeholders) and/or whether an action meets the moral obligation for equality of treatment across all people. Some common examples of rights include right to privacy, right to be compensated for work (i.e., right to not be subject to slavery), right to have fair and safe employment and so forth.

FAIRNESS. This approach focuses on the fair and equitable distribution of good and harm, and/or the social benefits and social costs, across the spectrum of society. The goal of this approach is to treat everyone equally; if there is unequal treatment it must have a just cause (i.e., a "fair reason"). In a business context, a fairness approach might rely on first identifying any differences in treatment or outcomes across various stakeholders. Then, each difference is examined for its legitimacy. For example, paying employees at different salary levels would be "fair" if these differences were based on job performance, and "unfair" if based on being "liked by the boss".

COMMON GOOD. This approach regards all individuals as part of a larger community that shares certain common conditions and institutions upon which our welfare depends. The goal of this approach is to ensure and enhance benefits of an action for the society as a whole. Unlike the utilitarian approach that weighs the net balance of goodness and harm for a group of individuals, the common good approach asks whether an action benefits or erodes a specific element of the common good for the entire society (e.g., public safety, a just legal system, healthy ecosystem, and so forth). Determining what is deemed in the ***"common good"*** can vary across countries due to different cultural or societal values. In a business context, a common good approach might rely on determination of whether or not a business practice is in line with what is valued and accepted in the society (or country) within which the business operates.

VIRTUE. This approach focuses on individual character traits and requires us to ask whether a given action is reflective of the kind of person we are or want to be. In a business context, the virtue approach would involve asking oneself if a certain action reflects the kind of employee or leader one would like to be. Or, asking whether or not the action is what a person with high levels of integrity, honesty, compassion, and so forth would do.

It is important to note that there is not one best theory or approach to take. They each have their strengths and weaknesses. Again, the purpose of examining a situation through multiple ethical approaches is to ensure that the facts you have collected are considered from a variety of perspectives. Doing so is the only way to ensure that you have fully investigated the ethical issues involved and that you understand the real choices at hand.

Step 2: Identify primary stakeholders

The second step in the ethical decision making process is to understand those who could be affected by your decision; that is, the various stakeholders impacted, which can include individuals, groups, and/or organizations. This is important for ethical decision-making because it allows you to take on the different perspectives of each stakeholder ("walk in their shoes" or "see it from their side").

Although a variety of stakeholders (often all stakeholders) are likely to be affected by a decision, it is generally more useful to focus on identifying the primary stakeholders who could be affected. ***Primary stakeholders*** are those parties that could be ***directly*** impacted by a decision. In the context of business, primary stakeholders will often be you, your boss, your customers, your colleagues, and your employees. After identifying the primary stakeholders, turn your attention to secondary stakeholders, those who could be indirectly affected by a decision. Finally, list the obligations you have to each group of stakeholders. Such obligations include job requirements, responsibilities to others, and others' expectations of you.

Step 3: Increase the number of alternative courses of action

The third step in the ethical decision-making process is to expand the solution set to three or more alternatives. As we noted earlier, ethical dilemmas are especially challenging because they often involve situations that present "right versus right" choices (rather than right versus wrong). In these situations, what typically happens is that we generate only two courses of action and, to make matters more difficult, these choices are frequently "either/or" in nature. A rule of thumb in ethical decision-making is that if your thought process revolves around only two options, you're much less likely to make a good decision. Therefore, the primary purpose of this step is to think creatively and generate as many courses of actions as possible. When stuck on only two choices in an "either/or" scenario, a useful tactic is to focus on a course of action that lies in the middle - a compromise. This tactic often helps to spur ideas for other alternatives.

The final step of the ethical decision-making process involves determining and inspecting the consequences of each alternative course of action generated in step 3. To begin this step, it is important to not only focus on the different options you've generated but also the various stakeholders that would be impacted and ***how*** they would be impacted by each option.

One pitfall to be avoided in this step is listing out ***all*** possible consequences without regard to their probability of occurrence. In other words, it's more effective to focus on consequences that are reasonably likely to occur, versus those of very low probability. In addition, it is important to consider both short-term and long-term consequences. Once reasonable consequences have been determined for each course of action, you can then examine each by considering factors such as fairness, feasibility, risks involved, costs/benefits, respecting or violating individuals' rights, and so forth.

Once you've arrived at a choice and decided upon a course of action, there are several final "checks" or "tests" you might want to con- sider. These will help you determine if you've made a choice that you can "live with".

- The ***"Wall Street Journal"*** Test – How would I feel if my decision made front- page news in the Wall Street Journal?
- The ***"Parent"*** Test – Would I be proud to tell my mother or father about my decision?
- The ***"Personal Gain"*** Test – What have I gained in this situation? Did the chance for personal benefits get in the way of my thinking?

- The *"Platinum Rule"* Test – Am I treating others the way they would like to be treated?

Putting it to the test: ethical decision making processes

Let's return to our example of the assistant account executive at the advertising agency, and examine how we can use the ethical decision-making process to examine the situation. Recall that a mid-level advertising executive has pressured a new hire to "fudge" a routine financial report provided to their client, a brand manager of skin care products with a large pharmaceutical company. The executive suggested, "it's just the way it's done around here." The new hire complies and the numbers are massaged to misrepresent the agency's spending of client funds.

Step 1: Investigate Ethical Issues

What exactly is the assistant account executive being asked to do? He is being asked to falsify a financial report and misrepresent the agency's spending of client funds.

Based on its client contract, the agency has a fiduciary responsibility to accurately report use of client funds. Not doing so invites a lawsuit as well as considerable harm to its reputation, which could result in the loss of other client relationships, which would erode profitability. Should this occur, those on the account team will not fare well.

Does the assistant account executive know all the facts he needs to know to make an informed decision? Yes and no. He should not need any additional information to know that falsifying a financial report is not a wise choice. However, understanding why the shortfall has occurred might enable him to see what other options are available to him besides the one his account supervisor is suggesting. Did the agency go over budget on a location shoot because it rained or because necessary production costs were simply underestimated - circumstances that could be addressed with the brand manager? Did the financial discrepancy occur at a higher accounting level and the account supervisor had not yet resolved it? Were the funds embezzled?

Have the facts been reviewed with those who could offer good advice? No, so the assistant account executive still has the opportunity to ask more questions of his account supervisor, her boss, the managing account supervisor, the account director, or the director of human resources, as well as those on the creative side who could potentially explain production-spending issues.

From a utilitarian perspective, is there a net benefit to falsifying the report? Possibly in the short term, the account supervisor's happiness will be maximized but not that of any of the other stakeholders. In the long run, even her marginal utility would not be greater than for the others unless she can quickly resolve the discrepancy because her job would be at risk. The likelihood that the budget shortfall would go unnoticed for long is not high, and the costs of discovery far outweigh the benefits.

Would the action respect the rights of others? No, the assistant account executive is being asked to do something against his better judgment, which undermines his sense of free choice and self-esteem. The brand manager has the right to expect that the agency will honor its contractual agreement with his company by adequately fulfilling their fiduciary responsibilities. Is there a good reason to make an exception and falsify the report on just one occasion? The risks and costs of discovery are too high. Would the account supervisor be pleased if the production team on the creative side falsified the financial report submitted to her? No, probably not.

Does the action represent a fair distribution of benefits and harms? No, the action could potentially put the profitability of the entire agency at risk, and there is no justification for spending client funds unaccountably.

Would the action ultimately safeguard the common good? No, it would undermine the expectation that business partners operate with trust and in good faith, which is at the very core of fair trade and commerce.

Would a virtuous person falsify a financial report? Would doing so in this instance be in accordance with the kind of person the assistant account executive aspires to be? No, the assistant account executive would be falsifying the report against his better judgment and it would be an embarrassment to the agency should it come to light.

Step 2: Identify Primary Stakeholders

Who are the primary stakeholders in this situation? The primary stakeholders are those directly affected by the course of action the account executive might take. These would include the assistant account executive himself, his boss, and the client. Other people affected include secondary stakeholders such as the immediate members of the account team and senior management, as well as the agency's partners or shareholders and all of the agency's employees.

Step 3: Increase Alternative Courses of Action

Did the assistant account executive generate multiple options for action? It doesn't appear so. The assistant account executive seems to have fallen prey to an "either/or" choice: either comply with the request to "fudge" the numbers or risk being viewed as "not a team player." There are a number of alternative courses of action that could be taken. In fact, if the assistant account executive would have gathered all the relevant information (as mentioned in step 1 above), other actions might have been revealed. For example, he could have discussed the causes of the running over budget, explored other ways the company could recoup the unbudgeted costs, explained the overrun to the client and explored ways to defray the costs, etc.

Step 4: Inspect the Consequences of the Alternatives

Were the reasonable consequences of the possible actions explored? No. Even for the "either/or" options, the assistant account executive does not seem to have explored possible consequences. For example, in the short term the account supervisor will not have to account for some misappropriation of client funds that occurred before the assistant account executive joined the agency, and that may allow time to remedy the situation. If the numbers are falsified, the assistant account executive will prove he is a "team player" and will initially secure his job. The brand manager will be unaware that there is a budget shortfall because he has not been apprised of the prior excessive spending. In addition, the assistant account executive did not perform any final "checks" on the chosen action, which could have further informed the choice. For instance, asking questions such as: What have I gained from fudging the numbers? What did the client lose? Am I treating the client the way they would like to be treated?

The need to incorporate ethics into strategy

Strategy dictates how a company carries out its operations. Strategic choices made by a company often will have ethical consequences. Most companies aspire to be perceived as ethical. The dictionary defines the word "ethics" as "the discipline dealing with what is good and bad and with moral duty and obligation." Not just individuals, but entire companies are expected to be ethical and to make ethical decisions. To make ethical decisions necessitates that companies develop ethical guidelines or principles to guide actions in the complex global business environment. It is important to incorporate ethics into company strategy to ensure that every facet of the company is aligned with the values of the company. A company adhering to a code of ethics has been shown to result in higher levels of goodwill, low regulation costs, high employee satisfaction, low attrition rates, and more customers.

Ethical issues arise in the interactions between a company and its stakeholders, including shareholders, customers, vendors, and employees. They may also arise where the work environment, environmental issues, product safety, bribes, and employee rights protection are concerned. The ethical issues that a business faces can be broadly categorized as arising in the following four decision areas:

Decisions made for personal gain:

On occasion, individuals with authority within organizations get tempted to use their business contacts, influence, and company resources for their own gains. Corruption is the term we use to refer to such instances where individuals use their positions of power to get what they want, rather than what the company or the stakeholders want. When individuals abuse their power and influence for personal gain, and the abuse is discovered and reported in the media, companies can suffer long-term reputational damage. Volkswagen, for example, was discovered to have lied about the emissions of their diesel-powered vehicles. When the fraud was revealed, individuals at the highest levels originally denied the allegations. Eventually, even the company CEO Martin Winterkorn lost his job over the handling of this scandal. That's why every company should ideally incorporate ethics into its strategy so that all its employees are prohibited from using business resources for personal gains and are held accountable for their actions.

Decisions that lead to a negative social impact:

All companies have unwritten responsibilities to society, such as environmental stewardship, community relationships, and local, national, and international citizenship. A business strategy may require a company to find the most cost-efficient way to manufacture and distribute its products. However, such interests of the company may conflict with the interests of society, and consequently, taint the brand image of the company. For example, a company may source labor and other materials from developing countries where resources are cheap. But if the laborers are forced to work in poor working environments on low pay, the negative social impact on the company's name would be damaging. Apple has been accused of sourcing labor in China that reportedly is subject to excruciating productivity requirements and abysmal work environments. Apple responded to these allegations by becoming more careful in the overseas vendors it selects and in monitoring their labor conditions.

Decisions that influence public interest:

Companies can expand and take over the resources of a large region within a country so that they become extremely powerful. The decisions of such companies may be in the public and economic interest of one nation but might hurt the interests of another. To avoid this, companies should analyze the potential impact of their strategies not just on the region in which they operate, but also on the nation and other nations where there may be an impact. Many large automobile companies sell products around the world. Different nations have different requirements regarding fuel efficiency, emission standards, safety standards, and others. These companies must ensure their products meet and even exceed the varying standards around the world.

Decisions that have an environmental impact:

The actions of all businesses these days have varying degrees of impact on the environment. Some of these actions result in environmental pollution and others are associated with the exploitation and depletion of natural resources. Such negative environmental impact can be mitigated through regulatory compliance, setting and adopting standards shared by companies in the same industrial sector, conducting research, and adopting health and safety measures. Large multinational oil companies, for example, have changed their operating strategies enormously over the years. Occidental Petroleum, for example, has had operations in South America for many years. Practices that at one time might have been acceptable, such as environmental damages, are no longer acceptable as global awareness of environmental issues has increased. Occidental has adapted its oil production and transmission strategies to accommodate these evolving concerns.

To tackle such ethical decisions, there are four elements that senior executives can consider when strategizing:

A code of ethics: This should lay down the values upheld by the company with regard to all the people who influence or are influenced by the company. The code of ethics of a company often evolves as the company grows over time and the management of a large number of people becomes difficult.

Ethical training: Simply laying down a code of ethics does not ensure that all employees will abide by it. Training sessions are necessary to equip employees with the knowledge to deal with conflicts and other complex ethical issues. Training should impress upon employees the ethical consequences and repercussions of their choices, teach them to integrate ethical decision making into their daily work life, and thus, aid in building a strong ethical work culture.

Ethics officers: Now and then, ethical dilemmas arise that cannot be resolved using a code of ethics and ethical training. Therefore, companies often employ an ethics officer to aid employees in determining the most ethical way to deal with complex dilemmas. An ethics officer can also use such situations to improve the company's ethical strategy and further develop its code of ethics.

Confidential reporting systems: Vocalizing certain ethical issues may leave employees vulnerable. Such ethical issues need to be dealt with in a sensitive manner. Organizations should have confidential reporting systems to allow employees to report their issues anonymously.

Ethical values must be embedded into organizational strategy, business models, and the decision-making processes of organizations. Organizational policies that have strong ethical foundations will add value to a company, while the lack thereof can lead to economic, social, environmental, and reputational damage.

Chapter 7 Review Questions

1. What makes a problem or situation an "ethical issue"?
2. How are business ethics and social responsibility related?
3. What is the triple bottom line?
4. What are the four steps in the ethical decision-making process?
5. What are some examples of ethical breaches common to business?
6. What is the primary focus of each of the five approaches to (theories of) business ethics?
7. What is the difference between primary and secondary stakeholders?
8. When faced with an ethical issue, what are some ways we can increase the number of alternative courses of action?
9. What are some "tests" we can consider to weigh the consequences of our actions?

8 Selling your company and making brilliant business presentations

Learning Goals

After reading this chapter you will be able to:

- Describe the key elements of an effective presentation.
- Discuss how the rule of three helps to frame a presentation.
- Describe how to make a presentation more memorable and understandable.
- Apply the four steps to effectively practice a presentation.
- Discuss why valuation is important to business.
- Compare and contrast tangible and intangible assets.
- Define and describe the meaning and importance of EBIT for valuing a company

Communication and valuation: two final skills

In the introduction, we learned that business is ideas, people and money, configured and reconfigured in infinitely different ways to satisfy customers' needs and make a profit.

We have considered managerial skills, decision making and financial skills, and have worked on coordination and alignment of resources and the selection of tactics to achieve a goal.

We have also discussed important stakeholders, both internal and external to a business, and looked at how businesses operate in the broader economic and social environment.

When it is time to present your outcomes to peers inside and outside the enterprise, there are two more issues we need to cover. First, we need to discuss one of the most critical management skills you will need to develop: delivering strong presentations. A company's results may come down to numbers, but numbers don't tell the whole story and a strong, well-prepared presentation is your opportunity to provide context.

Second, we will look at how to put a value on a company when it comes time to sell. Different stakeholders, inside and outside of a company, have different perspectives on the value represented by that company. Its ultimate valuation, therefore, is also more than a simple number like the book value of the company's assets. You may be surprised to learn that good communication can also play a role in a company's valuation and in the sale process.

FIT for a great presentation

Part of the process of valuing a company often involves making presentations to employees, customers, suppliers, bankers and the business community in general. Commonly we refer to this process as a roadshow. However it is not only when it's time to value and perhaps even sell a company that strong, persuasive presentations are critical. Whether you are trying to secure a contract with a major new customer, to convince your colleagues of a new approach or idea, or to present your annual results to shareholders, an understanding the basics of good business communication is vital.

To complete your business simulation experience with CapsimCore, you may be asked to prepare either a:

> **SHAREHOLDER PRESENTATION:** to convince your shareholders of your excellent stewardship of their company; or a
> **CAPITAL MARKET PRESENTATION:** to sell your company to investors who can capture and leverage additional opportunities for the company, or to your competitors who have identified additional synergies with their own companies.

You have spent several simulated years getting your company to this point and whether you are happy with your results or feel there is more work to do, you should have plenty to say about what you have tried to achieve.

The presentation is like a playoff final for a sports team. And just as a sports team must be game or match "fit," as a business person you need to get ***FIT*** for your presentation. Doing so requires you to follow three essential steps:

1. **F**rame the message
2. **I**llustrate your points
3. **T**rain for your delivery

Presentation skills are not just "nice to have" in business. With so many ideas and so much information competing for attention via so many communication technologies, the ability to make a persuasive personal presentation is an essential management skill – particularly in leadership roles.

You do not, however, have to be a polished performer or a "born showman" to deliver an excellent presentation. With careful thought and preparation, anyone can deliver a convincing presentation. Presenting is a behavior, after all, and all behavior can be learned and improved with practice.

According to Chris Anderson, a curator for TED Talks:

> *"I'm convinced that giving a good talk is highly coachable. In a matter of hours, a speaker's content and delivery can be transformed from muddled to mesmerizing."*

It does not require an expert coach to make that transformation, just some careful attention to the basics. Now let's take a closer look at each component in the FIT model.

Frame the message: the rule of three and being concise

Steve Jobs, Apple's late CEO, was renowned for turning product launches into major news events with perfectly rehearsed and carefully pitched multi-media presentations. Jobs spent hours, and sometimes days and weeks, working on his script, choreographing the content and the visuals, and honing his message to its most essential elements.

Most of Jobs' presentations were divided into three parts, because the "rule of three" is a basic principle of successful communication. In her book The Presentation Genius of Steve Jobs, ***Business Week's*** Carmine Gallo reports:

> *"The number three is a powerful concept in writing. Playwrights know that three is more dramatic than two; comedians know that three is funnier than four; and Steve Jobs knew that three is more memorable than six or eight. Even if he had 20 points to make, Jobs knew that the audience was only capable of holding three or four of them in short term memory. Better that they remember three than forget everything."*

So the idea here is to frame your presentation in three key parts. For example, the framework might be:

- Problem, Solution, and Call to Action for a sales presentation.
- Overview (key points you are going to make), Exposition (illustrating the key points), and Summary (repeating key points again) for an educational presentation.
- Achievements (major achievements for the period), Challenges (problems management is facing), and Goals for the future for a presentation to shareholders.

Once you have a broad three-point frame-work, distill the key points you want to make to one short sentence each. Use the notion of an "elevator speech" – you need to be able to make your pitch in the time it would take for a short elevator ride. Alternatively, you could think of it as being able to distill your points into the 140 characters that define a tweet.

> *"Steve Jobs created a single-sentence description for every product," Gallo says. "These headlines helped the audience categorize the new product and were always concise enough to fit in a 140-character Twitter post. For example, when Jobs introduced the MacBook Air in January 2008, he said that is it simply 'The world's thinnest notebook.' That one short sentence spoke volumes."*

Sample Outline: Shareholder Presentation

Frame it	Illustrate it
1. Achievements this year Your company's top three achievements	Story: A critical customer incident and an employee's brilliant response to it Slide: customer logo
2. Challenges What you anticipate and how you plan to deal with issues such as product placement and capacity	Story: How a specific management approach is cleverly designed to solve a problem
3. Goals for the future What you aim to achieve and how your current achievements demonstrate your ability to reach your goals.	Slide: Management team Slide: Your projected outcomes for next year in profit, ROS, ROA, and stock price.

Making your key points ***concise and precise*** takes effort – perhaps even more time than writing out your entire presentation. As Blaise Pascal famously told a correspondent, "The present letter is a very long one, simply because I had no leisure to make it shorter."

Illustrate it: Making it memorable and comprehensible

There are three ways to enhance your presentation's message by making it easier to understand and remember – and a presentation must be both understandable and memorable in order to be convincing enough to influence others.

TELL STORIES AND CONTEXTUALIZE. Data or numbers do not communicate well in a presentation, but word pictures do. People love stories. Stories stick in the mind. Your key points literally become "sticky" because they are attached to a story that has an emotional impact on the audience. This doesn't mean that stories are a replacement for data or evidence of your company's value, but simply that without a good story people are unlikely to be energized by the case you're trying to make.

The same is true if you are using visual aids for your presentation, such as presentation slides. Slides with lots of information dis- tract the audience from the speaker and the points being made. Simple visuals that add meaning to your key points are all you need. When Steve Jobs launched "the world's thin- nest notebook", for example, he used a photo of the computer slipping into a manila office envelope. No need for the technical specifications of the product or comparisons with other products – no need for additional information at all.

As Walt Disney said: "Of all our inventions for mass communication, pictures still speak the most universally understood language."

When you do need to present data or numbers, it's crucial to recognize that context matters. Put simply, numbers by themselves rarely communicate. Therefore, try to give your audience some kind of analogy or context for the numbers you are presenting.

Goodwill write-downs increasing

In 2000, when AOL and Time Warner merged, the sheer size of the merger and the spectacle of a new media company buying an old media company made it a huge news story. One year later, however, came an equally spectacular story.

AOL offered Time Warner more than $150 billion to be paid for in AOL stock – 1.5 AOL shares for every Time Warner share at a time when AOL was trading at more than $70 per share. The hard assets of Time Warner were worth much less than the valuation and so the balance – estimated to be more than $120 billion – was listed as "goodwill and other intangible assets".

The intangible assets included the Warner Bros film library, its catalog of copyrighted music, CNN, Time Magazine, the Atlanta Braves baseball team, cable-TV franchises, and much more, including the value inherent in simply being in control of these types of assets.

A change in the accounting rules governing goodwill, however, meant that within one year, AOL Time Warner had to admit it had overpaid for Warner's intangibles. The company announced a $54 billion write-off – the largest in American corporate history. Eight years later, the entire experiment in merging the two companies was abandoned, with Time Warner spinning off AOL.

The New York Times, on the 10th anniversary of the merger, reported: "The trail of despair in subsequent years included countless job losses, the decimation of retirement accounts, investigations by the Securities and Exchange Commission and the Justice Department, and countless executive upheavals. Today, the combined values of the companies, which have been separated, is about one-seventh of their worth on the day of the merger."

Duff & Phelps in their 2018 U.S. Goodwill Impairment Study reported that goodwill impairments were on the rise on corporate balance sheets, and that they are likely to get bigger in the near future. In 2017, impairment levels increased by 23% to $35.1 billion. Mega impairments such as those of GE's and Frontier Communications' account for the 21% rise in average goodwill impairment. As The Economist said: "Such hits can also sap investor confidence less directly, by raising awkward questions about managers' competence. If overpaying hugely for a rival does not count as inept, then what does?" However, the Wall Street Journal eventually reported a decline in goodwill impairments values of U.S. public companies in 2019.

For example, in news reports you often hear or read analogies such as "the line of people was as long as five football fields" or "the flood covered an area the size of Manhattan" or "the loss was equal to the GDP of Fiji." Journalists are taught to put numbers into context so people can grasp them. This is a valuable tactic for you to use to better communicate technical details, research results, and numerical information.

In the context of your CapsimCore Simulation for example, a profit of $7 million may be an exceptional result, if the competition is very tough. In a simulation where most of the companies failed to make a profit, however, a profit of $30 million to the winning company might be less impressive. Whatever the number – good or bad – try to give it context.

REMEMBER W.I.I.F.M. Before you write your presentation, put yourself in the shoes of a typical member of your audience. You are sitting out there, listening to someone talk and your major concern is: ***What's In It For Me?*** (W.I.I.F.M.) You wouldn't be in the audience unless you were expecting to benefit from the presentation. And, if you are in the audience under duress ("my boss made me come"), the speaker will have to work even harder to convince you of what's in it for you! Focus on benefits, tell success stories, and build a clear picture of why your key points are important using images and anecdotes. Try to make your message personal and relevant to your audience.

...AND K.I.S. In all elements of your presentation – structure, language, stories, visual aids the most important rule overall is to ***Keep It Simple***

If you have complex research data or technical information to present, consider distributing it as a handout. If your presentation can convince the audience of the importance of your information, they will eagerly seek out the background material later. (A note on handouts: If you provide your audience with material in advance of your talk, they will read it instead of focusing on your presentation. Time your distribution of handouts carefully).

Train for delivery: perfect practice makes perfect performance

If a seasoned professional such as Steve Jobs put months into the preparation of his presentations, the rest of us should at least put a little effort into training for ours! Practice is the secret to every successful presentation.

Sample Outline: Why You Should Buy My CapsimCore Company!

Frame it	Illustrate it
1. Why we are the company to buy? *Major selling points of your company (only three!)*	*Story: How we achieved market domination in one segment within three years.*
2. What is our future potential? *What we are set up to achieve next.*	*Slide: Smiling picture of management team at work.* *Story: How a planned innovation has been designed to solve a specific customer problem.*
3. What we are worth? *The valuation (EBIT X multiple)* *Wrap up with summary of selling points and potentials*	*Slide: Your R&D staff* *Slide: Chart that highlights your valuation compared with other similar companies with higher valuations*

How to best practice for an upcoming presentation? A few tips include:

WRITE IT: Write out your presentation in full and, if you have time, memorize it. If not, distill the key points to cards and use them to keep you on track.

READ IT: Read your draft out loud several times to ensure the words flow; then practice in front of an audience of colleagues, friends, family – anyone who can give you honest feedback.

TIME IT: It is important to know how long you will be speaking, to ensure your message will fit into the surrounding agenda. Audiences – not to mention program organizers – loathe presenters who go on and on.

REPEAT IT: The science of learning talks about the concept of overlearning, which refers to practicing beyond mastery (i.e., practicing your presentation until you are effective and then practicing a few more times). The benefit here is that your presentation can become automatic.

Don't be nervous about nerves.

Again, remember that giving a presentation is behavioral and all behaviors can be learned and improved. It is also important to recognize that being nervous or anxious is completely natural. In fact, if you are not at all "amped-up" it might actually signal to your audience that you lack enthusiasm about your topic! Chris Anderson from TED talks said in a ***Harvard Business Review*** report:

"In general, people worry too much about nervousness. Nerves are not a disaster. The audience expects you to be nervous. It's a natural body response that can actually improve your performance: It gives you energy to perform and keeps your mind sharp. Just keep breathing, and you'll be fine."

What are we worth? Valuing the firm.

There are several different approaches to determining the value of a company, and no single approach is universally recognized as the "right way". Every company is unique, which means those involved should consider a range of different elements before finally coming up with a number that represents a company's value.

It is important to point out that a company is only valued when someone wants to sell and someone wants to buy. Often you have interested buyers for a company, but the seller's shareholders are unwilling to sell because they assume they can create even more value in the future if they retain their ownership of the company.

Practically speaking, in any situation the buyer(s) and seller will need to discuss their perception of the company's value, and then negotiate in order to arrive at a final transaction price. The business and communication skills of the respective parties at the bargaining table, therefore, are critically important.

The most straightforward part of the valuation is "book value," which, as we discussed in Chapter 5, is the value of the company's assets on the balance sheet. Book value is calculated as Owners' Equity divided by the number of shares outstanding. These are the company's tangible assets.

However, what about the strong brand the company has created? The customer loyalty it has built? The efficient and well-trained work force? Its intellectual property? These are all integral to the company's success, but they are not assets on the Balance Sheet, they are referred to as "intangible .assets" The amount paid by the acquiring company over book value is referred to as "goodwill."

As mentioned, there are several ways to value a firm. A publicly traded company such as your CapsimCore company has a market value called "market capitalization," which is calculated as stock price multiplied by the number of shares outstanding. As we also know, the transaction value of the company – what the buyer pays for it – may be greater than or less than the capital market value. We know there is a price paid for intangible assets or goodwill, but value can be influenced by other pressures as well, including speculation on internal or external challenges, expectations for future growth, or media buzz that stimulates interest and excitement (or the opposite) for a company.

Common valuation approaches include calculations of Economic Value Added (EVA); Discounted Cash Flow (DCF); Free Cash Flow, and the very simple Public Market Value, which simply looks at what other, similar companies are being sold for in the current market environment.

One of the most often used calculations for valuation, however, involves or EBIT. We will expand on this concept because it will be useful if you are developing a capital market presentation for your CapsimCore company.

EBIT stands for Earnings Before Interest and Taxes. EBIT estimates the current operational profitability of the company for the current period. In this way EBIT reflects all of a company's profits before taking into account interest payments and income taxes. Analysts take this profitability measure and multiply it by a certain value to estimate the company's total value. Clearly, the big question is what value should be used as a multiplier?

For companies that are being purchased for their absolute value, the multiplier will be lower than for a company being purchased because it is a "strategic fit" with the organization making the purchase. For example, if your CapsimCore company was being purchased by an organization that had no presence in electronics production and saw your company as a good generator of cash, they might only pay a multiple between 4 and 8. However, if the purchaser saw your company as an excellent fit with their current sensor/electronics portfolio, they might pay anywhere between 10 and 12 times your EBIT. For example, a possible multiplier for the Andrews company shown in the table below can be estimated by dividing the market value ("market capitalization") by the EBIT. This results in a multiplier of 10 ($360 million/$36 million = 10).

Company	Revenue	EBIT	Market Capitalization ($180 per share)	Earnings per Share
Andrews (2 million shares outstanding)	*$240 million*	*$36 million*	*$360 million*	*$18*

Once you have determined a value, be prepared to defend it and to negotiate with your potential buyer. To help you get started, on the following page is a sample is a sample presentation template you could use for a capital market presentation. Remember that there are, of course, many ways to tell your company's story – this is just a starting point.

Chapter 8 Review Questions

Presentation Basics

1. What does it mean to be "FIT" for a presentation?
2. How does the rule of three apply to presentations? Provide an example.
3. What are some ways to make a presentation memorable and understandable?
4. How can we improve an audience's understanding of numerical information?
5. What are the four steps of effective presentation practice?

Valuation

6. Why is valuation important to business?
7. What is the difference between tangible and intangible assets?
8. What is "goodwill"?
9. What are EBITDA and EBIT? How do these affect valuation?

Case Stories Application

Case Stories Application in CapsimCore versus Real-World Application

What Impact Does Reliability Have on My Material Costs?

Application in CapsimCore

As part of the customer buying criteria, the reliability of each product is represented in hours. The higher a product's reliability, the longer the product will last. The reliability of each product is directly correlated to the product's material costs. The reliability rating for existing products can be adjusted to have a longer or shorter shelf life.

Customer Buying Criteria		
Performance Segment		
MTBF	22,000-27,000	43%
Ideal Position	Pfmn 9.4; Size 16.0	29%
Price	$25.00-$35.00	19%
Age	1 year	9%

Specifically, each 1,000 hours of reliability adds $0.30 to the material cost. Positioning a product's reliability outside of the range in the customer buying criteria will decrease demand. Each 1,000 hours of reliability that is above or below the primary segment's range on the customer buying criteria will decrease demand for those customers by 10%.

Real-World Application

In this article, the use of leather seats in vehicles is considered. As a durable material, leather has remained a staple for interior car design. Despite this, the article notes, "The problem with leather, for those whose budgets lean more toward non-premium beer than Champagne, is that it can add thousands of dollars to the sticker price."

As the article discusses, leather is more durable and therefore an appealing feature in high-end vehicles. However, suppling premium materials that last comes at a price causing these features to be more prevalent in high-end brands. The lesson? Consider the customer you are trying to appeal to when determining your product's reliability.

How Can We Build a Perfect Product That Is Profitable?

Application in CapsimCore

To consumers, a perfect product looks for the following:

- Be at the ideal position (the segment drifts each month, so this can occur only one month per year),
- Be priced at the bottom of the expected range,
- Have the ideal age for that segment (unless they are revised, products grow older each month, so this can occur only one month per year), and
- Have a reliability specification at the top of the expected range.

Customer Buying Criteria		
Low End Segment		
Price	$15.00-$25.00	53%
Age	7 years	24%
Ideal Position	Pfmn 1.7; Size 18.3	16%
MTBF	12,000-17,000	7%

Your customers want perfection, but it is impractical to have "perfect" products. In many cases, you will have to settle for "great" products. The better the product, the higher the costs. If you break down the customer buying criteria, you can see this holding true. Being aligned with the ideal spot and having a high reliability increases your material costs. If you were to price at the bottom of the expected range, it would be difficult to achieve a healthy margin. Your task is to give customers great products while still making a profit. This is tough to do, but you're not hopeless.

Real-World Application

In the following article, Forbes discusses maintaining a balance between meeting these customer expectations while remaining profitable in the e-commerce industry. One company, Casper, has done this well by providing mattresses directly at consumers' doors. In this instance, Casper is able to provide consumers with high-quality items at low costs.

However, overhead cost had to be cut elsewhere in order to achieve a healthy margin. Casper's business model provided this by eliminating the brick-and-mortar model that is traditionally associated with purchasing a mattress. In doing so, they have eliminated the cost of not only a storefront but also salespeople to maintain that storefront. Similar to what you experience in the simulation, something has to be sacrificed for the customer in order to ensure you're making a profit. In this instance, customers lost the ability to try multiple mattresses in one day with the assistance of a salesperson. In return, they could afford to purchase a high-quality mattress at a more affordable price.

Why Are My Sales Lower Than the Competition Even with a Higher Customer Satisfaction Score?

Application in CapsimCore

In any month, a product's demand is driven by its monthly satisfaction score. Assuming it does not run out of inventory, a product with a higher score will outsell a product with a lower score. A customer survey score reflects how well a product meets its segment's buying criteria as well as the company's promotional efforts.

Customer Buying Criteria

Criteria	Expectations	Product Able
Age	2 Years	2.1
Price	$20.00-$30.00	$29.50
Ideal Position	Size 16.0 Pfmn 4.0	Size 13.2 Pfmn 6.8
MTBF	14,000-19,000	17,000

Promotional efforts

Sales Budget $1,600	**Promo Budget** $1,100
Customer Accessibility 77%	**Customer Accessibility** 92%

Customer Satisfaction Score

30

Typically, the "best" product (from the customers' perspective) in the market tends to lead in sales but that does not always happen. As mentioned, this can happen as a result of a stock-out. This can also be impacted by the revision date of your products.

The satisfaction score shows you as of December 31 how satisfied the customers were with each product line. If a product has a late revision, then it may be more appealing at the very end of the year while overall sales were slow until the product's release.

Real-World Application

The iPhone is a great example for this. As we know, the iPhone is regarded as an industry leader. Despite this, Apple frequently experiences stock-outs after releasing an updated iPhone. This is usually a result of poor forecasting.

When comparing two market leaders, Apple and Samsung, you can view how release date can impact sales despite customer preference. The Samsung Note 8 was released in September with the iPhone 8. However, the iPhone X was not scheduled to release until two months later, in November. As the hype surrounding the iPhone X far exceeded the iPhone 8, it would be a reasonable assumption that many users will wait until November to purchase a newer Apple smartphone.

In that case, the overall sales that Samsung receives through the end of the year could surpass the sales of the iPhone X, regardless of the customers' preference. However, going into 2018, the iPhone X is poised for strong sales.

Reflection and conclusion

Whether your CapsimCore company made millions of dollars in profit for its shareholders or had to be saved from bankruptcy by an emergency loan – or both – there is one key lesson from the simulation experience: Business is both complex and endlessly fascinating.

The CapsimCore experience has taken you from the very beginning – ideas, people, and money – through to the moment when with pride (or great relief) you are in a position to put a value on the company you have built, and sell it.

Put simply, you have experienced running a business from start to finish.

The simulation was designed to give you the opportunity to try and fail, and try again, in an attempt to build mastery over the concepts that are fundamental to business. Concepts such as profit, management, market segments, stakeholders, demand, risk, and so forth all become more real when they refer to your company and ***your*** results.

Now it is time to take all that new knowledge and apply it in the real world.

Best of luck in your own business adventures!

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