

Unit 3

BUSINESS DECISIONS AND STRATEGY

1 CORPORATE OBJECTIVES

ACTIVITY 1

CASE STUDY: WRITING A MISSION STATEMENT

1 Choose one of the industries listed below and plan a mission statement for a business in that sector:

- 1 - airline industry
- 2 - soft drinks industry
- 3 - container shipping industry.

No answer required. This is a task for students to undertake.

ACTIVITY 2

CASE STUDY: FORD®

1 How could the functional objectives of Ford's marketing department support the 2106 corporate objectives stated above?

Ford's marketing department could support the corporate objectives described in the case study. For example, the department may have been involved in identifying the customer needs relating to the development of electric cars and autonomous vehicles. If the marketing department identifies the needs accurately, the new cars are more likely to sell when they are launched. The marketing department will also need to create awareness and build relationships with customers. It could achieve this using a number of communication channels, such as adverts and their website.

As the launch of the new vehicles approaches, the marketing department needs to ensure that high-quality adverts are designed. They should be posted or broadcast using appropriate and effective media. The marketing department needs to ensure that relevant information is available for customers to access. This is because the new vehicles, such as the autonomous cars, are 'revolutionary'. So, customers will need to be convinced that autonomous cars are safe. The marketing department will play a big role here.

2 How might the objectives of large firms, such as Ford, and those of small firms differ?

The objectives of large firms such as Ford tend to be financial. This is probably because shareholders are the most influential of stakeholders. Financial goals are also more objective and quantifiable; they focus mainly on the desired performance and results of the business over time. They may include goals such as market share, profit levels, creation of new products or processes, resource usage and scale economies, management of people and ethical behaviours. In this case, Ford's corporate objectives are to create and introduce some

important new products in the next few years. For example, electric vehicles and autonomous cars.

In contrast, small enterprises may have a wide variety of objectives. These might include the following:

- ensuring that the company breaks even at the end of the year
- improving the firm's cash flow in the next three months
- increasing sales by 25 per cent over the next three years
- recruiting two new staff with skills in sales
- marketing to have an important influence on markets
- reducing energy consumption by 5 per cent
- making more use of recyclable materials in production.

Clearly, there are similarities between the objectives of small and large businesses. However, large businesses will have to please more stakeholders and will also tend to be more ambitious.

ACTIVITY 3

APPRAISING MISSION STATEMENTS

1 What is the purpose of each of the statements?

- (a) RWDC's mission statement aims to ensure that all employees understand the intention to keep progressing as a business through 'increasing shared experiences and customer fun'. This mission statement is clearly focused on the actual products they develop and how they intend to stay at the 'cutting edge' with continuous development.
- (b) PM Camping's mission statement is targeted at both internal and external stakeholders. The mention of 'trust' and 'co-operation' indicate that this business has a clear ethical stance that it wants to share with its stakeholders.
- (c) Thomas Therapeutics and Pharmacy's mission statement is very clear and communicates exactly what the business does. The purpose of this mission statement might be to clarify the purpose of the business to potential customers and suppliers.

2 Who are the intended audiences?

- (a) RWDC's mission statement is targeted at employees and customers.
- (b) PM Camping's mission statement is a guideline for how they want their employees to do business.
- (c) Thomas Therapeutics and Pharmacy's mission statement is intended for potential customers and suppliers.

EXAM PRACTICE

CASE STUDY: LEGO® CORPORATE OBJECTIVES

1 Define the term 'corporate objective'. (2 marks)

A corporate objective is one set by the directors of a medium to large-sized business and comes from the company's aims and mission statement. One of LEGO's corporate objectives was to support the learning of 101 million children by 2015.

2 Explain one reason LEGO might have for setting an objective to achieve 100 per cent renewable energy by 2020. (4 marks)

By setting a target of using 100 per cent renewable energy by 2020, LEGO will become a sustainable business. It will not exploit the world's natural resources and will minimise its carbon footprint. This will send a strong message to its customers and consumers that the company feels it is important to think about the long-term impact of operating a global business. LEGO focuses on educating children and so this objective has the potential to educate children about the importance of the environment.

Setting this objective will help to will build LEGO's reputation as an ethical and socially responsible organisation.

3 Explain one possible reason why LEGO might have a mission statement. (4 marks)

LEGO has a mission statement in order to communicate its aims and purpose to all stakeholder groups. A good mission statement clarifies the company's vision and ambitions.

LEGO's mission statement – 'to inspire the builders of tomorrow' – is a simple principle that all stakeholder groups can understand and relate to. This statement shows customers that the product is more than just a toy. It reminds LEGO employees that all of their products must be good enough to inspire a younger generation.

4 Assess which of the LEGO Group's corporate objectives is the most important for the long-term success of the business. (12 marks)

LEGO's corporate objective to 'support the learning of 101 million children' is very important to their long-term success.

This is because the objective is clearly linked to the growth of the company and increasing the number of consumers who can access their educational toys. By achieving this corporate aim, LEGO will increase its market share of the global toy market. This will allow it to become more competitive. Also, this corporate objective is closely linked to the company's mission statement: 'to inspire the builders of tomorrow'. Achieving this objective will help LEGO to achieve its overall aim.

On the other hand, 'adopting a zero-waste mindset' is important to LEGO, as this will improve production efficiency and maximise capacity utilisation. With lower costs, LEGO will also increase the contribution per unit. This will help LEGO to maximise profitability and please its shareholders. However, it seems that LEGO has already achieved this objective, as indicated by the 2014 report. This means that it may not be as important to the long-term success because the target will not motivate employees.

Overall, 'supporting learning for 101 million children' seems to be the most important of the five corporate objectives. Apart from being closely aligned to LEGO's mission statement, it is

the objective that has yet to be achieved, according the 2014 report. The key to achieving this objective may be how successful LEGO is at expanding into the expanding Asian toy market as consumers become wealthier in countries such as Malaysia and China.

2 THEORIES OF CORPORATE STRATEGY

ACTIVITY 1

CASE STUDY: ATTA GLOBAL GROUP®

1 Explain how a business might use Ansoff's Matrix.

Ansoff's Matrix can be used by a business to help develop its corporate strategy. It is a decision-making tool that allows businesses to consider some key factors when deciding on a strategy. These include the level of investment in new and existing products, the exploitation of different markets, the growth strategy of the business and the level of risk a business is prepared to accept.

The matrix identifies four distinct strategies that a business might consider. The first is to sell more of its established products in existing markets. This is the least risky strategy because it requires much lower levels of investment than others. The second is to adopt a strategy of product development. This involves developing new or improved products in existing markets. In this case, the Atta Group could develop new metal products to sell in its existing markets. This might be relatively risky because new product development can be expensive, especially if new products are not well received.

A third strategy is to sell more established products in new markets. In this case, the Atta Group could sell its current products in new countries. Finally, the riskiest of all strategies is to diversify. This involves developing new products for new markets. It is risky because the business will be operating outside its area of expertise. It will have to compete with established and more experienced operators in these new markets.

A business can use Ansoff's Matrix to help decide which of the four distinct strategies might be most suitable for its current needs and position. In this case, Atta Group has opted to diversify into property.

2 What are the potential benefits of the Atta Group's diversification strategy to the business?

Atta Group has opted for the riskiest of all growth strategies: it has decided to diversify. The current activities of Atta include the processing of steel coil, tubes, strapping, steel furniture, metal roofing, floor decking, perforated metal and the industrial recycling of scrap metal.

However, Atta has decided to try property development. For example, one of its subsidiaries, Tetap Gembira Development, planned a new project on land at Barat Daya, in Penang, in 2018. In addition, other companies under its control, Park Avenue Construction and Progerex, have bought a number of double-storey bungalows. In 2018, Atta Group said that Park Avenue Construction would be purchasing a property company, Sungguh Gemilang Development for RM12 million.

The diversification strategy adopted by Atta is the riskiest of all growth strategies, according to Ansoff's Matrix. This is because Atta has no previous experience in property development. It will be operating in a completely different market. It will have to compete with existing operators who will be established and experienced.

However, although it is risky, there are considerable benefits if the strategy succeeds. For example, it will reduce how much Atta depends on the sale of metal products. Atta will be spreading its risk and increasing its security. Also, according to a spokesperson for Atta Group, 'The proposed acquisition is a strategic move in view of the company's proposed

diversification into property development and would expect to generate synergistic benefits to the group'. Information in the case study also states that the diversification into property by Atta should contribute over 25 per cent to the group's profits in the future.

If Atta has analysed and evaluated all of the possible risks, costs and benefits to entering the new market carefully, it is likely that the rewards of diversification will outweigh the drawbacks. However, this may not be known for a few years. If the attempt does fail, it could cost Atta severely.

ACTIVITY 2

CASE STUDY: RED BULL®

1 Explain how Red Bull's corporate strategy relates to Porter's Strategic Matrix.

Porter's Strategic Matrix helps to identify the sources of competitive advantage that a business might achieve in the market. In the matrix, three clear generic strategies are identified. These are cost leadership, differentiation and focus (on a narrow range of customers). In this case, Red Bull has clearly opted for a differentiation strategy.

Red Bull charges a premium price since the brand is perceived to provide consumers with additional benefits. For example, consuming Red Bull is believed to help people lead a full and active lifestyle and enhance mental and physical performance. Red Bull's competitive advantages, which help to differentiate the product, include first-mover advantage, a unique sweet flavour, an association with extreme sports and an effective marketing strategy. Red Bull is a market leader in the energy drinks market and its commitment to product differentiation has surely helped it to reach and maintain this position over the years.

2 What are the potential consequences for Red Bull of not adopting one of Porter's three generic strategies?

According to Porter, the consequences of failing to adopt one of the three generic strategies identified in his strategic matrix are severe.

Porter believed that if a business was 'stuck in the middle' with no clear strategy, it was unlikely to succeed. This might be because without a clear strategy a business will lose focus and fail to follow a clear strategic path. It may not use resources appropriately and fail to achieve a clear position in the market. Customers may become confused and stop buying the product. In this case, Red Bull has clearly differentiated its brand from those of competitors. It charges a premium price since the brand is perceived to provide consumers with additional benefits. Consuming Red Bull is believed to help people lead a full and active lifestyle and enhance mental and physical performance. At the moment, Red Bull is the market leader following a very clear differentiation strategy.

ACTIVITY 3

CASE STUDY: MOTORVITE®

1 Using the information in Table 1 and the Boston Matrix, analyse Motorvite's product portfolio.

At present, it seems that Motorvite has a strong portfolio of products. Two of these – the P4 and P901 models – have experienced exponential growth over the past year, with growth rates of 36.9 per cent and 27 per cent respectively. Both the P4 and the P901 seem to be 'Stars' for Motorvite and will generate a majority of the businesses sales revenue. It is important that Motorvite is able to keep up with demand for these products in order to maximise sales. Sales will eventually stabilise for these products, and Motorvite will hope to turn at least one of the products into a 'Cash cow' if high sales are maintained. Sales of the P6 are in decline, and this might suggest that the product is a 'Dog'. Motorvite might decide to discontinue this model and focus its attention on meeting demand for the P4 and P901. The final car is the P7, which was only launched within the last year. Sales are still relatively low and Motorvite will want to invest heavily in promoting this product in order to develop it into another 'Star'. It will be important for Motorvite to invest some of the revenue it is generating from the P4 and P901 into the promotion of this car.

EXAM PRACTICE

CASE STUDY: FLIPKART®

1 Explain what is meant by 'corporate strategy'. (4 marks)

Corporations will have objectives such as increasing profitability, growing market share or finding new markets. To achieve these objectives, firms will plan and adopt a number of measures or actions which are designed to achieve the corporate objectives. These may be described as the firm's corporate strategy.

An example of a corporate strategy might be to operate with very low costs. This might be achieved by selling very large quantities of output so that economies of scale can be exploited.

2 Explain how a tactical decision may differ from a strategic decision. (4 marks)

Strategic decisions are those that affect the long-term direction of a business. They are made to help achieve corporate objectives. In contrast, tactical decisions are made in response to specific opportunities or threats in the market.

Most daily decisions in business are tactical and involve decision making in response to the current business conditions. For example, a business might decide to increase opening hours over a busy holiday period. Although tactics should support the corporate strategy, tactical decisions are often made in isolation of the 'bigger picture'. While strategy is often based on a set of principles or guidelines set down by the CEO and board of directors, tactical decisions happen at managerial or supervisory level. In this case, the decision by Flipkart to switch from reducing losses to increasing market share is a strategic decision.

3 Discuss why Flipkart has adopted a new corporate strategy. (8 marks)

Flipkart adopted a new corporate strategy at the end of 2017. It decided to focus on building market share rather than trying to reduce losses. The decision was encouraged by one of Flipkart's key investors, Japanese-based SoftBank® Group. The bank wanted Flipkart to grow sales aggressively and build a larger market share. According to a report, SoftBank wanted Flipkart to grow its market share to 60 or 70 per cent over the next few years.

One of the reasons for the change in strategy may be due to the improving performance of Amazon® India, one of Flipkart's rivals. SoftBank (and Flipkart) may be worried about the growing threat that Amazon poses. For example, Flipkart's market share, including that of its fashion unit Myntra®, slipped to 38.5 per cent in 2016–17 from 40 per cent in 2014–15 in terms of gross sales or gross merchandise value (GMV). At the same time, Amazon India's market share grew from 12 per cent to 29 per cent. This increase in market share growth may be concerning.

SoftBank is committed to this change in strategy. For example, the investor said it was willing to invest several billion dollars to help Flipkart increase sales and widen its narrow lead over Amazon. In order to help deliver this strategy, Flipkart has commissioned the consultant Bain & Co. to devise a marketing strategy to increase customer base and improve customer loyalty. Flipkart is also planning more acquisitions to help boost market share.

Although Flipkart's losses have grown by 60 per cent, to US\$1.3 billion, in the last financial year, SoftBank and Flipkart clearly consider that growing market share is the most pressing objective. Also, if Flipkart can raise its market share to 60 or 70 per cent, it is possible that losses will fall anyway. It is a large increase in market share from the current 38.5 per cent, so it is almost certainly going to have a positive impact on sales revenues and profits.

However, this new focus on building market share is not without risk. If the company is currently making losses, it is possible that these losses might increase in the short term. This could have a negative impact on the company's cash flow. As a result, it might become vulnerable to severe cash shortages and threaten the survival of the business.

4 With reference to Ansoff's Matrix, assess the level of risk associated with Flipkart's new strategy. (12 marks)

A business can use Ansoff's Matrix to help select an appropriate growth strategy given its current needs and position. It is a decision-making tool that allows businesses to consider some key factors when determining a strategy. These include the level of investment in new and existing products, the exploitation of different markets, the growth strategy of the business and the level of risk a business is prepared to accept. The matrix identifies four distinct strategies that a business might consider.

In this case, to a large extent, Flipkart has chosen to sell more of its established products in existing markets (market penetration). This is the least risky strategy because it requires much lower levels of investment than others. Flipkart aims to increase its market share in the e-commerce market. It wants to sell more of its products online, such as books, media, consumer electronics and lifestyle. There is less risk in trying to expand sales in India where Flipkart already operates and has an established track record. In light of this aim, Flipkart has commissioned a specialist, Bain & Co., to devise an appropriate marketing strategy to help grow market share.

Flipkart has also said that it would develop some new products. This strategy (product development) is the second in Ansoff's Matrix. Flipkart is planning some acquisitions to help boost market share in India. For example, it has recently discussed the possibility of

investing in food-delivery app Swiggy®, services firm UrbanClap® and furniture retailer UrbanLadder®. Flipkart is also looking at some start-ups in insurance and wealth management. These may be new and unfamiliar areas for Flipkart, but they will be online operations aimed at the Indian market.

This approach to growth carries more risk. This is because Flipkart might lack experience in these different areas – particularly the financial products relating to insurance and wealth management. There may be some tough and experienced operators in the market which might prove difficult to compete with. However, since Flipkart is buying companies that already exist in these new markets (Swiggy, UrbanClap and UrbanLadder), the problems of product development might be overcome.

Finally, the change in strategy might be seen as risky because Flipkart is in a loss-making position and losses have increased in the last year. If the switch in strategy is unsuccessful, these losses may increase and even threaten the survival of the business. However, SoftBank is a key investor and happy to fund Flipkart's strategy of growth in market share. This suggests that they are confident in the performance of the company.

3 SWOT ANALYSIS

ACTIVITY 1

CASE STUDY: SALY FISHING TRIPS

1 Outline the internal strengths and weaknesses of Saly Fishing Trips.

One of the key internal strengths of Saly Fishing Trips is that the business is the leader in the market. This is a strength because it reflects the success that the business has enjoyed since it was established and makes it one of the first providers that customers will look at when organising a fishing trip. Market leaders can also sometimes charge higher prices. Another internal strength is that the business has a sound cash flow and is profitable. Also, Keita has an excellent local knowledge of fishing in the sea – about 98 per cent of customers caught fish on a four-hour trip. This will help to attract customers if they know their trip is likely to be successful.

One of the internal weaknesses of Saly Fishing Trips is that the boat needs some repairs and about 70 per cent of the fishing tackle needs replacing. This will obviously require funding and may interfere with Keita's expansion plans. It could also be argued that the business needs to improve its marketing. Saly Fishing Trips does not have a website and has never invested any money in marketing.

2 Suggest two possible external threats to Saly Fishing Trips.

One external threat mentioned in the case is poor weather. If the weather is too bad, fishing trips have to be cancelled – this will reduce revenue and result in disappointed customers. Another possible external threat might be stronger competition. Saly is currently the market leader. However, a new or existing business might start to offer a better service and threaten Saly's leading position.

3 Suggest two possible opportunities for Saly Fishing Trips.

In the future, the exchange rate might change so that holidays in Senegal become cheaper. This would help to increase the number of customers for Saly. Saly might also be able to develop their product. For example, by expanding, they may be able to operate more trips and offer other features such as a beach BBQ or visits to places of interest along the coast of Senegal.

EXAM PRACTICE

CASE STUDY: GLOBAL PORTS HOLDING

1 Explain how an internal audit might play a role in SWOT analysis. (4 marks)

When making plans or developing a business strategy, it is important to gather appropriate information. One way to gather information is to carry out an audit of the business and its external environment.

An internal audit is an analysis of the business itself and how it operates. It attempts to identify the strengths and weaknesses of its operations. It might cover areas such as products and their costs, quality and development, finance (including profit), assets and cash flow, and production (including capacity, quality, efficiency and stock management).

In a large business, the internal audit might be conducted by outside management consultants. This might help to produce a more independent-minded analysis of the business's situation.

2 Explain how an external audit might play a role in SWOT analysis. (4 marks)

An external audit is an analysis of the environment in which the business operates and over which it has little or no control. The audit should analyse the market, or markets, in which the business operates. For example, it should analyse the size and growth potential of the market or the characteristics of the customers in the market.

The external audit should also analyse the competition in the market. The nature and strength of competitors will be an important influence on the development of a strategy. For example, the audit should analyse the structure of the industry (including the number and size of competitors), their production capacity and marketing methods, how likely it is that there will be new entrants to the market and how likely it is that businesses will leave the industry.

Finally, the third area that needs to be addressed can be audited using PESTLE analysis. This is an analysis of the political (P), economic (E), social (S), technological (T), legal (L) and environmental (E) issues relevant to the business.

3 Discuss how useful a SWOT analysis might be to a business such as GPH if it were planning to expand into a new market. (8 marks)

SWOT analysis involves looking at the internal strengths (S) and weaknesses (W) of a business and the external opportunities (O) and threats (T) that it faces. It is an analytical tool that can help managers with complex decisions. SWOT analysis might be used by senior managers before drawing up a strategic plan. It helps to build up a picture of the relative advantages and disadvantages of a particular decision and might also help to make the current position of a business easier to understand.

In this case, GPH is the world's largest operator of cruise ship ports. It has a 25 per cent share of the market in the Mediterranean and operates in some of the world's most popular and admired ports such as Venice, Malaga and Lisbon. GPH does have some attractive opportunities that it could explore – expansion into new markets such as river cruising, which is growing fast, for example. Also, the current market shows steady solid growth over a 10-year period according to Figure 3. The number of cruise passengers has grown by around 53 per cent.

A business like GPH might use SWOT analysis to help make an important decision such as whether to expand into a new market. In this case, the new market might be river cruising. Once all of the strengths, weaknesses, opportunities and threats have been clearly identified and analysed, the business must decide whether the strengths and opportunities outweigh the threats and weaknesses. If they do, then the business might decide to go ahead and expand into the new market.

However, SWOT analysis is quite basic. For example, it is not a quantitative approach to decision making (i.e. one that can be measured with numbers). There are also other factors that must be considered such as PESTLE. For example, there may be environmental pressure from groups that oppose river cruisers – in this case, because of the possible damage they do to marine life. It will also be important to take into account financial issues such as cash flow, the availability of investment funds and whether expanding into new markets fits with the existing corporate strategy.

4 Assess the position of GPH by carrying out a SWOT analysis. (12 marks)

Strengths

- The business model is quite unique and helps to add value for cruise ships.
- The recent stock market flotation will help to raise the profile of the business.
- The flotation has helped to boost funds significantly. This will help to stabilise the financial position of the business.

Weaknesses

- The focus is on a very narrow market range – more diversification may be needed (i.e. developing a wider range of services).
- The share price has fallen consistently since the flotation. This may suggest a lack in investor confidence.
- They do not operate in the Americas where cruise holidays are very popular.
- Following the flotation, the company will be under severe pressure to meet the needs of shareholders.
- The company has made a US\$14.1 million financial loss in the current financial year compared to a US\$4.4 million profit in the previous year.

Opportunities

- It may be possible to expand into new markets such as river cruising, which is growing fast.
- The current market shows steady solid growth over a 10-year period according to Figure 3. The number of cruise passengers has grown by around 53 per cent.
- The flotation will help to raise the profile of the business which may be reflected in higher sales levels and more power in the market.
- It may be possible to offer new services at ports to boost sales.
- It may be possible to cash in on the rapid growth in commercial ports. For example, following the lifting of UN sanctions against Iran, there has been an increase in commercial shipping.

Threats

- A significant proportion of the company's revenue is generated in Turkey where there is reduced foreign investment.
- Growing economic uncertainty around the globe may reduce the number of people travelling internationally.
- Demand might fall suddenly if there is a downturn in global economic growth (i.e. if the economy becomes weaker) – demand for cruise holidays is probably income elastic. Demand might also fall if there is an unexpected change in consumer tastes relating to the choice of holidays.
- Cruise ships may become a soft target for criminals. They do not employ armed guards and the negative publicity that would come from a single attack in the future could devastate the industry.

4 IMPACT OF EXTERNAL INFLUENCES

ACTIVITY 1

CASE STUDY: GLOBAL SOLAR POWER

1 Explain how PESTLE analysis might be useful for a business.

PESTLE analysis involves identifying the political (P), economic (E), social (S), technological (T), legal (L) and environmental (E) factors that might influence business activity and performance.

PESTLE analysis is used to examine the impact that external influences might have on a business. Some external influences can have a significant effect on businesses. The effect can be positive or negative. For example, if a business has a lot of debt and interest rates fall, their costs will fall and profits will subsequently rise. By contrast, if unemployment falls very sharply, many businesses will struggle to hire more staff. This could limit their growth ambitions. These are examples of economic factors that might effect a business.

2 Consider the impact of (a) political, (b) environmental and (c) technological factors on businesses in the solar energy industry.

(a) The graph in Figure 1 shows the very rapid growth in the use of solar power. It shows that the capacity of global solar panel installations has grown from virtually zero in 2002 to 64 892 mw in 2015. The growth is exponential (i.e. the rate becomes faster and faster) and is due to many external factors.

One of these factors is political. For example, in 2015, politicians from 195 countries around the world signed a document promising to reduce global warming. This was called the Paris Climate Agreement. The agreement aims to reduce carbon emissions and limit global warming. It includes guidelines suggesting measures that can be taken by developed countries to reduce carbon dioxide emissions. As a result of this agreement, some governments have introduced quite generous subsidies and tax benefits to assist operators in the solar power industry.

(b) Another influential external factor is the environment. Globally, there is a growing awareness of the damage to the environment caused by using fossil fuels for energy. Many people are increasingly concerned about global warming. They have stopped using power made by fossil fuels and now use renewable energy such as solar power. Also, some people see solar as a status symbol. In addition, many businesses recognise the importance of reducing their carbon footprint. As a result, many are choosing solar power as a source of energy.

(c) Technological factors have also helped to boost growth in the use of solar power. Historically, one of the barriers to growth in solar power was the performance of batteries used to store the energy created by solar power. They were huge lead-plate batteries made with sulphuric acid, expensive to make and harmful to the environment. Due to advances in technology, newer batteries use saltwater as the only electrolyte. They are also made of lithium iron, which is safer because there is less risk of fire. Improvements in battery technology have helped to make solar power more attractive. Technological developments have also helped to bring the cost of solar power down as shown in Figure 1.

ACTIVITY 2

CASE STUDY: CONSOLIDATION IN THE EUROPEAN AIRLINE MARKET

1 What is meant by 'consolidation' in the European short-haul market?

Consolidation in a market means that the number of firms in the market falls. The European market for short-haul flights has been consolidated recently. This is because three airlines (Monarch[®], Air Berlin[®] and Alitalia[®]) have collapsed and left the market in recent months. There are now fewer airlines in the market.

2 Give one reason why the European short-haul market has become more consolidated.

Consolidation in the European short-haul market has happened because three airlines have collapsed and withdrawn from the market. These three airlines were struggling to survive. For example, Figure 3 shows that the profit margins of two of these airlines, Air Berlin and Alitalia, were both negative. This means they were making losses. It is likely that their costs were too high and that they were unable to charge high enough prices to recover costs and make a profit. Prices have been forced down by the most efficient operators in the market. For example, Ryanair[®] and Wizz Air[®]. These two operators have margins of 23.1 per cent and 15.7 per cent respectively. Competition in this market is intense and only the 'fittest' will survive.

3 What are the factors that might influence the level of consolidation in the European short-haul market?

The European short-haul market is very competitive. With three airlines leaving the market in such a short space of time, it is clear that firms must be efficient and meet customer needs to survive. Those operators that cannot lower their costs and match the attractive prices that the leaders are offering to customers are likely to collapse. Figure 3 suggests that other firms in the market are vulnerable. Four other firms, Eurowings[®], THY[®], Pegasus and Flybe[®], also have negative profit margins. If they cannot improve their efficiency soon, they may be under threat. Also, more than half of the airlines in the market have margins which are less than 10 per cent. Therefore, more consolidation looks likely.

There are more airlines operating in the European market than in any other region in the world and comparison with the US short-haul market also suggests that consolidation will occur. According to OAG, Europe has a total of 217 operators, compared with 100 in the USA. Also, US carriers are expected to post a US\$15.4 billion net profit in 2017, compared with a US\$7.4 billion profit for European airlines. Although the population of Europe is bigger than the USA, it is not more than double. This suggests that Europe does not need 217 carriers, so consolidation may be inevitable.

EXAM PRACTICE

CASE STUDY: RETAILING IN VIETNAM

1 Explain one reason why there are changes in the competitive environment of the Vietnamese retail industry. (4 marks)

Over time, the structure of a market is likely to change. This is because the number of operators in a market rarely stays the same. In this case, the number of operators in Vietnam's retail industry is growing quite rapidly. Competition in the market is intensifying.

For example, one of the reasons for the changing competition environment in retailing in Vietnam is the relaxation of trading rules and regulations. Businesses wanting to open a store in Vietnam have to carry out a review. This is to determine the possible impact of the operation on the local community. It is supervised by the local authorities. However, the review process has now been simplified and the criteria used in the process are clearer. This has made it a lot easier for businesses to develop a chain of stores.

Another reason why competition in the Vietnamese retail market is intensifying is because of growing the interest from overseas retailers. For example, Japanese retailer Aeon® opened a store in Ho Chi Minh City in 2014. Then, Aeon opened another three stores in Hanoi and other cities more recently.

Finally, the growth in online selling has also contributed to intensifying competition in the market. Online retailers can be based anywhere in the world. This makes it so much easier to supply wider markets.

2 Discuss how Porter's Five Forces analysis might be used by an established business in Vietnam's retail market. (8 marks)

Michael Porter outlined five forces that determine the profitability of an industry. These are the bargaining power of suppliers, the threat posed by new entrants, the threat posed by substitute products, the bargaining power of buyers and the rivalry among existing businesses. He argued that the ultimate aim of a competitive strategy is to cope with, and ideally change, those rules in favour of the business.

In this case, the threat posed by potential entrants is high. The Vietnamese retail market is becoming increasingly profitable due to rising incomes. As a result, more and more firms are joining the market. For example, Japanese retailer Aeon opened a store in Ho Chi Minh City in 2014. Also, 7-Eleven®, the Japanese-owned US convenience chain, was planning to open its first store in South East Asia in 2018 in Vietnam. Barriers to entry are relatively low in retailing, so the threat of new entrants is significant.

The retail market is fiercely competitive, and each operator knows that there are close substitutes for its products. For example, in Vietnam there are likely to be thousands of stores selling clothes. There will also be huge numbers of firms all over the world that can serve the clothes market online. However, Hanoi Style® has been successful in the clothes market. It has been able to sell attractively designed clothes at premium prices. If the Văn Thanh brothers can continue to meet customer needs with their 'classy' designs, their success may continue.

In this market, the buyers do have some power. There may be very little brand loyalty unless businesses have been able to differentiate their products (i.e. make the products stand out). One feature of the retail market is the development of price comparison sites. A buyer can go online and use a price comparison site to find the best deal when buying a particular product. The amount of information about the large number of outlets from which consumers can choose has helped to put the buyer in a strong position in the Vietnamese retail market.

Suppliers to retailers probably have very little power. These are the manufacturers of goods who sell their output to the various retailers in the market. However, increasingly suppliers/manufacturers are selling their goods directly to consumers online. This eliminates retailers and strengthens the position of suppliers. Suppliers may also be able to increase their power by differentiating their products, lowering their costs and improving quality.

Finally, rivalry among existing firms in the Vietnamese retail sector is strong. The profit made by any individual firm is likely to be limited. This is unless the firm can differentiate its product

or operate more efficiently than its rivals. In the future, there may be some takeover and merger activity that might consolidate the market. This might have some impact on profitability.

3 Evaluate whether the success of Hanoi Style is the result of (a) external influences or (b) internal influences. (20 marks)

According to Figure 7, Hanoi Style has experienced rising profits over the last nine years. Profits have increased by 1219 per cent from US\$12 900 to US\$170 100 between 2010 and 2018. Profits did fall for a while between 2015 and 2017. However, this was caused by the extra cost of developing an online business at the time. The performance of the business has been affected by both external and internal influences. One important external influence has been the performance of the Vietnamese economy. Hanoi Style sells a 'classy' range of clothes at premium prices. This may not have been possible without significant economic growth. Figure 5 shows that national income in Vietnam has more than doubled from US\$93.1 billion in 2008 to US\$205.28 billion in 2016. This is a significant factor. Additionally, there has also been growth in the size of Vietnam's middle-class consumer group. This has helped Hanoi Style because their clothes are aimed at those people who can afford the higher prices.

Another economic influence that may have helped Hanoi Style was the fall in interest rates in 2013–14. According to Figure 6, they fell from 8 per cent to 6 per cent. This reduced the cost of the borrowed money which was needed to develop an online operation. This would have been a welcome change in economic conditions.

Hanoi Style may also have benefited from political influences. The Vietnamese government has been relaxing some of the trading rules and regulations. For example, businesses wanting to open a store in Vietnam are required to carry out a review. This is to determine the possible impact of the operation on the local community. It is supervised by the local authorities. However, the review process has now been simplified and the criteria used in the process are clearer. This has made it a lot easier for businesses to develop a chain of stores. These changes, and others like it, began a few years ago when Vietnam joined the World Trade Organisation. In 2016, the government planned to change the law so that small retailers (less than 500 m² floor space) would be able to start up without having to get approval from the authorities. These developments may have helped Vũ Văn Thanh and Nguyễn Văn Thanh when starting and developing their stores.

Developments in technology may have had an impact on Hanoi Style. Online selling is globally successful. Vietnam's e-commerce market climbed to about US\$4 billion in 2016 and is one of the fastest-growing markets in the world. Revenue from online retailing in Vietnam is expected to hit US\$10 billion by 2020. This accounts for 5 per cent of the country's retail market.

A final external influence may have had a negative impact on Hanoi Style. Hanoi Style has had to deal with some difficulties, like other retailers in Vietnam. The country has an underdeveloped logistics network. Narrow streets in towns and cities are filled with motorcycles and are badly congested. Distribution is inefficient and deliveries are often late which is particularly a problem for online retailers. This is a risk for domestic retailers such as Hanoi Style. They are unlike foreign companies that have the knowledge and capacity to cope with such an inadequate infrastructure.

A number of internal influences on Hanoi Style can also be identified. The decision to go 'upmarket' by the brothers was important. They designed stylish and popular clothes and targeted them at the growing middle-class market. This was a good business decision. It

allowed the business to charge premium prices and differentiate products from those of rivals.

It was also a good decision to set up an online operation. Since the introduction of its online selling, operation profits have increased significantly. Hanoi Style could benefit if online shopping in Vietnam grows as well as predicated. However, Vũ Văn Thanh and Nguyễn Văn Thanh may never know what might have happened if they had accepted the offer from the Chinese retailer. They may have enjoyed an instant boost in revenues and profit. They may have got offers from other retailers. This was another important decision. Vũ Văn Thanh and Nguyễn Văn Thanh have complete control over their business because they developed an online operation.

In conclusion, it is often difficult to account precisely for particular outcomes when a number of causes are thought to have had an effect. Clearly, both external and internal influences have had an impact on Hanoi Style. However, it might be argued that external influences have had the most powerful influence. For example, national income in Vietnam has more than doubled in less than 10 years. This is important because, without growing incomes, it is unlikely that Hanoi Style would have been able to sell their expensive brand of clothing in enough quantities to make a profit and grow the business.

5 GROWTH

ACTIVITY 1

CASE STUDY: MILK PRODUCTION

1 Explain what is meant by economies of scale in the case of the UK dairy industry?

The size of a business can influence the unit cost. As a business grows, its unit costs will fall. This is due to economies of scale. As a business expands the scale of its operations, efficiency is improved. Larger businesses get cost benefits from employing specialist managers, buying in bulk, spreading the risk of business and making more use of equipment, for example.

In this case, dairy farmers are seeing their average costs fall as they increase the size of their herds. For example, when the herd size is 85 cows, the average cost of milk production is just over 35p per litre. However, when the herd size rises to 339 cows, the average cost falls to around 30p per litre.

2 Give one example of an internal economy that might account for lower unit costs when larger herds are used in the UK dairy industry.

Internal economies of scale are the cost benefits that a single business will enjoy as it grows. They occur for a number of reasons. In this case, there is one clear example. As farmers increase the size of their herds, they have to buy more inputs. One of the most expensive inputs is cattle feed. A farmer with a herd size of 339 cows will require around four times more cattle feed than one with a herd of 85 cows. Suppliers of cattle feed are likely to give discounts to farmers who buy much larger quantities. This will help to lower unit costs.

ACTIVITY 2

CASE STUDY: RTR LTD

1 Calculate the percentage increase in dividend payments between 2012 and 2017.

Between 2012 and 2017, dividends per share rise from 17 cents to 30 cents. The percentage increase is given by:

$$\text{Percentage change} = \frac{(30-17)}{17} \times 100 = \frac{(13 \times 100)}{17} = 76.5$$

2 Explain one benefit to RTR shareholders of the growth of RTR.

When a business grows it will usually make more profit. In this case, the profit made by RTR has grown significantly, from a loss of €127 million in 2012 to a profit of €979 million in 2017.

The owners of a business – in this case, the shareholders – will benefit from this. As a business makes more profit, it can pay higher dividends to shareholders. RTR has increased its dividends per share by 76.5 per cent. So, a shareholder owning 100 000 shares in RTR will see returns increase from €17 000 (17 cents × 100 000) to €30 000 (30 cents × 100 000).

EXAM PRACTICE

CASE STUDY: CATA COMPANY®

1 Explain one reason why some of Cata Company's growth may be regarded as inorganic. (4 marks)

Internal growth, or organic growth, happens when a business grows naturally by selling more of its output using its own resources. In contrast, external growth, or inorganic growth, results when businesses join together. They could double in size overnight following the merger of two companies. In this case, there is some evidence to suggest that Cata Company's huge 4500 per cent growth between 2014 and 2016 was helped by outside companies. This means that at least some of the company's growth was inorganic.

For example, in 2015 Cata Company secured an important partnership with Prosegur®, a cash transit service, with operations in 18 countries. More recently, Cata Company claimed it was developing partnerships with other CIT companies such as Protégé® and Preserve®.

2 Explain one internal economy of scale Cata Company might benefit from. (4 marks)

Internal economies of scale are the cost benefits experienced by an individual business as it grows. For example, a business might get discounts for buying much larger quantities of raw materials from suppliers. This is because its order size increases due to the growth of the business.

External economies of scale are the reductions in costs which any business can experience as the whole industry grows. External economies are likely to exist when an industry is concentrated in a particular geographical region. In this case, Cata Company is likely to enjoy internal economies of scale. This is because it is able to increase the scale of production where it makes its cash machines.

3 Discuss how Cata Company might be exploiting risk-bearing economies. (8 marks)

One example of an internal economy of scale is risk-bearing economies. Risk-bearing economies occur when a business begins to diversify in an effort to reduce risk. A business might diversify by introducing new products. Therefore, if demand for one product falls sharply, it may continue to have revenues from other products in the company's portfolio. A business may also diversify by finding new markets for its products. For example, a business might start to export its products. This is so it does not have to only rely on the domestic market. This will also help to reduce risk.

In this case, Cata Company, which is a relatively young business, has already introduced new products into the market. Its first product was CataCoin®, which provides a client-facing, interactive coin machine. It recirculates coins in Brazil and directs them to certain locations needed by retailers. Cata Company also introduced some mini safes called CataCash One® and CataCash Mille®. The company's latest product is a Shielded Vault System. This helps to remove the risk of huge losses resulting from bank and CIT (cash-in-transit) robberies.

Cata Company is also spreading risk by exporting. It has developed a branch in Florida and is currently exporting its CataCoin® machines to the USA, Peru, Australia and Spain. CataCash machines are being sold in the USA, Mexico, Argentina, Paraguay and Spain. The company is also currently testing a number of new products on the market.

Cata Company is clearly spreading business risk both by finding new markets and developing new products. It could be argued that new product development might be difficult to sustain. This is because in the future the use of coins may eventually disappear. There is a growing trend towards the use of cards and mobile phones to make payments. In countries such as New Zealand and Australia, more than 90 per cent of transactions in the economy are cashless. Therefore, finding new markets might be more important to Cata Company.

4 Assess the possible growth objectives of Cata Company. (12 marks)

Businesses like to grow because the benefits can be very attractive. For example, revenues will be higher, unit costs are likely to be lower and the business will have a higher profile with a larger market share.

In this case, Cata Company was the fastest growing small to medium-sized company in Brazil. It is likely that it will have lower average costs as the business expands. For example, it may benefit from purchasing economies as it buys materials and commercial services in bulk. It may also benefit from managerial economies as it begins to employ specialists in the different functional departments. Financial economies and risk-bearing economies may also be exploited further in the future. For example, Cata Company is often introducing new products and expanding into new overseas markets.

One growth objective is to dominate the market. As businesses grow, other businesses in the market are left with a smaller market share. Some of the weaker firms may also be forced to close. If a business is large enough, it may be able to charge higher prices. This is because competition in the market might become limited. As a result, customers may be left with less choice and forced to pay the higher prices charged by the dominant firm.

Sometimes, a business may be able to apply pressure on its suppliers. For example, it may be able to force the costs of materials and commercial services down if it buys large quantities from smaller suppliers. Cata Company is probably the leading company in this market. It is one of the first to launch new initiatives, such as its Shielded Vault System.

As businesses grow, their share of the market is also likely to grow. This will give them more power and they may be able to experience the benefits outlined above. However, they will also benefit from having greater brand recognition. As Cata Company gets a larger share of the market, customers will become more aware of the brand name. This is because they are more likely to see the brand advertised in the media. As the brand becomes stronger, a business may be able to charge higher prices, differentiate the product from those of rivals, create customer loyalty, help product recognition and develop an image. It will also be easier for a business with a strong brand to launch new products. A business with a larger market share is also more likely to attract media attention. For example, environmental issues are important to many people today. Cata Company has already received some positive feedback from environmental groups relating to its contribution in recycling coins and reducing the need to extract more minerals. This will help to promote the company.

Finally, one of the main objectives of growth is to make more profit. Larger businesses tend to make bigger profits than smaller ones. As profits grow, returns to the owners will also grow. It will also have more profit for investment and innovation. This will allow Cata Company to develop and launch even more new products and make acquisitions. If these investments are successful, Cata Company is likely to grow even further.

There is no information about the profits made by the company, but profit will be important. This is because the venture capitalist, Fundo SC, will want a return on its investment. As Cata Company is quite young and plans to expand quickly, it might be appropriate to conclude that the main growth objective is to increase market share and develop the brand.

6 ORGANIC GROWTH

ACTIVITY 1

CASE STUDY: APPicon®

1 How has APPicon achieved organic growth?

Organic growth occurs when a business grows naturally by selling more of its output using its own resources. In the early stages of business development, most owners are likely to look for organic growth. Entrepreneurs are likely to be cautious and grow their businesses gradually to start with, perhaps by selling more products to existing customers or trying to attract new customers.

In this case, APPicon has grown organically for five years. Sales revenue has grown rapidly from about US\$45 000 to about US\$270 000. Rufus has accumulated 25 000 designs to sell and is also designing tailor-made icons for app developers. The business has grown internally without joining with other businesses. This is organic growth.

2 Suggest one way in which Rufus might continue to grow his business organically in the future.

Organic growth usually involves a business growing by building on its strengths to increase sales. However, there are a number of different approaches to growing organically.

In this case, perhaps the easiest approach for Rufus is to drive sales from existing activities. He may be able to attract new customers by reaching out to a greater number of app developers. However, this approach to growth may need investment in marketing to increase the customer base. Some businesses grow by developing new products. They may be very innovative and committed to research and development.

In this case, Rufus might start to use the business's design skills in related fields. For example, the business might be able design logos for companies and their products, labels for products, or icons for display units like warning lights on cars. Alternatively, it might identify customers with slightly different needs. This may involve adapting or modifying existing products to meet these needs. Using this approach to organic growth may require APPicon to invest in product development.

ACTIVITY 2

CASE STUDY: KANTUR PALM OIL

1 Why are some shareholders unhappy with Kantur's organic growth strategy?

One of the disadvantages of organic growth is that it can be a relatively slow process. Although organic growth may be less risky than inorganic growth, for some business owners this growth strategy does not generate sufficient financial returns. In this case, the shareholders have become unhappy because the growth rate has only averaged 3.4 per cent per annum since it was established. In 2018, groups of shareholders expressed their dissatisfaction at the Annual General Meeting (AGM). These shareholders wanted faster growth to justify their investment in the business. They were critical of the directors for pursuing an organic growth strategy.

2 Why is Kantur unable to exploit economies of scale?

If a business can exploit economies of scale it will experience lower unit costs. With lower costs it may be possible to reduce prices, gain a competitive edge on rivals and increase profits. In this case, Kantur has been operating with higher costs than many of its rivals. It was argued by some shareholders that this was because the company was growing too slowly and not able to exploit economies of scale. This suggests that Kantur is not a large enough operation to exploit economies of scale. The business needs to grow more quickly so that it can reach a size where economies of scale can be exploited.

EXAM PRACTICE

CASE STUDY: MINDTREE IT SOLUTIONS®

1 Calculate Mindtree's percentage growth rate between 2010 and 2017. You are advised to show your workings out. (4 marks)

Between 2010 and 2017 Mindtree's revenue grew from INR12 332 million to INR52 364 million. The growth rate over this period is given by the following formula:

Difference between the two numbers ÷ original number × 100.

So:

$$\frac{\text{INR52 364 million} - \text{INR12 332 million}}{\text{INR12 332 million}} \times 100$$

$$\frac{\text{INR 40 032 million} \times 100}{\text{INR12 332 million}} = 324.6 \text{ per cent}$$

2 Explain one way Mindtree plans to grow in the near future. (4 marks)

Historically, a significant proportion of Mindtree's growth has come from acquisitions. For example, in 2015 it made three significant acquisitions. It bought Discoverture Solutions® LCC (USA), Bluefin® Solutions Limited (UK) and Relational Solutions® Inc. (USA) for US\$15 million, US\$42.3 million and US\$10 million, respectively. In 2016, MindTree bought another company, Magnet 360® (USA) for US\$50 million. However, in the near future MindTree has said that it would pursue an organic growth strategy. This means that it will now grow without the help of acquisitions or mergers. It will generate future growth from its current resources.

One product area that Mindtree hope to develop is digital. At the moment, the digital market is growing twice as fast as Mindtree. This should provide opportunities for the company to generate more revenue as they claim a share of this growing market for itself.

3 Evaluate whether or not the advantages of organic growth will outweigh the disadvantages to Mindtree in the future. (20 marks)

Mindtree has experienced impressive growth. It has grown its revenues by 324.6 per cent from INR12 332 million in 2010 to INR52 364 million in 2017. The increase in revenue has been the result of both inorganic and organic growth.

However, more recently, the company has promised to focus only on organic growth. Entrepreneurs know a business really well when it grows organically using its own strengths and expertise. Entrepreneurs can experience the satisfaction of seeing their business develop and perform well. They can also choose the pace of growth – a rate that is comfortable for their own personal needs. An organic growth strategy has a number of advantages.

One very important advantage is that organic growth is much less risky than other growth strategies. Growth is achieved by using practices that are known and understood, so there is less scope for error. The culture and norms of the business are established and effective. In this case, Mindtree has around 350 active clients and 43 offices in over 17 countries. Some of their high-profile customers include Toyota®, Kellogg's®, Honeywell®, the BBC and GlaxoSmithKline. Mindtree may have maintenance contracts with many of these companies which will generate revenue.

Mindtree plans to grow by developing products that have proven to be a success in the past. They might sell more services and solutions to existing clients. Organic growth also avoids the complications that can arise when integrating with another organisation. For example, sometimes after a takeover, there may be a culture clash. The integration process may be expensive and there may be a conflict of interests among the employees of the two organisations. Risk has been reduced by focusing on the core strengths of the business.

Another advantage is that organic growth is relatively cheaper than using other methods. A lot of organic growth is financed from retained profit. Retained profit is the cheapest of all sources of finance – there will be an opportunity cost, but the financial cost is zero. Businesses that grow inorganically often have to borrow money or raise fresh capital, which adds to the costs of growth. Organic growth is also cheaper because it avoids the premium prices that are sometimes paid when buying other businesses. When Mindtree made some acquisitions recently, the company paid out around US\$150 million for four companies. This is likely to have had a financial impact on the business.

Another advantage of organic growth relates to control. Mindtree will keep more control when growing organically. The shareholders, or the senior management team, will have complete control of the growth process. If growth is achieved by joining with another business, some control is lost because people in another organisation will probably want to keep some control of their own.

Finally, the financial position of a business might be better protected with organic growth. As growth is gradual, there will be less strain on financial resources. Cash flow will be stronger, and the business will keep more liquidity. Inorganic growth often requires huge outlays of money. As stated above, Mindtree spent around US\$150 million recently on acquisitions. Such an approach might put financial pressure on the business. In this case, growth has been very rapid, but it appears to have been managed and there is nothing to suggest that the business is struggling financially.

Despite the advantages of organic growth, there are some drawbacks. For example, the pace of organic growth may be too slow for some stakeholders. Organic growth often means that growth is more measured and less exciting. However, in this case growth has been very fast. Mindtree has grown by 324.6 per cent since 2010 (although this does include some acquisitions).

Organic growth may prevent the business from tapping into the resources owned by other businesses. As a result, it might miss out on some profitable developments. However, before Mindtree's recent commitment to organic growth, it managed to widen its capabilities through acquisitions. For example, Discoverture was bought to help Mindtree tap into the US\$1.5 billion global P&C services market. It will also help Mindtree gain access to 15 high profile

clients and add over 300 experts across the USA, UK, Canada and India. Bluefina® was bought because it had expertise in SAP software. Mindtree also said that the acquisition will help boost its European presence and its range of competencies.

Another problem might be that growing slowly may mean that a business gets left behind in the market. If others in the market are growing through mergers and acquisitions, the business may end up feeling small in comparison. As a result it may get dominated and lose its ability to compete effectively. However, there is no evidence of this regarding Mindtree because the company is growing so quickly. It is also one of the current market leaders.

Finally, as a business grows it may be able to exploit economies of scale. However, if a business is growing organically it may take some time before such economies are fully exploited. This could mean that a business has to operate with higher costs for longer, lowering their profit margins and making them less competitive. In this case, the pace of growth suggests that Mindtree may be exploiting economies of scale already.

There is little evidence, in this case, to suggest that the disadvantages of growth outweigh the advantages. Mindtree is performing very well indeed. It is benefiting from focusing on its most important strengths and already has a healthy share of the total market. There is plenty of scope for more growth. Digital is one such example. Mindtree has invested in digital and is very focused on the development of this product. The company claims to have delivered some path-breaking solutions for customers which nobody in their industry has ever done before. In March 2017, the growth rate of the digital market was twice that of Mindtree.

Mindtree has many customers all over the world. It has established products and a wide range of expertise. It also has growing markets which it can exploit more, such as digital. It is very unlikely that the disadvantages of organic growth will outweigh the advantages in the future for Mindtree.

7 INORGANIC GROWTH

ACTIVITY 1

CASE STUDY: BIDVEST®

1 Explain what is meant by ‘inorganic growth’.

Inorganic growth involves a business increasing its size by joining together with other businesses. This might be in the shape of a merger or a takeover. In this case, Bidvest has grown inorganically for many years. Table 1 shows a sample of the businesses Bidvest has acquired since 2011. Its most recent acquisition was the Irish company, Noonan®. Inorganic growth helps a business to grow more quickly.

2 Discuss the possible reasons for Bidvest’s numerous acquisitions.

The list of acquisitions made by Bidvest, shown in Table 1, suggest that the company is committed to inorganic growth. There are a number of reasons why Bidvest may have chosen this growth strategy. One of the main motives for multiple acquisitions is to grow quickly. Opening up new businesses from existing resources, one after the other, can be a slow process. This may annoy shareholders and result in a loss of support. Buying up other companies is a far quicker method of growth. Provided Bidvest is well capitalised, and has a sound cash flow, making regular acquisitions may help to meet shareholder growth needs.

Bidvest operates a diverse range of businesses such as food, automotive, brushes and finance. It would probably be quite difficult to develop such a wide range of business interests with a single management team through organic growth. It is unlikely that they would have the necessary expertise, experience and knowledge to succeed in all of these very different business activities. Taking over companies that have their own specialised management teams already in place would overcome this problem.

Another possible motive for adopting an inorganic growth strategy is that it might be cheaper than organic growth. Sometimes it is possible to buy a company at a discount – particularly if it has not been performing according to expectations.

Finally, making acquisitions can be an effective way to break into new markets. Bidvest has a proven track record in buying businesses in completely new markets. For example, in 2015 it bought Bush Breaks®, a tour company operating safari holidays. In 2014, it bought a brush company, Brushware®. This helps to spread business risk. Also, more recently, Bidvest are looking to develop overseas interests, so it bought Noonan, an Irish company.

These are just some of the reasons why Bidvest might have chosen to grow inorganically by making multiple acquisitions.

ACTIVITY 2

CASE STUDY: FIRST MAJESTIC SILVER® AND PRIMERO MINING®

1 Explain what is meant by ‘horizontal integration’. Use the example in this case to support your answer.

Horizontal integration occurs when two firms in the same line of business and at the same stage of production join together. In this case, First Majestic Silver has taken over Primero Mining. Both of these companies operate silver mines – they extract silver from the earth.

Consequently, this is an example of horizontal integration because both firms are in the same line of business and are exactly in the same stage of production.

2 How might First Majestic Silver benefit from this takeover?

Some of the best benefits from mergers or takeovers often come from horizontal integration. This is because of the similarities in operations. Generally, horizontal integration means that there is a common knowledge of markets and production techniques. There will be less disruption when joining together because workers have similar skills and little training is required. Because of the similarities there is less chance of failure due a lack of knowledge and experience.

In this case, First Majestic Silver will get a new mine that builds on the company's strengths and expertise in Mexico and underground mining. The takeover gives First Majestic a well-established mine with low-cost operations which complements its existing operations. The new mine will help to increase output, the value of net assets, cash flow and access to valuable resources. These should bring positive financial benefits to First Majestic's shareholders.

3 Explain how Primero shareholders will benefit from being taken over by First Majestic Silver.

The price of Primero's shares have fallen very sharply in the last few years. Figure 2 shows that the price has fallen from 4.5 cents to almost zero. This suggests that the company is not doing well. Consequently, the offer made by First Majestic looks attractive. The deal provides a significant and immediate up-front premium to Primero shareholders. They will be given shares in First Majestic that will be 200 per cent more valuable than their current shares in Primero. These First Majestic shares give holders a stake in a well-performing company with a strong balance sheet and diversified portfolio of seven operating mines with strong growth potential. Most, if not all, of Primero's shareholders are likely to be happy with the takeover by First Majestic.

EXAM PRACTICE

CASE STUDY: LINDE® AND PRAXAIR® MERGER

1 Explain one difference between the Linde and Praxair merger and a takeover. (4 marks)

Both mergers and takeovers involve two or more businesses joining together to form one. In this case, the integration of Linde and Praxair involves a merger. This means that the two companies are joining together willingly, with both sets of shareholders in full agreement. The merger is friendly and the owners of both companies stand to benefit.

A takeover, sometimes called an acquisition, means that one company 'swallows' another. The takeover process usually involves the 'predator' buying enough shares in the 'target' to gain control. When the takeover is complete the 'target' usually loses its identity. Its assets (and liabilities) are absorbed by the 'predator'.

2 Explain one financial reward that might arise from the proposed merger between Linde and Praxair. (4 marks)

The financial rewards resulting from a merger can be significant. It is possible for a number of stakeholders to benefit. In this case, shareholders in both Linde and Praxair will benefit

financially. It is claimed that there will be a US\$1.2 billion increase in shareholder value due to lower costs and exploiting synergies.

Also, once the merger goes ahead (if approved) the new company will have a stronger balance sheet and improved cash flow. This will provide financial flexibility for future investments. The business will also be larger, with a combined revenue of US\$29 billion and market value of US\$73 billion. In the future, if the merger goes well, the dividends paid to shareholders are also likely to be higher.

3 Discuss the role played by the Competition Commission in the proposed merger between Linde and Praxair. (8 marks)

One of the disadvantages with mergers and takeovers is that they may threaten competition levels in a market. Consolidation in markets reduces the number of firms competing and therefore reduces choice for consumers. Also, if the remaining firms are too powerful, they may raise prices. As a result, mergers and takeovers are likely to attract the attention of the competition authorities. In this case, the European Competition Commission said that an investigation will happen because it felt that the merger threatened the level of competition in the gas industry. According to Competition Commissioner, gases like oxygen and helium are important for many products used daily. The Commissioner said it would assess whether the proposed merger would lead to higher prices and/or less choice in the EU.

Such investigations take time and can cause expensive delays. The investigation into the Linde–Praxair merger was expected to take until July 2018. Linde and Praxair have begun to sell off assets to win favour with the regulators. The exact scale of the sell-off is still under negotiation. However, both companies have agreed that if they have to sell businesses worth more than US\$3.7 billion in sales or US\$1.1 billion in earnings before interest, taxes, depreciation and amortisation (EBITDA), either party can withdraw from the deal without penalty.

This shows the power that the European Competition Commission has over businesses when mergers and takeovers are proposed – especially large ventures like this one. The commission could block this merger if consumers' interests are at risk. However, the likely outcome is that Linde and Praxair will have to sell off some assets to maintain competition levels. The two companies know this, which is why they have started to sell off parts of their businesses.

4 Evaluate whether or not the advantages of the proposed merger between Linde and Praxair outweigh the disadvantages (20 marks)

The senior management team of Linde and Praxair believe that operating as one company will make them a leader in the industrial gas industry. One advantage of this merger is that the company will grow more quickly than trying to grow organically. This means that the benefits of growth, can be enjoyed more immediately. Benefits include larger market share, lower costs resulting from economies of scale, more market power and higher profitability. In turn, this might benefit a range of stakeholders. For example, the merged company will generate extra value for shareholders through lower costs. After three years, it is expected that about US\$1.2 billion would be created for shareholders.

Also, mergers can help businesses to improve their strategic position. Firms often join together because their activities may complement each other. For example, if two companies join together, collectively they may have a more balanced and diverse global product portfolio. A business can fill gaps in its product portfolio very quickly by making acquisitions.

Inorganic growth often means that the strengths in one company can compensate for the relative weaknesses in the other, and vice versa. In this case, the strengths of the two companies will complement each other. Linde's engineering and technology expertise and Praxair's operations will help to improve performance. These strengths are summarised in Table 2. For example, Linde is strong in engineering and technology while Praxair has a reputation for operational excellence. The combined group will also have a more balanced and diverse global product portfolio. It will also have more exposure to the long-term growth trends in healthcare, emerging markets, digitalisation and clean energy will be improved.

An important advantage of this merger is that the company may benefit from economies of scale. For example, when Praxair and Linde join, the new organisation will only need one head office. Therefore, one can be closed down, reducing administration costs significantly. Sometimes, after an acquisition, the size of a business can double. This provides huge scope for making cost savings. For example, bulk buying, increased specialisation of resources and raising capital.

Also, inorganic growth can help to reduce competition in the market. If a company takes over a rival, there will be fewer operators in the market. If the process of acquisitions continues in the same market, competition becomes less and less. This may lead to one firm, or just a few firms, dominating the market. This might allow the remaining companies to raise prices and limit choice for consumers. In this case, each company's product portfolio seems complementary. However, there will be some significant overlaps, otherwise the regulators would not need to investigate the merger.

Businesses that use inorganic growth strategies are usually trying to grow rapidly. Unfortunately, there is risk associated with this and some mergers and takeovers actually fail. Failure probably means that outcomes did not match expectations. One problem, in this case, is regulatory intervention. In most countries, mergers and takeovers may attract the attention of market regulators. They have the power to order an investigation if they think the merger or takeover acts against the interests of the consumer. This takes time and may cause delays. After the investigation, the regulator often has the power to recommend that the merger be blocked. Alternatively, it may allow a merger or takeover to go ahead, but with certain conditions. These delays in proceedings and undertakings take time and cost money, such as the sale of assets. In this case, the European Competition Commission said that an investigation will take place because it felt that the merger threatened the level of competition in the gas industry.

Another possible problem is that mergers can cost a lot of money. Although in this case money is not being paid out to buy a company, there will be some significant costs. For example, after a merger has been completed, the two organisations must be physically integrated. This can be a very complex, expensive and time-consuming.

Some of the costs come from organisational and personnel changes, severance pay for dismissed workers, technical changes, systems changes, training and many others. It is not uncommon for businesses to underestimate these costs. They may encounter problems when carrying out the consolidation process. For example, merging two different cultures can be particularly problematic. It can be very difficult to impose a new culture on a business and there may be resistance. If changes are forced through too quickly (e.g. without proper discussion), this resistance is likely to be stronger. Such problems are likely to be more intense if growth is too rapid and firms are combining two contrasting cultures too quickly. There is not any information in the case study about the cultures of Linde and Praxair. However, Linde is a German company and Praxair is American, so there may be some cultural differences.

Another possible disadvantage is the danger that rapidly growing companies might ignore customer needs. Too much attention and resources get focused on the process of growth, so customer needs are overlooked. For example, after a takeover or merger the name of a business may change. Some consumers may be confused by this change. This could damage the image of the company and result in the loss of customers. In this case, the company will be called Linde – the Praxair name will disappear. This could cause some confusion.

In conclusion, mergers such as this pose great scope for the growth of the new company through expansion and diversification. The advantages of faster growth, improved strategic position, lower costs, reduced competition and greater shareholder value seem to outweigh the possible disadvantages. These include regulatory intervention, high integration costs, possible culture clashes and ignoring customer needs.

The company can reduce the risks associated with it by prudent planning and compliance management. The costs of merging can be very high, but suitable measures can help reduce them, such as using a compliance management software. One problem with this merger is regulatory intervention. Both Linde and Praxair are aware of the threat posed by regulators. They are already taking measures to meet regulator needs by selling off assets. However, the two companies have agreed that if they have to sell businesses worth more than US\$3.7 billion in sales or US\$1.1 billion in earnings before interest, taxes, depreciation and amortisation (EBITDA), either party can withdraw from the deal without penalty. This shows how powerful the threat is.

However, there are many advantages and financial rewards, such as the US\$1.2 billion increase in shareholder value. The stronger balance sheet, improved cash flow, a combined revenue of US\$29 billion and market value of US\$73 billion suggest that the advantages do seem to outweigh the disadvantages.

8 PROBLEMS ARISING FROM GROWTH

ACTIVITY 1

CASE STUDY: BHP BILLITON®

1 Explain what is meant by diseconomies of scale and, using the example of BHP Billiton, explain why they occur.

The minimum efficient scale of operations is the level of output corresponding with the lowest point on the long-run average cost curve. Diseconomies of scale may occur if a business expands the scale of its operations further than the minimum efficient scale. This is where average costs rise as output rises. Essentially, a business will start to suffer inefficiencies because the organisation has got too big.

In this case, Andrew Mackenzie, Chief Executive at BHP Billiton, was worried by diseconomies of scale. According to a report by consultant EY, individual mining operations were sometimes getting too large to be managed effectively, resulting in lower productivity. 'The industry thought that bigger was always going to be better and it hasn't always worked out that way,' says Paul Mitchell, global mining and metals advisory leader at EY. 'It is bad enough [managing a mine] with 100 people on site – with 1000 it becomes much more complex.'

In this case, the rapid growth in the size of mines quickly led to two problems. First, resources such as labour and materials rose sharply, which raised average costs. Then the EY report also mentioned the increased complexity of running larger mines. It said that high staff turnover in the industry meant that mines were being run by inexperienced managers, and that those managers were not being given the resources needed to deal with the increased complexity. Executives in the industry said that communication across departments was poor and that a 'silo mentality' had developed in some quarters. As a result, productivity has fallen.

2 Discuss one way in which BHP Billiton has dealt with the problem of diseconomies of scale.

BHP Billiton has responded to the problem of rising costs and falling productivity caused by diseconomies of scale by reducing its scale of operations. It has decided to sell off about US\$20 billion of non-core assets. This will reduce the size of the business and hopefully lower average cost again. Cutting back scale means that the business will be moving back towards the minimum efficient scale, where average costs are lower.

ACTIVITY 2

CASE STUDY: CAIRO SA (CAIRO STUDENT ACCOMMODATION)

1 Calculate the total annual interest payments on all of the properties owned by Cairo SA in 2018.

The total interest paid on all of the properties owned by Cairo SA is given by:

EGP1.5 million × 20 per cent = EGP300 000 per annum, or EGP25 000 per month

2 Assess the extent to which the collapse of Cairo SA was the result of overtrading.

Over a four year period, Cairo SA bought three, three-bedroomed apartments and a small 10-bedroomed apartment block. These properties cost a total of EGP1 660 000 (EGP280 000 + EGP280 000 + EGP300 000 + EGP800 000). A significant proportion of the money needed to buy these properties was borrowed: a total of EGP1.5 million.

Potentially, the business was profitable. The annual interest payments would have been EGP300 000 and the annual rental income would have been EGP570 000 ($19 \times 12 \times \text{EGP}2500$). This means that a total of EGP270 000 would have been left over to meet other overheads and contribute to profit. If interest rates had not risen so sharply the profit potential would have been even higher. However, interest rates did rise and other there were other problems.

Tarek underestimated the cost of refurbishment for the new apartment block. Refurbishment costs increased due to electrical issues and the need to construct a proper fire escape. Cairo SA was forced to go overdrawn, causing a six-month delay. Then, Tarek struggled to fill the rooms. The college year had ended at Cairo University and the supply of student accommodation was greater than demand. Seven of his rooms in the new block stood empty and so were not earning any revenue. Cash flow was very weak and after three months, the business collapsed. In order to generate some cash, Tarek tried to sell one of the three-bedroomed apartments. However, at the auction, it failed to reach the reserve price.

There is some evidence to suggest that Tarek was overtrading. He was expanding fast using large amounts of borrowed money. The money was used to buy properties, which are illiquid assets – it takes time to convert such assets into cash – whenever necessary. It might be argued that the business was undercapitalised and relied too heavily on loans.

It might also be argued that the business was operating on slim profit margins. Cairo SA had an annual sum of EGP270 000 after interest. However, much of this would be needed to cover business overheads and the cost of refurbishment. This would not leave much left for profit, as shown by the business being forced to go overdrawn.

Tarek might argue that he was unlucky. Interest rates rose, he had some unexpected costs and he couldn't fill the rooms at a critical time. However, Tarek's sister said that he had been foolish to try and grow the business so quickly. She could be right. If Tarek had taken more time, he may have avoided going into so much debt when interest rates rose and he might have realised that his profit margins were too slim.

EXAM PRACTICE

CASE STUDY: ELS ELECTRONICS

1 Explain one difference between internal and external diseconomies of scale. (4 marks)

When a business becomes too big and expands output further than the minimum efficient scale of plant, average costs will start to rise. The increases in costs are caused by internal and external diseconomies of scale. Internal diseconomies of scale are the rising costs caused by excessive growth in the business. Most internal diseconomies are caused by the problem of managing very large business organisations. For example, a business that has got too big might be experiencing communication problems. In this case, there is evidence of communication problems as the information in Figure 3 shows. For example, a 79 per cent of the workforce in Chicago say that they do not have enough time to communicate with their work colleagues.

External diseconomies occur when an industry grows too big (rather than the firm itself). Rapid growth in an industry can result in the price of production factors rising sharply. This is because growing demand for them drives up the price. This means that all businesses in the industry experience rising costs. In this case, suppliers are charging more for components and wages of some key workers are being driven up in Seoul.

2 Discuss the internal communication problems being experienced at ELS Electronics. (8 marks)

If a business grows too big, there could be a problem with internal communication. The number of layers in the management structure is likely to grow and, as a result, channels of communication get longer and the scope for error in sharing messages increases. Distortions to information may occur as it is passed through the managerial hierarchy. At worst, this could lead to misunderstandings and arguments between workers and managers. Such arguments use up resources and any costs resulting from a misunderstanding or argument will reduce productivity.

In this case, a number of internal communication problems can be identified. One of the human resources managers believed that important information was being hidden at head office. She said that there needed to be more information sharing. For example, it was important to learn from efficient plants that had discovered good working practices. This suggests that examples of 'good practice' are not being communicated to the whole company. This is quite a serious problem because the whole organisation could improve performance if such information was made available to all plants and departments.

There also seems to be communications problems at the Chicago division. A staff survey was carried out which highlighted a number of communication problems. For example, according to Table 1, 77 per cent of the workforce said that staff consultation was inadequate. This is a high percentage. If a business fails to consult staff, they will not feel trusted or motivated. The business may also fail to use the ideas and knowledge of the whole workforce. Also, more than half the staff in the survey said that formal communication channels were unclear. If workers are unsure about the communication channels available, communication is bound to be limited.

Clearly, ELS Electronics has some internal communication problems which may be affecting the performance of the business. Ineffective communications may raise business costs.

3 Assess the disadvantages for ELS Electronics in experiencing diseconomies of scale. (12 marks)

There is some evidence to suggest that ELS Electronics is suffering from diseconomies of scale. For example, one internal diseconomy is the increase in bureaucracy in the organisation. One drawback of increasing bureaucracy is that resources are wasted in administration. Too much time may be spent filling in forms or writing reports. Also, decision making may be too slow and communication channels too long. If resources are wasted in administration, average costs will start to rise. In this case, there have been complaints that the company has become too bureaucratic. Some middle managers from Turkey explained that too much of their time was being spent writing reports, carrying out risk assessments and documenting boring operational procedures. However, the directors explained that the bureaucracy was necessary. It helped to maintain control and ensure that key performance indicators were being monitored. However, the managers said that staff turnover in important

managerial positions was increasing quickly. Also, the increase in bureaucracy was raising recruitment and retention costs exponentially.

There is also evidence that ELS Electronics is experiencing communication problems. This can happen if a business has grown too big. For example, according to Table 1, a huge 79 per cent of the workforce said that they were not given enough time to discuss work matters with their colleagues. This drawback means that important communication might not be happening. For example, a worker may need to explain to a colleague that product specifications have changed. But there might not be enough time to communicate the changes effectively. This might result in poor-quality products.

Another drawback is that worker motivation in the organisation, particularly in Chicago, is also declining. Evidence in Table 1 supports this view. For example, more than 50 per cent of workers in the survey are unhappy with the key human resource issues raised in the questionnaire. Workers will feel demotivated if company goals are unclear or if they feel that they cannot approach their line manager.

There is also evidence that ELS Electronics is suffering from external diseconomies. This is another drawback. In Seoul, due to an increase in demand for the products being manufactured, more components were needed from local suppliers. Unfortunately, most local suppliers were operating at full capacity due to rising demand from a wide range of customers in the electronics industry. When ELS increased demand by 20 per cent, suppliers raised prices by 18 per cent. There was also an increase in labour costs for some skilled electrical engineers. Shortages of certain types of labour in the electronics industry were driving up wages.

In conclusion, there is strong evidence to suggest that ELS Electronics is suffering from diseconomies of scale. This has resulted in a number of drawbacks for the business. From a financial perspective, revenues rose from US\$93.1 billion to US\$99.3 billion in 2018. However, profits before tax fell from US\$14.31 billion to US\$11.48 billion. This shows that costs have risen in the face of growth. Also, some senior managers think that profits will fall further in 2019 if they cannot exert more control on costs.

In recent years, the company has grown quite quickly by making a number of strategic acquisitions around the world. However, some of the cost benefits have not happened. There have been some significant drawbacks resulting from diseconomies of scale – both internal and external.

9 QUANTITATIVE SALES FORECASTING

ACTIVITY 1

CASE STUDY: MORENO SERVICE CENTRE

1 Calculate the three- and four-period moving averages for as many years as you can to complete the table.

Three-period moving average (rounded): Year 4 = 172; Year 5 = 182; Year 6 = 187; Year 7 = 187; Year 8 = 197; Year 9 = 217.

Four-period moving average (rounded): Years 2–5 = 161; Years 3–6 = 176; Years 4–7 = 184; Years 5–8 = 185; Years 6–9 = 195; Years 7–10 = 210.

2 Plot the sales figures and both trend lines onto a graph on graph paper and explain the relationship between the trend and the actual sales revenue figures for the Moreno Service Centre.

No answer required. This is a task for students to undertake.

ACTIVITY 2

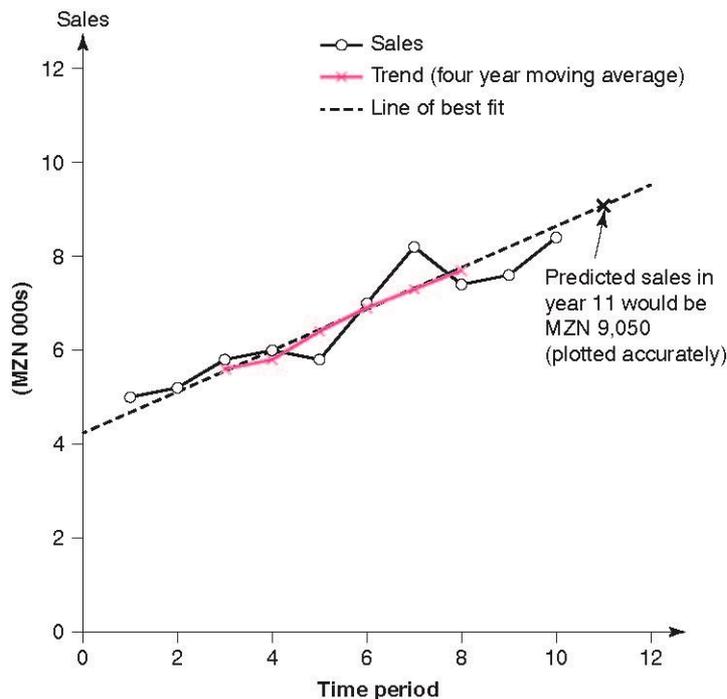
CASE STUDY: KAMBALA FARM

1 Calculate a four-yearly moving average from the figures to show the trend taking place.

Unit MNZ

Year	Output	4 yearly moving total	8 year moving total	4 yearly moving average
1	5000			
2	5200			
3	5800	22 000	44 800	5600
4	6000	22 800	47 400	5925
5	5800	24 600	51 600	6450
6	7000	27 000	55 400	6925
7	8200	28 400	58 600	7325
8	7400	30 200	61 800	7725
9	7600	31 600		
10	8400			

2 Plot the trend onto a graph on graph paper and predict the likely output in year 11.



Predicted output in year 11 would be 9050 units (plotted accurately on graph paper).

3 Calculate:

- (a) the cyclical variation for each year
 (b) the average cyclical variation over the period.

(a) The cyclical variation is: $\frac{+250}{6} = 41.7$

6

(b) The predicted output figure in year 11 from the four-yearly moving average is 9050 units. However, this figure is unlikely to be totally accurate because it is based on a trend, and the trend is a smoother version of the actual figures.

A more accurate prediction would be to add or subtract the average cyclical variation from the predicted output in year 11. This will 'add back on' or 'take away' the amount removed or added when the trend was smoothed out. So for year 11, output is $9050 + 41.7 = 9091.7$ units.

EXAM PRACTICE

CASE STUDY: PROSPER-i®

1 Define the term 'sales forecast'. (4 marks)

A sales forecast is a prediction of future sales revenue. This is often based on previous sales data.

2 Explain the extent to which sales of i-do could be described as being influenced by seasonal factors. (4 marks)

The evidence suggests that sales of i-do are influenced by seasonal factors. Sales vary at different times of the year and follow a similar pattern in 2018 as 2017. Sales increase during Q4, suggesting a strong seasonal demand linked to the holiday season. The i-do is clearly a desirable gift. Sales in Q4 are four times those in other quarters, so are clearly influenced by seasonal factors linked to the holiday season.

3 Assess the extent to which quantitative sales forecasting is useful to Prosper-i. (12 marks)

Quantitative sales forecasting is very useful to Prosper-i, given the nature of the product. Firstly, the products produced and sold by Prosper-i are subject to seasonal variation in demand. Quantitative sales forecasting allows the business to examine the extent of changes in demand throughout the year. Where sales tend to peak in Q4, this is mainly due to increased demand during the holiday season. Quantitative sales forecasting techniques will help to inform the extent of this rise in demand.

It is essential that the business accurately judges demand at different times of the year, so that sufficient numbers can be produced to avoid shortages and this impact this would have on customer relations. In 2016, there were shortages of Google® Pixel and Pixel XL smartphones due to order numbers exceeding forecasts.

Source: <http://www.eweek.com/mobile/demand-for-google-pixel-smartphones-soars-shortages-result>

However, there are limits to the usefulness of this technique for this business. The nature of the technology market usually means that past records of sales can only be of limited use in predicting future sales. The market for technology-based products is fast moving. A product that might be fashionable in one period might not be in the next as new arrivals come onto the market. The case study refers to the fact that some retailers were reluctant to hold the levels of stock that Prosper-i had anticipated.

While sales forecasting is never an exact science, it does give businesses important information about market trends. The extent to which they are important to Prosper-i depends on how the forecasts will be used. The nature of its market, being based around technology, means that there will always be an element of unpredictability in sales forecasting, but this is true of all other markets. Providing the business is using information other than quantitative sales forecasts – for example, by using more qualitative information – it can gain very important information from such statistical data sets.

10 INVESTMENT APPRAISAL

ACTIVITY 1

CASE STUDY: DELLE ROSE ASSOCIATES

1 Explain what is meant by 'expected net cash flow'.

The expected net cash flow is the amount of money the business expects to receive each year over the life of an investment project, less the estimated running costs. For example, in this case, Delle Rose Associates expects to get €6000 every year for six years if System A is purchased – that is, €6000 after the running costs have been deducted.

2 Calculate the payback period for each system and state which system Delle Rose Associates should select.

The payback period for each system is:

System A 4 years

System B 4 years and 6 months

System C 3 years

System C has the shortest payback period, so Delle Rose should select System C.

3 Explain one possible reason why Delle Rose used the payback method of investment appraisal in this case.

The payback method is a very simple method of investment appraisal. This is one of its advantages. However, one important reason why Delle Rose may have used the payback method in this case is because computer systems can become out of date very quickly. Computer technology moves fast and Delle Rose would be keen to get its money back as soon as possible, because it might have to upgrade its computers again in the near future.

ACTIVITY 2

CASE STUDY: EC GROUP

1(a) Calculate the average rate of return for each project.

Investment project	Profit (JPN}	Profit pa (JPN}	ARR
R&D	8 000 000	1 333 333	13.88%
Marketing campaign	7 000 000	1 166 666	12.96%
New CNC machinery	4 200 000	700 000	8.97%

(b) Explain which project should be selected.

According to the ARR in the above table, the R&D project should be selected. However, it is only marginally better than the marketing campaign.

2 Explain the advantages to EC Group of using this method of appraisal.

The main advantage of the ARR method of investment appraisal to EC Group is that it shows clearly the profitability of an investment project. For example, it is clear in this case that the R&D project generates the highest return. Also, as well as allowing a range of projects to be compared, the overall rate of return can be compared to other uses for investment funds. For example, if EC Group were to place funds in a bank deposit account, the rate of return in 2017 might be about 1 per cent. The returns generated by all three investment projects are greater than this. However, if interest rates increased significantly, EC Group might decide to reconsider their position.

ACTIVITY 3

CASE STUDY: MIAH LTD

1 Calculate the discounted cash flow for each machine and each year using a discount rate of 15 per cent from the discount table, Table 9.

	0	1	2	3	4	5	6
	-600	100	150	200	300	200	100
Machine A (BDT 000s)	-600	87	114	132	171	100	43
		100×0.87	150×0.76	200×0.66	300×0.57	200×0.50	100×0.43
	-600	200	300	200	150	100	100
Machine B (BDT 000s)	-600	174	228	132	85.5	50	43
		200×0.87	300×0.76	200×0.66	150×0.57	100×0.50	100×0.43

2 Calculate the net present value for each machine.

Machine A

$NPV = (\text{BDT}87 \text{ million} + \text{BDT}114 \text{ million} + \text{BDT}132 \text{ million} + \text{BDT}171 \text{ million} + \text{BDT}100 \text{ million} + \text{BDT}43 \text{ million}) - (\text{BDT}600 \text{ million}) = \text{BDT}47 \text{ million}$

Machine B

$NPV = (\text{BDT}174 \text{ million} + \text{BDT}228 \text{ million} + \text{BDT}132 \text{ million} + \text{BDT}85.5 \text{ million} + \text{BDT}50 \text{ million} + \text{BDT}43 \text{ million}) - (\text{BDT}600 \text{ million}) = \text{BDT}112 \text{ million}$

3 Why might Miah Ltd buy Machine B if it uses the net present value method of decision making?

Machine B would be chosen because it has a higher net present value. Both machines have an initial cost of BDT600 million but, after taking this away, the net cash flow from Machine B is higher.

EXAM PRACTICE

CASE STUDY: FLORIPORI LTD

1 Calculate the average rate of return of each investment project. (4 marks)

	Greenhouses (KES million)	TQM (KES million)
Capital cost	50	44
Total income	14.2	11.4
Profit	9.2	7
Profit pa	1.84	1.4
ARR	36.80%	31.80%

2 Calculate the net present value of each investment project. (4 marks)

	Greenhouses	KES (million)	TQM	KES (million)
Yr 1	$23 \times 0.95 =$	21.85	$21 \times 0.95 =$	19.95
Yr 2	$26 \times 0.9 =$	23.4	$21 \times 0.9 =$	18.9
Yr 3	$28 \times 0.86 =$	24.08	$23 \times 0.86 =$	19.78
Yr 4	$33 \times 0.82 =$	27.06	$24 \times 0.82 =$	19.68
Yr 5	$32 \times 0.78 =$	24.96	$25 \times 0.78 =$	19.5
PV		121.35		97.81
Less capital cost		50.00		44.00
NPV		71.35		53.81

3 Explain one advantage of the net present value method of investment appraisal to FLORIPORI Ltd. (4 marks)

The average rate of return method of investment appraisal does not take into account the impact that interest rates have on investment decisions. The existence of interest rates means that any money received in the future will have a lower value today. It is important to calculate this lower value, which is called the present value, when appraising investment projects. This is because the money generated from an investment project is always received in the future. Therefore, the main advantage of the net present value method of appraisal is that interest rates are taken into account. This improves the accuracy of the investment decision.

4 Assess which investment project FLORIpори should select. (12 marks)

According to the calculations in (1) and (2), the financial returns on the investment in the greenhouses appears to be superior. The ARR for the greenhouse project is 36.8 per cent. This is higher than the ARR for the TQM project, which is 31.8 per cent. Similarly, the NPV for the greenhouse project is KES71.35 million. This is higher than the NPV of the TQM project, which is only KES53.81 million. For financial reasons alone, FLORIpори Ltd should construct the new 'state-of-the-art' greenhouses.

However, when businesses evaluate investment projects, they should look at both quantitative factors and qualitative factors.

The quantitative factors relate to costs and predicted net cash flows. In this case, for quantitative reasons, the greenhouse project is likely to be selected. This is because it generates the highest returns according to the ARR and the NPV.

However, the directors of FLORIpори Ltd may also consider qualitative factors – these are non-financial considerations. In this case, there is a significant qualitative factor to consider. Both investment projects will have an impact on the workforce. If the greenhouse programme is selected, some staff are likely to lose their jobs. This could have an impact on the morale of the remaining workers. They may feel that in the future their jobs could be threatened as well. They may also resent their colleagues being made redundant. Involuntary redundancies are likely to lead to conflict and disruption – for example, there may be strikes.

The introduction of TQM will also affect staff. According to an employee representative, 'The introduction of TQM will create pressure and stress for many of the folk here... Some of them just aren't up to it'. This may mean that staff would resist the introduction of TQM. However, faced with the choice between redundancies and retraining in TQM it is likely that the workers would prefer TQM. This means that the directors of FLORIpори have a difficult choice to make. Do they go for the greenhouse project and risk industrial conflict, or do they invest in TQM and try to maintain good relations with workers?

They would probably choose the greenhouse project. This generates a much better ARR and NPV. So, although the key qualitative factor in this instance is significant, it is not likely to change the minds of the directors. The company is currently making a loss and therefore must improve financial performance. This means that quantitative factors are more important to them.

11 DECISION TREES

ACTIVITY 1

CASE STUDY: SWIFTHAIR

1 Complete Table 1.

Probability of failure:

Monday = $0.5 (1 - 0.5)$

Tuesday = $0.5 (1 - 0.5)$

Wednesday = $0.3 (1 - 0.7)$

Thursday = $0.4 (1 - 0.6)$

Friday = $0.4 (1 - 0.6)$

Expected monetary values:

Monday $EV = 0.5 \times SEK1300 + 0.5 \times -SEK200 = SEK650 - SEK100 = SEK550$

Tuesday $EV = 0.5 \times SEK1700 + 0.5 \times -SEK400 = SEK850 - SEK200 = SEK650$

Wednesday $EV = 0.7 \times SEK400 + 0.3 \times -SEK1,200 = SEK280 - SEK360 = -SEK80$

Thursday $EV = 0.6 \times SEK1000 + 0.4 \times -SEK800 = SEK600 - SEK320 = SEK280$

Friday $EV = 0.6 \times SEK1100 + 0.4 \times -SEK400 = SEK660 - SEK160 = SEK500$

2 On financial grounds, on which day should the special offer be arranged?

On financial grounds the special offer should be arranged for Tuesday. This is the day that has the highest expected value (SEK650).

ACTIVITY 2

CASE STUDY: ISAAC CHAILA, MUTANDA IN ZAMBIA

1 What is happening at points B and C in the decision tree?

In the diagram, points B and C represent chance nodes. These chance nodes show that there are different possible outcomes when a particular course of action is chosen. For example, at node B there are three possible outcomes. These are a good crop of potatoes, an average crop, or a poor crop. At point C there is only a chance of a good crop or a poor crop.

2 Calculate the expected values of each course of action and decide, on financial grounds, which course Isaac should take.

The expected values of each course of action are:

Potatoes

$$\begin{aligned} \text{Expected value} &= (0.3 \times \text{ZK}50\,000) + (0.3 \times \text{ZK}30\,000) + (0.4 \times \text{ZK}10\,000) \\ &= \text{ZK}15\,000 + \text{ZK}9\,000 + \text{ZK}4\,000 \\ &= \text{ZK}28\,000 \end{aligned}$$

Carrots

$$\begin{aligned} \text{Expected value} &= (0.5 \times \text{ZK}40\,000) + (0.5 \times \text{ZK}10\,000) \\ &= \text{ZK}20\,000 + \text{ZK}5\,000 \\ &= \text{ZK}25\,000 \end{aligned}$$

When using decision trees to make decisions, a business should choose the course of action with the highest expected value. In this case, Isaac should plant potatoes because the expected value is ZK28 000, ZK3000 higher than for carrots.

ACTIVITY 3**CASE STUDY: TRUMED INC**

1 Calculate the expected values of each research programme and advise Trumed which is the best option.

The expected values of the different research programmes are:

VAC 1

$$\text{EV} = 0.3 \times \text{US}\$20\text{m} + 0.7 \times \text{US}\$2\text{m} - \text{US}\$2\text{m} = \text{US}\$6\text{m} + \text{US}\$1.4\text{m} - \text{US}\$2\text{m} = \text{US}\$5.4\text{m}$$

VAC 2

$$\text{EV} = 0.4 \times \text{US}\$17\text{m} + 0.6 \times \text{US}\$4\text{m} - \text{US}\$2.6\text{m} = \text{US}\$6.8\text{m} + \text{US}\$2.4\text{m} - \text{US}\$2.6\text{m} = \text{US}\$6.6\text{m}$$

VAC 3

$$\text{EV} = 0.5 \times \text{US}\$9\text{m} + 0.5 \times \text{US}\$6\text{m} - \text{US}\$1.4\text{m} = \text{US}\$4.5\text{m} + \text{US}\$3\text{m} - \text{US}\$1.4\text{m} = \text{US}\$6.1\text{m}$$

The research programme with the highest expected value is VAC 2. On financial grounds, Trumed should adopt this one.

EXAM PRACTICE

CASE STUDY: OPAL MEDIA

1 Calculate the expected values for withdrawing and replacing *Squash Monthly*. (4 marks)

Withdraw and thoroughly develop:

$$EV = 0.5 \times \text{€}3.5\text{m} + 0.3 \times \text{€}1.8\text{m} + 0.2 \times \text{€}0.9\text{m} - \text{€}0.4\text{m}$$

$$EV = \text{€}1.75\text{m} + \text{€}0.54\text{m} + \text{€}0.18\text{m} - \text{€}0.4\text{m}$$

$$\mathbf{EV = \text{€}2.07\text{m}}$$

Withdraw and rapidly develop:

$$EV = 0.6 \times \text{€}2.8\text{m} + 0.2 \times \text{€}1.2\text{m} + 0.2 \times \text{€}0.5\text{m} - \text{€}0.1\text{m}$$

$$EV = \text{€}1.68\text{m} + \text{€}0.24\text{m} + \text{€}0.1\text{m} - \text{€}0.1\text{m}$$

$$\mathbf{EV = \text{€}1.92\text{m}}$$

2 Calculate the expected values of retaining *Squash Monthly* and (a) investing in above-the-line promotion and (b) developing some extension strategies. (4 marks)

(a) Retain and advertise:

$$EV = 0.4 \times \text{€}3.9\text{m} + 0.6 \times \text{€}0.7\text{m} - \text{€}0.5\text{m}$$

$$EV = \text{€}1.56\text{m} + \text{€}0.42\text{m} - \text{€}0.5\text{m}$$

$$\mathbf{EV = \text{€}1.48\text{m}}$$

(b) Extension strategy (relaunch):

$$EV = 0.5 \times \text{€}3.0\text{m} + 0.5 \times \text{€}0.6\text{m} - \text{€}0.3\text{m}$$

$$EV = \text{€}1.5\text{m} + \text{€}0.3\text{m} - \text{€}0.3\text{m}$$

$$\mathbf{EV = \text{€}1.5\text{m}}$$

Extension strategy (new markets):

$$EV = 0.3 \times \text{€}8.0\text{m} + 0.7 \times \text{€}0.8\text{m} - \text{€}0.6\text{m}$$

$$EV = \text{€}2.4\text{m} + \text{€}0.56\text{m} - \text{€}0.6\text{m}$$

$$\mathbf{EV = \text{€}2.36\text{m}}$$

3 Explain, on financial grounds only, one option Opal Media should select. (4 marks)

When using decision trees to choose the most profitable course of action, it is necessary to select the option with the highest expected value. In this case, the option which Opal Media should select is to launch *Squash Monthly* in Canada and the USA. This option has the highest expected value at €2.36m.

Just before the final decision was made by Opal, it was brought to the attention of the marketing department that future exchange rate forecasts would have an impact on the revenues earned in Canada and the USA. It was estimated that the euro would rise against the dollar over the next few years and the revenues earned could fall to €6.5m and €0.6m (depending on the success of the launch).

4 Explain one reason why this might affect the decision? (4 marks)

With the adjusted revenues for the second extension strategy, the expected value of entering the Canadian and US markets is now:

$$EV = 0.3 \times \text{€}6.5\text{m} + 0.7 \times \text{€}0.6\text{m} - \text{€}0.6\text{m}$$

$$EV = \text{€}1.95\text{m} + \text{€}0.42\text{m} - \text{€}0.6\text{m}$$

$$\mathbf{EV = \text{€}1.77\text{m}}$$

The change in revenue means that this option is now not the best. The best option now is to withdraw *Squash Monthly* and launch *World Cup '22*, following thorough development.

5 Assess the limitations to Opal Media of using decision trees to make a decision about the future of *Squash Monthly*. (12 marks)

Using decision trees to make important decisions will benefit Opal Media. Constructing a tree diagram will help the marketing department to see the different courses of action very clearly. Decision trees place numerical values on decisions and outcomes. This tends to improve results. Most people agree that the use of quantitative decision-making techniques improves the quality of decision making. One significant advantage to Opal Media of using decision trees is that it forces decision makers to take into account risk. This is important because many decisions in business have an element of risk. Certainly in this case every course of action is subject to risk because the outcomes are not certain.

However, despite these advantages, the use of decision trees has a number of limitations. Decisions are not always concerned with quantities and probabilities. They often involve people and are influenced by legal constraints or people's opinions, for example. These factors cannot be represented quantitatively very easily, if at all.

Decision trees ignore qualitative data, such as the effect of Canadian and US legislation if trying to launch the magazine in those countries. Another limitation is time lags. By the time numerical data is gathered and processed, it may be out of date. Making decisions based on out-of-date information could result in Opal Media choosing the wrong course of action. Some might argue that the whole process is too time-consuming and expensive on business resources. However, if computerised decision-making models can be used to analyse decision trees, this would save time.

One serious limitation with decision trees is that decision makers might manipulate the data to encourage a particular course of action. For example, a manager might be biased when estimating probabilities for certain outcomes. In this case, for example, the success of the overseas launch of *Squash Monthly* might have been given an exaggerated probability value by a manager for personal reasons. This will obviously change the final result and influence the decision. A problem also exists with the general accuracy of the numerical data. Because the financial values and the probabilities have to be estimated, the data is naturally imperfect and could lead to inaccurate decision making. A final limitation is that decision trees fail to

take into account the dynamic nature of business. In this case for example, the exchange rate forecasts in the case could be subject to external forces and turn out very differently. This would affect the final decision.

In conclusion, Opal Media would have to consider these disadvantages before relying on decision trees when making their final decision. If the numerical data can be gathered and processed quickly, if it is accurate and impartial and if qualitative factors are not too important, then Opal Media may consider that the benefits of decision trees outweigh the disadvantages.

12 CRITICAL PATH ANALYSIS

ACTIVITY 1

CASE STUDY: INDAIR

1 What is the minimum amount of time it takes for the turnaround of the aeroplane?

$12 + 20 + 15 \text{ minutes} = 47 \text{ minutes}$

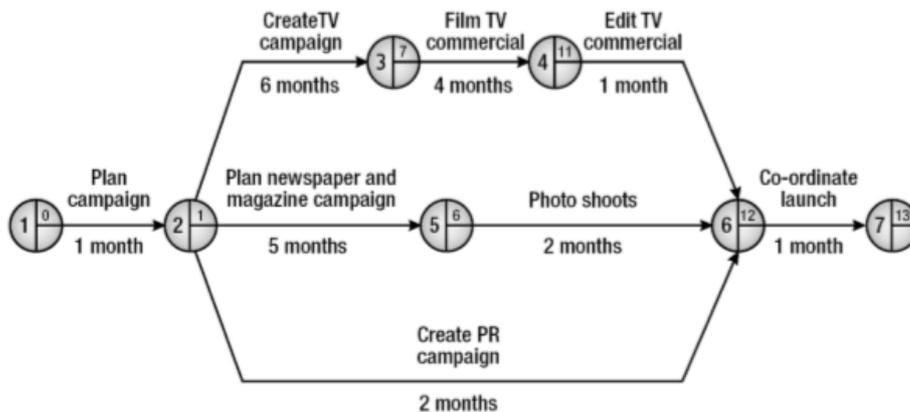
2 Would the time change be affected if the company cut the time it takes to clean a plane from 20 minutes to 14 minutes?

Yes – the minimum time would now be: $12 + 16 + 15 \text{ minutes} = 43 \text{ minutes}$

ACTIVITY 2

CASE STUDY: FLEUR ROUGE

1 Copy out the network in Figure 6 and fill in the earliest start times marked by .?'

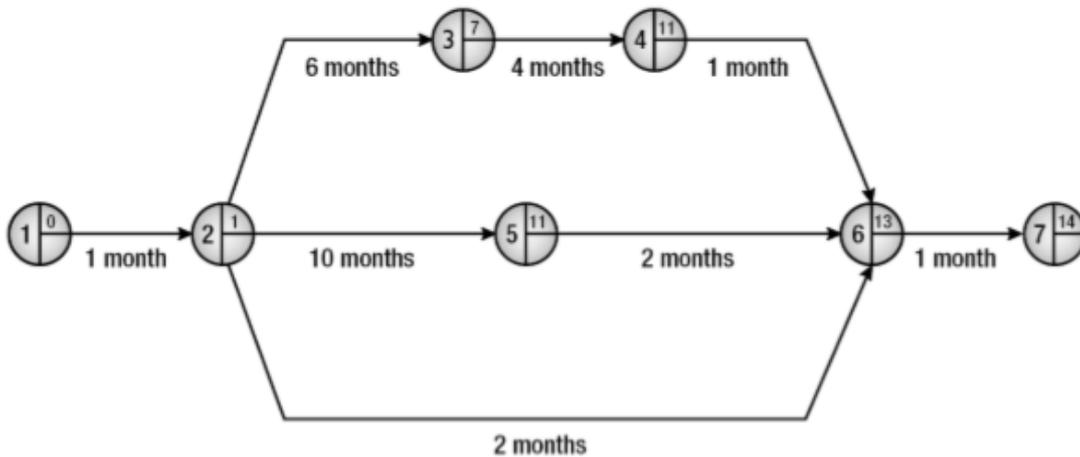


2 What is the minimum amount of time the campaign will take to complete?

13 months

3 In the one month taken to plan the campaign at the start, the advertising agency revises its estimate of the time taken to plan the newspaper and magazine campaign to 10 months. How will this affect (a) the earliest starting times and (b) the overall time taken to complete the campaign?

(a)

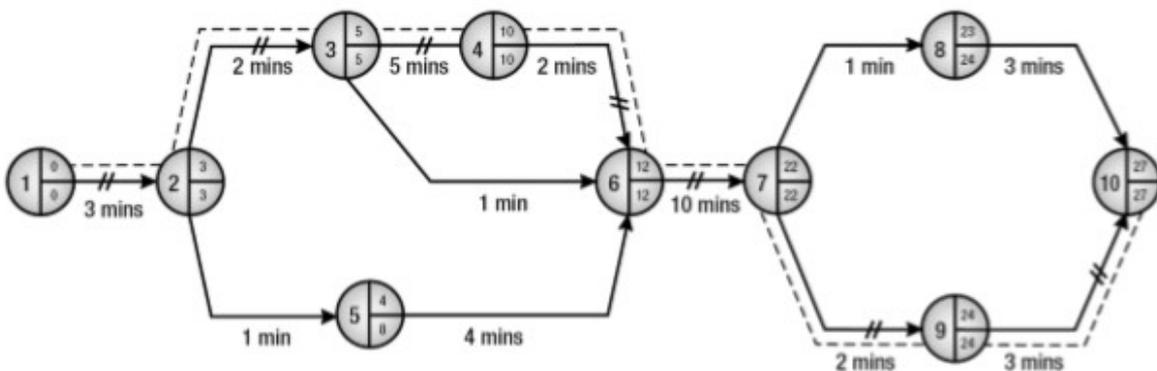


(b) The overall time taken will increase to 14 months.

ACTIVITY 3

CASE STUDY: HURFORD'S

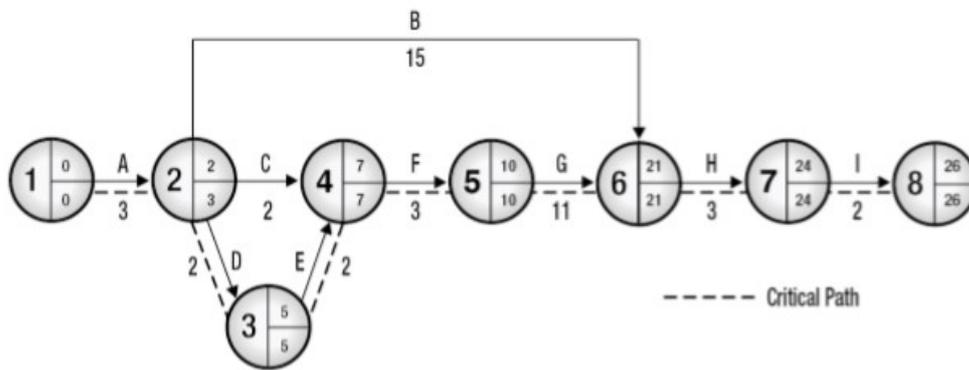
- 1 Copy out Figure 9 and fill in the earliest start times for each job on your diagram.
- 2 Fill in the latest finishing times on the diagram.
- 3 Show the critical path on the diagram.



EXAM PRACTICE

CASE STUDY: MANGUXI HOLDINGS

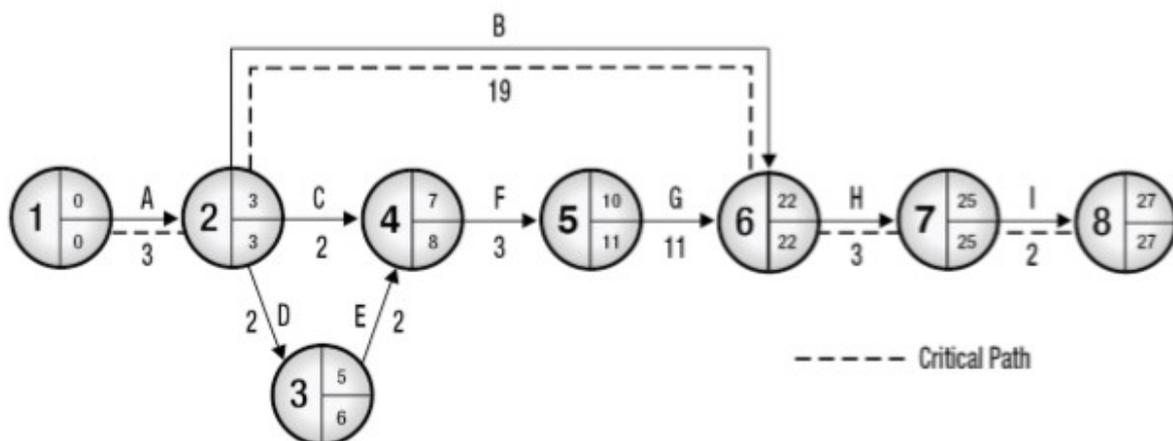
- 1 Calculate the earliest start times (ESTs) for the activities required to install the new technology. (4 marks)
- 2 Calculate the latest finish times (LFTs) for the activities required to install the new technology. (4 marks)



3 Explain what is meant by the critical path and state the minimum amount of time in which this project can be completed. (4 marks)

The critical path consists of the tasks involved in a project, which, if delayed, could delay it. According to the diagram above the construction time will be completed in 26 days. All nine tasks will be completed before the stocks gathered by the business run out. Manguxi Holdings can store a maximum of 30 days' stocks. Therefore, the company has four days spare, assuming the project is completed on time.

4 Explain one reason why the construction time will be affected if Task B is delayed by four days? (4 marks)



If task B is delayed by four days it will take 19 days instead of 15 days. This will change the EST at node 6 to 22, at node 7 to 25 and at node 8 to 27. So, the minimum completion time has increased to 27 days. However, this is not a problem because the construction can still be completed within the 30 days. However, the critical path has changed. Task B is now critical and cannot be delayed. Tasks C, D, E, F and G are no longer critical. The critical path is now A, B, H and I. This is shown on the figure above.

5 Assess the advantages and disadvantages to Manguxi Holdings of using critical path analysis (CPA). (12 marks)

One of the advantages of using CPA is that it provides a visual image of a complex project. The network diagram shows the order of each task and provides a range of useful

quantitative information. When decision makers see a picture of a problem it may be easier for them to solve.

CPA might be used by Manguxi Holdings to reduce the time lost between tasks, ensuring that projects run smoothly. CPA will encourage the company to plan ahead. This is because CPA requires staff to identify all the tasks required in a particular operation and how long each task will take. The construction of the network diagram forces decision makers to consider all aspects of a project. CPA should help Manguxi Holdings to improve efficiency.

For example, during the construction of the new assembly line the level of working capital can be minimised by ordering and receiving resources 'just-in-time'. By identifying critical and non-critical tasks, resources such as labour and machinery can be used more effectively.

Finally, Manguxi Holdings may improve its cash flow using CPA. This is achieved by not ordering supplies too early and only making purchases when they are required.

However, there are some disadvantages of CPA. The construction of the network diagram alone will not guarantee the smooth running of a complex project. The co-operation and commitment of the entire workforce is needed to ensure that each task in the construction is completed on time according to schedule. It is important to consult staff and not just assume that they can complete tasks in certain times.

CPA is only a useful tool if the information used to construct the network diagrams is accurate. For example, if the task durations are wrong, the minimum completion time that is calculated will also be wrong. The critical path will also be inaccurate and misleading.

In conclusion, provided Manguxi Holdings is aware of the drawbacks of CPA and takes measures to avoid the pitfalls, it should be a useful tool for the business.

13 CONTRIBUTION

ACTIVITY 1

CASE STUDY: HAMZA JOBE

1 Explain what is meant by contribution.

Contribution is the amount of money left over after variable costs have been covered following a sale. The contribution on a single unit of output is calculated by subtracting variable costs from the selling price. The money left over contributes to a firm's fixed costs and profit.

2 Calculate the unit contribution of a 1 kg bag of peanuts.

$$\begin{aligned} \text{Contribution} &= \text{selling price} - \text{variable cost} \\ &= \text{GMD}15 - \text{GMD}10 \\ &= \text{GMD}5 \end{aligned}$$

3 Calculate the total contribution for sales in October.

$$\begin{aligned} \text{Total contribution} &= \text{unit contribution} \times \text{number of units sold} \\ &= \text{GMD}5 \times 210 \\ &= \text{GMD}1050 \end{aligned}$$

ACTIVITY 2

CASE STUDY: FREDRIKKE HOLMGAARD

1 Explain what is meant by 'contribution pricing'.

Contribution pricing involves setting a price for orders or individual products which exceeds the variable cost. This means that a particular order or product will always make a contribution when sold. This approach ignores fixed costs because a single order or product may not generate enough contribution to cover fixed costs. In this case, Fredrikke charges clients a price which more than covers her variable costs such as food. For example, Dinner Party 1 in Table 4 makes a contribution of DKK850. This does not cover the weekly fixed cost of DKK1000.

2 Calculate the week's profit made by Fredrikke's business using the information in Table 4.

$$\begin{aligned} \text{Weekly profit} &= \text{total contribution} - \text{fixed costs} \\ &= \text{DKK}4350 - \text{DKK}1000 \\ &= \text{DKK } 3350 \end{aligned}$$

Dinner party	Price (DKK)	Variable cost (DKK)	Contribution (DKK)
1	2400	1550	850
2	1400	700	700
3	3200	1800	1400
4	2000	600	1400
	9000	4650	4350

3 Why should contribution pricing be used carefully?

Contribution pricing needs to be used carefully. Obviously, to make a profit it is necessary for total contribution to exceed fixed costs. It is possible/likely that the contribution for a single order would not cover fixed costs for a period of time. For example, in this case, the contribution from Dinner Party 1 of DKK850 did not cover the weekly fixed costs of DKK1000. However, over the week, the total contribution easily exceeds fixed costs. Contribution pricing is most likely to be used when fixed costs are relatively low compared to variable costs or when a business knows through experience that fixed costs will be covered. In this case, it might be argued that fixed costs are relatively low and that Fredrikke has sufficient experience/confidence to use contribution pricing.

EXAM PRACTICE

CASE STUDY: CHENGDU PLASTIC CONTAINERS

1 Explain one difference between unit contribution and total contribution. (4 marks)

Unit contribution is the contribution a business receives from selling one unit of output. It is calculated by subtracting variable costs from the selling price. For example, in this case, for the Wong & Co. order, unit contribution is CNY140 (CNY800 – CNY660).

When more than one unit is sold it is possible to calculate the total contribution. This is the unit contribution multiplied by the number of units produced. For the Wong & Co. order the total contribution will be CNY2.8 million (CNY140 × 20 000). If this order was accepted by Chengdu Plastic Containers, the CNY2.8 million would contribute to the fixed costs and profit for the order.

2 Calculate the total contribution made by each of the four orders. (4 marks)

Wong & Co. (CNY800 – CNY660) × 20 000 = **CNY2.8 million**

BNY Stores (CNY850 – CNY760) × 30 000 = **CNY2.7 million**

VC Singh (CNY700 – CNY570) × 25 000 = **CNY3.25 million**

Chow Ltd (CNY1050 – CNY810) × 20 000 = **CNY4.8 million**

3 Explain which two orders should be accepted by Chengdu Plastic Containers. (4 marks)

The orders which make the largest total contribution will be selected when using contribution costing to help make business decisions. In this case, Chengdu Plastic Containers only has the capacity to accept two orders. Therefore, the business will accept the two that make the highest contributions. These will be the orders from VC Singh and Chow Ltd.

4 Calculate the profit made from the two orders accepted by Deng Xuri. (4 marks)

The profit made by accepting these two orders outlined above is given by:

Total contribution – fixed costs

VC Singh = CNY3.25 million – CNY500 000 = **CNY2.75 million**

Chow Ltd = CNY4.8 million – CNY500 000 = **CNY4.3 million**

Therefore the total profit made from accepting these two orders is **CNY7.05 million**

5 Discuss the qualitative factors that might be taken into account by Chengdu Plastic Containers when using contribution to help make business decisions. (8 marks)

The use of contribution to help make business decisions is a quantitative approach to decision making. However, in practice, qualitative issues may be important and therefore would have to be taken into account. For example, when using contribution to select which orders to accept, it is possible that a business might choose to accept an order even though the total contribution fails to cover fixed costs entirely. A business may accept an order with a relatively low contribution from a new customer. It may do this in the hope that in the future it will receive more high-profit orders from this new customer.

Also, if a business is quiet it may accept orders with low contributions in order to reduce the burden of fixed costs. Even though an order may not be profitable overall, if it makes a contribution to fixed costs, losses will be lower. Finally, orders with low contributions may be accepted in order to keep resources occupied in a business. For example, a business may accept unprofitable orders to keep employees busy. It may not be a good idea to make workers redundant because they may be needed in the future when trading conditions improve. A business may also want to resist making staff redundant because it has invested in their training.

In this case, the approach to selecting orders used by Chengdu Plastic Containers will always ensure that the most high-profit orders are accepted. This will help to boost the financial performance of the company. However, there is a possible long-term drawback from using this approach. The customers that have their orders rejected may not return to Chengdu Plastic Containers again for another quote. This may be fine while Chengdu Plastic Containers is busy and demand for their products is high. But, in the future, if demand falls, they may regret rejecting the orders.

14 CORPORATE CULTURE

ACTIVITY 1

CASE STUDY: TOP 10 BEST COMPANIES TO WORK FOR IN CANADA

1 Discuss the cultural factors that may have led to these companies being voted into the Top 10 'Best Big Companies' to work for. You could pick two companies and carry out your own research.

Employees have voted for these companies as some of the best to work for, so it is clear that they must have very strong, identifiable cultures where the workers identify with one another and feel part of the organisation. A strong organisational culture motivates the workforce because the norms, values and beliefs of the organisation are shared by the whole workforce. Within these organisations you could expect to see clear signs of a strong culture, such as set rituals, norms and specific business language that may also feature in each company's mission and values.

Furthermore, you could expect these values, missions and objectives to be explicit across the organisation. Considering Hofstede's cultural dimensions, it is also likely that these organisations manifest a high level of collectivism versus individualism. A high level of collectivism encourages a sense of belonging and identity within the workforce, which can lead to high levels of motivation. Overall, any company that has a highly motivated workforce is likely to take into account their needs and communicate with its employees well.

ACTIVITY 2

CASE STUDY: TAKEOVER OF ISTA INTERNATIONAL

1 Assess the factors that CK Asset Holdings and Ista International may have to consider to ensure their cultural differences impact in a successful way following the takeover.

CK Asset Holdings and Ista International will have to consider a number of factors regarding their cultural differences. One of these is the influence played by the CEOs of each corporation. CK Asset Holdings' CEO, billionaire Li Ka-shing, is a very experienced and high-profile business magnate. He is the richest person in Hong Kong and is also a famous philanthropist. This suggests that he is quite an influential and respected individual, both in Asia and worldwide. Although there is no information in the case about the CEO of Ista, it is unlikely that he/she will have the same reputation as Li Ka-shing, who is likely to have far more influence on cultural development than Ista's CEO. Furthermore, the impact that a leader has on the culture of a business can vary greatly, so there is potential for leadership styles and approaches of the two CEOs to clash.

Considering Hofstede's cultural dimensions, European and western Asian countries also adopt different cultural approaches to business practices. For example, power distance is much greater in China than in Germany, and Chinese organisations typically adopt a more long-term approach to decision making. The graph in Figure 1 shows a clear difference in cultural 'time horizons' between China and Germany. Chinese companies tend to have a much more long-term outlook when making decisions than both Germany and the world average. These two factors could cause problems for how the two companies set objectives after the takeover. Finally, according to Figure 1 German employees have a much more individual approach to their work than Chinese employees. This might cause some 'friction' when staff from each of the two organisations integrate.

Overall, the German sub-metering business is likely to be a relatively small proportion of the whole organisation's portfolio, so the cultural differences may not have a significant bearing on the overall business. Furthermore, both businesses are multinational companies and will have significant experience dealing with international developments. For this reason, both businesses are likely to have experience in managing cultural differences. Also, since Ista has been taken over, its influence over future developments will be weak compared to that of CK Asset Holdings.

EXAM PRACTICE

CASE STUDY: MOSAIC®

1 Explain one reason why Mosaic's corporate culture could be referred to as a 'strong culture'. (4 marks)

Mosaic can be considered to have a strong culture because it has a number of clearly established norms and routines. All employees are given half a day per week to work on innovative ideas, and every month employees and the executive team meet to discuss these new ideas. Norms like these build up a way of working in the organisation that encourages creativity. These practices are shared across the whole company and this creates a sense of belonging and shared vision within the company.

2 Assess the benefits for Mosaic of fostering a creative culture. (12 marks)

By fostering a creative culture, Mosaic can create a highly motivated workforce. Employees are given the opportunity to spend half a day each week working on innovative ideas, so they can focus their efforts on ideas that satisfy them. Through creative tasks workers can achieve self-actualisation, which encourages loyalty and helps employees to feel that they are contributing to the business. A creative culture is also likely to give the company a distinctive capability that could lead to competitive advantage. Fostering a culture of creativity could lead to innovations in products and processes: for example, it could result in the company producing software and smartphones that are better than the competition. As a result, the company will be more competitive in the market, leading to increased market share.

Although there are benefits to fostering a creative culture, there are drawbacks too. The initiatives that go into developing creativity are likely to be expensive. Investment in healthy-living programmes and social activities such as the 'Mosaicians' could be reassessed quickly if revenue should start to fall. There is also no guarantee that devoting half a day per week on creative tasks is going to result in new products and ideas that will generate more revenue for the company.

Overall, fostering a creative culture is very important for a company such as Mosaic, which operates in a fast-paced technology industry. However, creativity must be linked to real outcomes, such as productivity and products that will secure the long-term success of the company.

3 Evaluate whether or not a strong corporate culture is important to the long-term success of Mosaic. (20 marks)

A strong corporate culture is very important for the long-term success of Mosaic, for a number of reasons. A strong culture can lead to highly motivated employees and a sense of

being together among the workforce. If employees feel that they are part of one group with a common identity, this is likely to reduce labour turnover and dissatisfaction. The company philosophy of 'Live to give' is particularly important in ensuring that all employees follow the vision and values of the organisation. Equally, there are many other factors that will contribute to labour turnover, such as pay and remuneration. Mosaic will only have a highly motivated workforce if these factors are sufficient as well as the other initiatives, such as a free, healthy breakfast. Also, a strong culture – particularly one focused on creativity – can lead to a distinctive capability. This can then become a competitive advantage if it leads to new products and innovations that keep Mosaic ahead of its competition. This is particularly important for a technology-based company where innovation occurs at a fast speed.

Nevertheless, a creative culture is no guarantee that Mosaic will develop products that are competitive and commercially successful, and a strong corporate culture can be difficult to change should adjustment become necessary. For example, if the business needs to improve efficiency in times of economic uncertainty, the current culture of creativity and freedom might be difficult to change, or at least it might be a slow process. Furthermore, while a strong corporate culture is very important, it will play little part in the long-term success of a company if it does not support the company's strategy. For a business to succeed it must have good products, be competitive in the market and offer good value to customers at the right price level. Many other non-human factors go into achieving this.

Overall, Mosaic's strong corporate culture is very important as it brings employees together to achieve the aims of the company. In terms of contribution to business success, corporate culture can be difficult to measure compared to other factors, such as profit, share price or customer satisfaction. However, without a strong culture, a vision and direction are hard to achieve, especially in a large organisation. The key to corporate culture is making sure it is used to lever the best out of a workforce and make sure employees become a key business asset. For Mosaic to achieve this, it is important that it can measure the contribution that initiatives like the 'Mosaicians' and on-site gyms make to the overall performance of the company.

15 STAKEHOLDER MODEL VERSUS SHAREHOLDER MODEL

ACTIVITY 1

CASE STUDY: NIKE®

1 What is the difference between 'internal' and 'external' stakeholders? Use examples from this case.

Various groups of people have an interest in the activities of the business. These groups are called stakeholders. The interest each stakeholder has will vary according to the nature of their stake. Some groups of people inside the business have a direct interest in its survival and well-being. Examples of internal stakeholders in this case would be the employees – Nike employs over 1 million people worldwide. Other stakeholders are external stakeholders. These are groups outside a business that may have an interest in its activities. Examples in this case include the customers, suppliers such as Flex and the shareholders of Nike.

2 Explain how two groups of stakeholders in this case might be affected by Nike's plans to increase automation.

One type of stakeholder – shareholders – should enjoy a boost from Nike's plans to increase automation in its operations. Automation usually improves productivity and financial performance. In this case, greater automation in production will help Nike to lower its costs and drive up profit margins. It has been estimated that the involvement of Flex using automated processes to produce Nike's 2017 Air Max shoes, one of its top-selling lines, will lower labour costs by 50 per cent and material costs by 20 per cent. This could help to increase gross profit margins by 12.5 per cent. If Flex were to make 30 per cent of Nike's North American footwear, the company could save \$400 million. This would add 5 per cent to earnings per share.

Customers will also benefit from greater automation. It will speed up the delivery of brand-new designs to Nike's fashion-conscious customers. Greater automation in shoe production will speed up lead times from several months to three to four weeks for a customised pair of sneakers. Also, if Nike can reduce costs dramatically, there may be scope for lower prices, although there is no information in the case to suggest that this will happen.

Unfortunately, Nike's worldwide workforce of over 1 million are afraid of automation. Automation notoriously reduces the need for human resources. According to the UN's International Labour Organisation, in the next decade or two, about 56 per cent of jobs in Cambodia, Indonesia, the Philippines, Thailand and Vietnam could be lost to automation. Clothing and footwear manufacturing jobs are particularly at risk. More than 75 per cent of footwear line workers for Nike work in Vietnam, Indonesia and China. Clearly, Nike's employees will be worried about their job security. However, Nike has suggested that employees should not be worried. Jobs lost to automation will be made up in other parts of the supply chain, assuming that sales grow.

ACTIVITY 2

CASE STUDY: TAKEOVER OF MONSANTO® BY BAYER®

1 What are likely to be the main objectives for customers as stakeholders in the market for seeds?

Customers are external stakeholders. They want good-quality products at a fair price. They also want clear and accurate information about products and high-quality customer service. They may also want choice, innovative products and flexibility. Finally, for some products, such as machinery, electrical goods and children's products, safety is an important issue. If these needs are not met, customers will spend their money somewhere else. In this case, the interests of customers may be affected negatively by the Monsanto takeover by Bayer. For example, it was feared that the takeover would raise seed prices for farmers and limit their seed choices.

2 Discuss the conflict between stakeholders that exists in this case.

Conflict between shareholders and customers is most likely to arise if a business charges prices that are too high or if customer service levels are poor. Higher prices will help to boost shareholder returns but reduce the purchasing power of customers. In this case, following the takeover of Monsanto by Bayer, agricultural groups in the USA expressed their concerns. They said it could have a devastating impact on farmers, consumers and economy. For example, they said that the merger would decrease competition in the seed and agrochemical markets because the merger would mean that three companies would have more than 80 per cent of US corn seed sales market and 70 per cent of the global pesticide market. They feared that the takeover would raise seed prices for farmers and limit their seed choices. For example, while the price of corn seed has nearly quadrupled in the last 20 years, the price farmers get for their output is roughly the same as it was at in 1996. However, these costs may be due, in part, to the greater use of genetically modified seeds (which have increased from 25 per cent of all US corn seed planted in 2000 to 92 per cent of all corn seed in 2016). The agricultural groups also said that the lack of competition in the market would reduce the incentive to innovate.

In contrast, shareholders should benefit from the takeover. For example, Monsanto shareholders will benefit from the takeover. They will get \$128 per share – a 44 per cent premium over the company's closing price before rumours of a takeover surfaced. It was expected that the merger would generate cost savings for the combined company. Money will be saved if employment in some areas is scaled back. However, the companies would not discuss possible job cuts which are inevitable after big mergers. About 80 per cent of the \$1.5 billion in synergies the companies predict after three years will be cost cuts in administration, sales and marketing.

The future benefits enjoyed by shareholders could well be at the expense of customers if Bayer uses its market power to raise prices and restrict choice. The threat of this is likely to attract the attention of the US competition authorities before the takeover is given the go-ahead.

EXAM PRACTICE

CASE STUDY: MASDAR BEVERAGES

1 Assess the possible benefits to a business like Masdar Beverages of adopting a stakeholder approach to decision making. (12 marks)

If a business adopts a stakeholder approach to decision making, it means that it will consider the objectives of a wider range of stakeholders in addition to shareholders. Although this might reduce the short-term returns to shareholders, there are likely to be some long-term benefits for all stakeholders. For example, if a business considers employee objectives by

paying fair wages and providing high-quality employee welfare, worker motivation may improve. This will help to reduce staff turnover, raise productivity and increase profit levels. It will also help to attract and retain high-quality staff in the future. This will have positive long-term benefits for the business.

If a business is customer-orientated, it will be in a better position to meet customer needs. By charging fair prices, offering high-quality customer service and investing in product development, it will attract more customers, generate more sales and increase revenue. This will also improve the long-term performance of the business.

If a business puts something back into the community, such as creating local employment and listening to the concerns and wishes of local residents, it will improve its image. If it has regard for the environment, it may be able to reduce costs. For example, by cutting waste and recycling more materials the cost of inputs may fall which will help to increase profit.

In this case, there is evidence to suggest that Masdar Beverages has taken into account the objectives of other stakeholders. Masdar claims that it engages with a wide range of stakeholders. The frequent communication with stakeholders provides important information which is used in Masdar's decision-making process, and helps the company to continuously improve and make progress toward their 2025 sustainability goals. For example, it uses hotlines, local websites, plant tours, research, surveys, social channels and focus groups to engage with consumers.

2 Evaluate whether Masdar Beverages has adopted the (a) stakeholder approach or (b) shareholder approach; to business. (20 marks)

A business that adopts a stakeholder approach will take into account the needs of all stakeholders – not just the shareholders. In this case, there is some evidence to suggest that the objectives of a wide range of stakeholders are being met. Masdar claims that it engages with stakeholders to gather information which is used to help make decisions.

Starting with employees, Masdar Beverages uses a number of methods to engage with this important stakeholder group. It uses staff surveys, senior executive business updates, regular meetings, employee communications, individual development plans, health and safety communications programmes, community and employee well-being projects. Masdar also has an ethics hotline which can be used by staff if they have any concerns at work. If a company has a wide range of communication channels for employees, it is likely that the needs of employees will be clear.

Customers appear to be well served by Masdar. The fact that the company has survived and grown rapidly in the highly competitive soft drinks market is evidence of its ability to consistently meet customer expectations. The soft drinks industry is market led and Masdar Beverages has managed to keep in touch with its customers and consistently meet their needs. Masdar engages with customers using hotlines, local websites, plant tours, research, surveys, social channels and focus groups.

Masdar Beverages claims that it is also committed to local communities. To get feedback from local communities it holds community meetings, encourages plant visits, develops partnerships on common issues, uses sponsorships and organises visits to local schools and colleges. One example of Masdar's commitment to the community is their 'Business Skills' programme, aimed at young entrepreneurs. It aims to help young people overcome the problems they face when setting up and running a business. Masdar offers access to training, financial services and connections with peers and mentors. At the moment, their focus is in the Middle East and a number of African states.

Some of the information here does suggest that Masdar Beverages adopts a stakeholder approach to business. However, the owners of the business – the shareholders – also appear to be doing well. According to the graph in Figure 1, returns to shareholders have increased consistently. The returns to shareholders (as measured by the stock price plus reinvested dividends) has risen by nearly 60 per cent between 2013 and 2018. However, it is very unlikely that employee wages have risen by this amount during the same time period.

There is also some criticism aimed at Masdar about its use of plastic and the environmental damage that the company contributes to. According to one environmental group, Masdar sells 4 billion single-use plastic bottles every year. In 2018, the company announced a goal to help to collect and recycle a bottle or can for everyone it sells by 2040 as part of its 'Save our Seas' programme.

In conclusion, it is difficult to say for sure whether Masdar has adopted a stakeholder model or a shareholder model, in its approach to business. There is certainly evidence in this case which suggests that Masdar engages with a range of stakeholders. Masdar Beverages will also recognise that there are gains to be made from acting responsibly and meeting the needs of a wider range of stakeholders. However, Masdar dominates the soft drinks industry in many of its markets and spends billions on protecting its market position. The growth in financial rewards to shareholders probably exceeds those of other stakeholders and it is unfortunate that the company appears to have avoided the important issue of plastic waste. With its influential market power, Masdar could have led the way in reducing the use of plastic across several regions.

16 BUSINESS ETHICS

ACTIVITY 1

CASE STUDY: ANIMAL TESTING

1 What is meant by an 'ethical issue' in business?

Many businesses may wish to consider whether strategic decisions are morally 'right or wrong'. Such decisions address ethical issues which are not covered by the law. This means, for example, that a certain practice is allowed by law but may be seen as morally wrong by many people. All businesses have to make ethical decisions. For example, should an employer allow a worker to take a paid day off work to look after a sick child? Should a company stop buying goods from a factory where it knows that work conditions are poor and wages are very low? In this case, the important ethical issue in question is the use of animals by businesses to test their products. In many countries this is legal, but many people say that it is morally wrong. This is an ethical issue – not a legal issue.

2 Discuss whether animal testing is justifiable in business.

In the pharmaceuticals, cosmetics, household goods and food industries, businesses might argue that animal testing is justifiable if animals do not suffer in experiments. They may argue that it is justified if the gains from animal testing could not be achieved in any other way. In contrast, people who oppose all animal testing argue that it causes pain and suffering to animals. They may also argue that the benefits of animal experiments to humans are not clearly proven and that any benefits that humans do enjoy can be achieved using other methods.

In countries where animal testing is permitted, some might argue that certain types of experimentation are not justifiable. For example, cosmetics are not necessities, so the argument against animal experimentation might be very strong. However, it might be less strong when used to test the safety and effectiveness of drugs and medicines. If tests on animals were outlawed, scientists say that either there would be an end to testing new drugs, or that humans would be used for tests instead. Animal experiments are not used to show that drugs are safe and effective in human beings because that is not possible. Rather, they help to decide whether a particular drug should be tested on people. Animal experiments are used to confirm whether drugs are ineffective or dangerous to humans. Only if a drug passes the animal test is it then tested on humans.

ACTIVITY 2

CASE STUDY: SPOTIFY'S CODE OF CONDUCT AND ETHICS

1 Explain what is meant by an 'ethical code of practice'.

In order to help explain to employees what is expected of them regarding their conduct at work, many businesses draw prepare an ethical code of practice/conduct. The code explains how employees in the business should respond in situations where they experience ethical issues. Ethical codes will differ from one business and one industry to another. In this case, Spotify's code addresses issues such as compliance with the law; Full, fair, accurate, timely and understandable disclosure; conflicts of interest; confidentiality; insider trading; competition and fair dealing; anti-corruption and bribery; gifts and entertainment; discrimination and harassment; health and safety; user and IT security; protection and proper use of Spotify assets and record keeping.

2 Assess the possible advantages to Spotify of having an ethical code of practice.

One of the main advantages to Spotify of having an ethical code of practice is that their employees will have clear guidelines on how to behave at work. For example, Spotify's code explains very clearly that staff must not give anything of value, directly or indirectly, to any government official, political candidate, or business person in order to get business deals or privileges. Such guidelines will help staff to maintain very high standards of conduct and ethical behaviour. The code may also help employees to avoid workplace conflicts with other stakeholders.

The code will also help Spotify to behave ethically. As a result, the image of the company may be improved and help to build trust amongst all stakeholders. Companies with a good image may escape negative media publicity and win the support of stakeholders, making the company stronger.

Companies with a strong ethical stance may be able to recruit and retain high-quality staff. Generally, people will prefer to work for a business that has a good ethical record. If Spotify can recruit and retain the best staff available, their financial performance is likely to be improved.

Businesses with a poor ethical record will attract the attention of the media. However, worse than that, they may face legal action. For example, they may be pursued by the competition authorities for using anti-competitive practices. Spotify's code of ethical of conduct and practice should help the company avoid expensive legal costs.

Finally, many customers prefer to buy goods and services from suppliers that have a good ethical record. People do not normally want to be associated with suppliers who are untrustworthy and those who exploit weak or at-risk people. Therefore, by adopting a strong ethical stance, Spotify may attract more customers and improve the performance of the business. This should help to drive sales, increase revenue and raise the profit of the business.

ACTIVITY 3

CASE STUDY: MINIMUM WAGES IN AUSTRALIA

An Australian chain store employs 2100 people on the minimum wage across the country.

1 Calculate the annual increase in total wages paid to this group of employees.

The increase in the wages paid to the chain store's lowest paid is given by:

$$2100 \text{ workers} \times 52 \text{ weeks} \times \text{AUS\$}22.20 = \text{AUS\$}2\,424\,240 \text{ per annum}$$

2 How might an increase in the national minimum wage benefit the government?

In some countries, low-paid workers are entitled to financial benefits from the government if they are not paid enough. This helps to improve the living standard of low-paid workers. However, if businesses are forced to pay their workers more money by a national minimum wage, this will also help to raise the living standards of the low paid. Therefore, the amount of money needed from government benefits will be reduced. This will lower the financial pressure on the government and 'release' funds for other uses such as improving the quality of education and healthcare.

3 Discuss whether the increase in the minimum wage in Australia will result in job losses

In theory, an increase in the wage rate should result in a fall in the demand for labour. This will cause unemployment to rise. In this case, business representatives in Australia said that the increase in the national minimum wage by \$22.20 per week was excessive and could result in job losses. Also, the Australian Chamber of Commerce and Industry said that the job prospects of the 744 000 unemployed were 'at risk from minimum wage increases beyond what is affordable for small and award-reliant businesses'. The Chamber of Commerce said that wage rises across the rest of the economy have been lower than the increase in the minimum wage. This means the commission has increased pressure on the small and medium businesses who rely on awards. Therefore, it will make it harder to compete.

However, the Fair Work Commission (FWC) said that the increase was justified since inflation was lower, labour productivity was higher and business profits had grown. These favourable economic conditions had provided the opportunity to reward the 2.3 million Australians who relied on national minimum wages. The FWC also said that international research had not provided very much evidence, if any, that modest and regular wage increases result in unemployment. Finally, if the Australian economy is doing well and businesses are enjoying positive trading conditions, workers will be needed. Therefore, an increase in unemployment is unlikely – particularly as productivity and profitability has increased.

EXAM PRACTICE

CASE STUDY: SUPERMARKET PACKAGING

1 Explain one purpose of a corporate social responsibility (CSR) report. (4 marks)

Many businesses produce corporate social responsibility reports. CSR reports help to show a firm's responsibility not just to their shareholders, but to all stakeholders. It does this by auditing its performance in a wide range of activities. For example, audits are likely to address issues such as the company's responsibility to employees, customers, the community, the environment and suppliers. A CSR report will show members of the public what measures a business has taken to improve relations with stakeholders and the strength of its ethical stance. Auditing often involves inspecting evidence against established standards. Auditors can then say that the evidence presented by the business is 'true and fair'.

In this case, two supermarkets have used their CSR report to show their commitment to the reduction of waste and the elimination of plastic bags. For example, German supermarket Lidl, claimed in 2017 that it wanted to cut plastic waste by setting targets. It had removed microbeads from all its cosmetic and household products and was committed to switching to biodegradable cotton buds. For the last 24 years it has charged for plastic carrier bags, and last year it stopped selling single-use bags.

2 Analyse the possible impact on the environment of the increasing use of plastic made by businesses. (6 marks)

The use of plastic packaging in business has become an ethical issue. This is because the production and use of plastic in modern society has reached problematic proportions. The impact of rising plastic use, particularly plastic shopping bags and plastic drinks bottles, is already being felt. At least 8 million tons of plastic enter the oceans each year and there is more micro plastic in the ocean than there are stars in the Milky Way. Over 4322 million tons

of plastic were produced in 2015 and between 60–90 per cent of marine litter is plastic-based. In the next 10 years the amount of plastic in the world's oceans could increase tenfold.

The damage done by plastic entering marine habitats is extremely bad. For example, in 2017, a 6-ton, 33-foot-long sperm whale was found dead in southern Spain. It had eaten 64 lb of plastic rubbish. The marine species at most risk from plastic pollution are sea turtles, seals and sea lions, seabirds, whales and dolphins and fish. Plastic pollution kills millions of marine birds each year. For example, around 98 per cent of albatrosses studied were found to have eaten some kind of plastic waste. Ingested plastic causes an obstruction in the digestive tract and can tear internal organs resulting in pain and death.

Recent studies have also shown that much of the fish we eat from the sea contains worrying amounts of plastic. We do not know yet what the long-term effects of consuming plastic will be – although it's not likely to be positive! If this rate of pollution is not checked, some marine life may die out and ecosystems will be affected. This could threaten the survival of a very important source of food for the human race.

3 Evaluate whether or not supermarkets are likely to take a stronger ethical stance and reduce the amount of plastic packaging they use in the future. (20 marks)

Historically, the use of plastic for the packaging of goods was taken for granted. Few were really aware of the long-term damage that plastic waste may cause. However, due to the work of pressure groups and parts of the media, people now understand that too much plastic can have a very harmful impact on the environment. Marine species such as sea turtles, seals and sea lions, seabirds, whales and dolphins, and fish are particularly at risk. Plastic pollution kills millions of marine birds each year. For example, around 98 per cent of albatrosses studied were found to have ingested some kind of plastic waste. Ingested plastic causes an obstruction in the digestive tract and can tear internal organs resulting in pain and death. Consequently, some people may now regard the increasing use of plastic for packaging as morally wrong. It can be argued that it has become an ethical issue.

However, at this point in time the use of plastic for packaging is not illegal. It is common and accepted by very large numbers of people. In many cases, the products sold by supermarkets need the protection that plastic affords. For example, if bleach was not sold in plastic bottles, it could be dangerous. If certain food items were not packed in plastic their condition might reach the point where they become potentially harmful. Most people are happy with this and accept it. However, the unnecessary use of plastic packaging is likely to be criticised.

A growing number of supermarkets are aware that the use of plastic packaging is becoming an ethical issue and have taken some modest measures to reduce it. For example, Maruetsu, a Japanese supermarket, said it was working together with customers to reduce the number of plastic bags used. Each customer who presents his or her T card (loyalty card) earns two T points when declining to use plastic bags. Maruetsu also encourages shoppers to bring their own shopping bags in their 'Bring a Shopping Bag Campaign'.

However, many would argue that supermarkets are not doing enough and that they are putting profit before ethics. Greenpeace have suggested a number of measures that would reduce plastic use. These include removing all non-recyclable plastics from own-brand products, the removal of single-use plastic packaging for own-brand products and the use of dispensers and refillable containers for own-brand items like shampoos, house cleaning products and beverages. They should also trial reusable packaging and product refills via

home deliveries and push national-brand suppliers to eliminate non-recyclable plastics and to stop using single-use plastic packaging.

Supermarkets, driven by profit and the need to minimise costs, are not likely take any great measures to reduce the use of plastic packaging. In the future, it may require government legislation and/or a radical change in shoppers' habits, so that they learn to avoid buying goods with large amounts of unnecessary packaging. Only then are they really likely to respond. A possible 'game-changer' might be for one large supermarket to take a really strong ethical stance relating to plastic packaging in an effort to gain a competitive advantage. This might be risky, but if effective would result in a change that many people would support.

17 INTERPRETATION OF FINANCIAL STATEMENTS

ACTIVITY 1

CASE STUDY: MOOSEWEAR LTD

1 What is meant by 'cost of sales'? Use examples from this case to illustrate your answer.

Cost of sales refers to the direct costs, such as raw materials and direct labour. For a retailer it will be the cost of buying in stock to re-sell; for a service provider it will include the direct costs of providing a service, such as labour. In this case, where the business is an online retailer, the cost of sales will mainly be the cost of stock. This would include the fake-fur products that are imported from Alaska and Canada. The value of cost of sales in this case is DKK1 210 000 in 2014.

2 Calculate the percentage increase in (a) revenue and (b) profit for the year (net profit) after tax for Moosewear Ltd from 2016 to 2017.

$$\begin{aligned}
 \text{\% change in revenue} &= \frac{\text{DKK}3\,450\,000 - 2\,980\,000}{2\,980\,000} \times 100 \\
 &= \frac{\text{DKK}470\,000}{2\,980\,000} \times 100 \\
 &= \mathbf{15.8\%}
 \end{aligned}$$

$$\begin{aligned}
 \text{\% change in profit after tax} &= \frac{\text{DKK}500\,000 - 380\,000}{380\,000} \times 100 \\
 &= \frac{\text{DKK}120\,000}{380\,000} \times 100 \\
 &= \mathbf{31.6\%}
 \end{aligned}$$

3 Discuss whether shareholders are likely to be happy with the performance of Moosewear Ltd in 2017.

The statement of comprehensive income can be used by shareholders to help assess the performance of the business. Shareholders are likely to be interested in the profit made by the business – particularly the profit after tax. This is an effective guide to the performance of a business, but by no means the only guide. Rising profits suggest an improving performance. In this case, the profit after tax has grown by 31.6 per cent. This is a significant increase. It is likely that the shareholders would be very pleased with the improvement in profit levels between 2016 and 2017.

It is also possible to assess the growth of the business by looking at the statement of comprehensive income. If the revenue is rising, it suggests that the business is growing. In this case, revenue has grown by 15.8 per cent over the two years. Again, the shareholders

are likely to be pleased with this performance. If this growth rate continued into the future, the business would double in size in five years.

However, the statement of comprehensive income only shows the figures for two years. To make a more informed judgement about performance, shareholders would probably want to look at revenue and profit levels for a longer period of time before reaching a final conclusion.

ACTIVITY 2

CASE STUDY: GROSICKI & CO

1 Complete the balance sheet by calculating the missing values for (a) net assets and (b) current tax liabilities.

Net assets = PLN18 335 000

Current tax liabilities = PLN1 121 000

2 Give two possible examples of trade and other payables for Grosicki & Co.

Trade and payables are current liabilities. They are amounts of money owed by a business to suppliers and other enterprises. Examples for Grosicki & Co might be money owed to suppliers of raw materials, such as flour, sugar, spices, dried fruits, eggs and other cake ingredients. Money owed to utilities, such as gas, water and electricity, might also be examples, as would money owed to the providers of commercial services, such as printers, marketing agencies, cleaners and IT consultants.

3 Explain the difference between current liabilities and non-current liabilities.

Any money owed by the business that is expected to be repaid within 12 months is called a current liability. These are the immediate debts of a business.

Grosicki & Co has two listed current liabilities. The first is trade and other payables, which refers to trade creditors and other amounts owed by the business to suppliers of goods, services and utilities, for example. The second is current tax liabilities, which refers to corporation tax, employees' income tax and any other tax owed by the business that must be repaid within 12 months. Other examples not listed in the Grosicki & Co statement of financial position include borrowings and dividends payable.

Non-current liabilities are the long-term liabilities of a business. Any amount of money owed for more than one year will appear in this section of the statement of financial position.

In the Grosicki & Co statement of financial position there are two examples of non-current liabilities. The first is borrowings, which refers to money owed by the company that does not have to be repaid for at least 12 months. Examples would be long-term bank loans and mortgages. The second is pensions. Companies need to show any money owed to past employees in the form of pension obligations. Another example not included in the Grosicki & Co statement of financial position is provisions. Provisions have to be made if a company is likely to incur expenditure in the future. Such expenditure might arise as a result of agreements in contracts or warranties.

4 What has happened to the value of Grosicki & Co between 2017 and 2018?

The statement of financial position can be used to assess the value of a business. The net assets provide a rough guide to its value. In this case, the value of Grosicki & Co has increased slightly from PLN16 951 000 in 2017 to PLN18 335 000 in 2018. This is an increase of 8.3 per cent.

EXAM PRACTICE

CASE STUDY: MALAGA MARINE PARK

1 Explain one reason why suppliers might want access to the statement of financial position for Malaga Marine Park. (4 marks)

Suppliers will be most interested in the solvency of the business. Suppliers are not likely to offer trade credit to a business that only has a limited amount of working capital. Using the statement of financial position, suppliers will be able to extract information about the size of working capital. In this case, the working capital position for Malaga Marine Park is not good. In 2018, current assets were only slightly larger than current liabilities. The marine park only has a small amount of working capital, so it might struggle to get generous trade credit terms. However, this will also depend on the marine park's recent trading history and its past credit record. Banks and other moneylenders will be interested in the statement of financial position for the same reasons.

2 Explain one reason why managers and directors might want access to the statement of comprehensive income for Malaga Marine Park. (4 marks)

Managers and directors are responsible for running the business, so they are likely to use key information in the statement of comprehensive income to monitor their progress. For example, they might be setting annual targets for growth in revenue or net profit. Changes in the revenue, for example, will show how fast a company has grown and whether targets have been met. In this case, revenue has grown by 46 per cent over the two years. The managers will also be pleased that the business has returned a profit. In 2017, Malaga Marine Park made a loss of €360 000. This suggests that managers and directors are succeeding in improving the business after a difficult few years.

3 Evaluate whether or not there has been an improvement the financial performance (profitability and liquidity) of Malaga Marine Park between 2017 and 2018. (20 marks)

The statement of comprehensive income and the state of financial position can be used by businesses to analyse and evaluate its performance. Both statements contain some key information relating to performance.

The statement of comprehensive income shows that revenue has grown by 46 per cent from €4 180 000 in 2017 to €6 110 000. This is a significant increase and all stakeholders are likely to be pleased with this performance.

The statement of comprehensive income also shows that gross profit has increased significantly from €1 190 000 to €1 900 000.

However, the most impressive improvement is probably the increase in operating profit. This has risen by 341 per cent from €240 000 in 2017 to €1 060 000 in 2018. The reason for this

improvement is the increase in gross profit resulting from growth in visitor numbers and revenue, coupled with an improvement in efficiency. Both selling expenses and administrative expenses have been reduced by the business – particularly the admin expenses, which have been cut by 20.8 per cent from €480 000 to €380 000. One would normally expect such expenses to rise along with the sharp growth in turnover. Finance costs have also been reduced slightly, which suggests that borrowings have come down. Finally, the business made a €450 000 profit in 2018. This compares with a loss of €360 000 in 2017. The statement of comprehensive income shows some significant improvements over the two years for Malaga Marine Park.

The statement of financial position also helps to reinforce this view – to a limited extent. The value of non-current assets has risen slightly, which suggests that the business has invested a small amount of money in the marine park's infrastructure – approximately €500 000. The value of current assets has also risen slightly from €2 120 000 in 2017 to €2 580 000. This increase is due to a rise in the amount of cash the business has – from €200 000 to €600 000. This shows that the business's liquidity position has improved a little.

However, current liabilities are still a little high relative to current assets. In 2017, current liabilities were €2 962 000. In 2018, they were lower at €2 551 000. This does represent an improvement, though. In 2017, the business had negative working capital (–€842 000) because current liabilities were greater than current assets. This is not a good position to be in. Fortunately, in 2018 working capital was positive at €29 000. The business has been able to reduce some of the money owed in the short term as a result of its growth in revenue in 2018. The value of non-current liabilities has also fallen from €5 963 000 in 2017 to €5 434 000 in 2018. So, long-term borrowings have also been reduced a little.

Finally, over the two years, the value of the business, as represented by the net assets, has increased by 34.9 per cent from €5 043 000 to €6 802 000. In conclusion, the performance of Malaga Marine Park has improved over the two years, as shown by the accounts. Revenue is up sharply, the business has converted a loss into a profit, both short-term and long-term debts are down slightly, and the value of the company has risen. The business still faces pressure from animal rights groups and working capital levels are very low. To survive into the future, the business needs to maintain these sales levels and go ahead with its plans to improve the image of the company.

18 RATIO ANALYSIS

ACTIVITY 1

CASE STUDY: Hildra Comms

1 Calculate (a) the current ratio and (b) the acid test ratio for Hildra Comms for 2016 and 2017.

	2017	2016
(a) Current ratio	1.13	1.21
(b) Acid test ratio	1.10	1.18

2 Calculate the profit for the year (net profit) margin for Hildra Comms in 2016 and 2017.

	2017	2016
Profit for the year (net profit) margin	9.77%	9.62%

3 Discuss the liquidity and profitability of Hildra Comms over the two years.

The financial position between 2016 and 2017 for Hildra Comms seems quite stable. The current ratio is below the 1.5–2 'safe' range and gets slightly worse from 1.21–1.13. Although it was a little lower in 2017, the business does not appear to be under any threat. This means that Hildra has enough liquid resources for the day-to-day running of the business and does not look likely to run out of cash any time soon. In both years, the acid test ratios are above 1. These values suggest that Hildra's liquidity position is strong. They are close the value of 1 which is said to be the 'ideal'.

The net profit margin shows a very small improvement over the two-year period from 9.62 per cent to 9.77 per cent. This is a good return for the business and the shareholders would probably be happy with this return. Note, though, that this measure does use the profit before tax. Therefore, taxes would have to be taken from the year's profit to calculate what was available to distribute to shareholders.

ACTIVITY 2

CASE STUDY: AL FAQAR ENERGY

1 Calculate the gearing ratio for Al Faqar Energy in 2017 and 2016.

For 2017:

$$\text{Gearing ratio} = \frac{\text{Non-current liabilities}}{\text{Capital employed}} \times 100\%$$

$$= \frac{\text{AED150 000 000}}{(\text{AED2 054 000 000} + \text{AED1 551 000 000}) - \text{AED268 000 000}} \times 100$$

$$= \frac{\text{AED150 000 000}}{\text{AED3 605 000 000} - \text{AED268 000 000}} \times 100$$

$$= \frac{\text{AED150 000 000}}{\text{AED3 337 000 000}} \times 100$$

$$= \mathbf{4.5\%}$$

For 2016:

$$\text{Gearing ratio} = \frac{\text{AED533 000 000}}{(\text{AED2 602 000 000} + \text{AED1 726 000 000}) - \text{AED153 000 000}} \times 100$$

$$= \frac{\text{AED533 000 000}}{\text{AED4 328 000 000} - \text{AED153 000 000}} \times 100$$

$$= \frac{\text{AED533 000 000}}{\text{AED4 175 000 000}} \times 100$$

$$= \mathbf{12.8\%}$$

2 Assess the extent to which Al Faqar Energy is low geared.

Between 2016 and 2017, the gearing ratio for Al Faqar Energy has fallen significantly, from 12.8 per cent to just 4.5 per cent. In both years, the ratio is low. However, in 2017, we could say that Al Faqar Energy was very low geared, with just 4.5 per cent of its long-term finance borrowed. A business is not considered highly geared until the gearing ratio reaches 50 per cent. Al Faqar Energy is quite a long way off this position. The main reason why the gearing ratio has fallen for Al Faqar Energy is because the value of non-current liabilities fell quite sharply in 2017 from AED533 000 000 to AED150 000 000.

ACTIVITY 3

CASE STUDY: ARDU

1 Calculate the ROCE for Ardu for 2017 and 2016.

2017:

$$\text{ROCE} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100$$

$$= \frac{\text{PHP}106\,000\,000}{(\text{PHP}1\,662\,000\,000 + \text{PHP}486\,000\,000) - \text{PHP}758\,000\,000} \times 100$$

$$= \frac{\text{PHP}106\,000\,000}{\text{PHP}2\,148\,000\,000 - \text{PHP}758\,000\,000} \times 100$$

$$= \frac{\text{PHP}106\,000\,000}{\text{PHP}1\,390\,000\,000} \times 100$$

= 7.6%

2016:

$$\text{ROCE} = \frac{\text{PHP}139\,000\,000}{(\text{PHP}1\,662\,000\,000 + \text{PHP}471\,000\,000) - \text{PHP}742\,000\,000} \times 100$$

$$= \frac{\text{PHP}139\,000\,000}{\text{PHP}2\,133\,000\,000 - \text{PHP}742\,000\,000} \times 100$$

$$= \frac{\text{PHP}139\,000\,000}{\text{PHP}1\,391\,000\,000} \times 100$$

= 10%

2 Discuss the performance of Ardu between 2016 and 2017

Between 2016 and 2017, Ardu saw its revenue grow slightly, from PHP2 282 million to PHP2 313 million. This is an increase of just 1.4 per cent. However, its return on capital employed (ROCE) fell significantly from 10 per cent in 2016 to 7.6 per cent in 2017.

The main reason for this was the fall in operating profit from PHP139 million to PHP106 million – a fall of 23.7 per cent. As a result, we would expect ROCE to fall. As revenue has increased slightly over the two years, there must have been a greater increase in Ardu's costs than expected. Information in the case mentions that Ardu experienced some high advertising costs when breaking into the Australian market. This might help to explain the higher costs.

EXAM PRACTICE

CASE STUDY: HASARANGA COCONUT PRODUCTS (HCP)

1 Calculate the gearing ratios for HCP for the years between 2015 and 2018. (4 marks)

	2015	2016	2017	2018
Gearing ratio	23%	22%	41%	35%

2 Calculate the return on capital employed for HCP for the years between 2015 and 2018. (4 marks)

	2015	2016	2017	2018
Return on capital employed	14%	15%	8.50%	18%

3 Discuss the performance of HCP between 2015 and 2018. (8 marks)

The return on capital employed compares the profit made by the business with the amount of money invested. The advantage of this ratio is that it connects profit to the size of the business. The return on capital employed (ROCE) for HCP has improved over the four-year period, from 14 per cent to 18 per cent. This means that a bigger financial return is being generated from the amount of money invested in the company.

However, there was a sharp dip in ROCE in 2017. This was probably due to the extra cost of launching products in new overseas markets. Setting up an export operation can be expensive. A number of new costs might have to be met such as changes in labelling, new marketing strategies, establishing a distribution network, transport costs and perhaps some changes to production methods to follow health and safety legislation in the EU, for example. These exceptional costs will reduce profits temporarily while the export operation is being developed. The ROCE in 2017 was only 8.5 per cent. However, there was a sharp recovery in 2018 when ROCE reached a new high of 18 per cent for the period shown.

The gearing ratio shows the long-term financial position of the business. It can be used to show the relationship between loans on which interest is paid, and shareholders' equity on which dividends might be paid. In this case, the gearing ratio for HCP has increased over the time period from 23 per cent to 35 per cent. However, it is not as high as it was in 2016 when it reached 41 per cent. Generally, if the gearing ratio is below 50 per cent, a company is said to be low geared. It is not until the gearing ratio reaches 50 per cent that concerns are raised. A gearing ratio of around 23 per cent, in 2015, means that the business is not overburdened with long-term debt. Higher gearing ratios mean that a much larger proportion of business finance is borrowed. With low-g geared companies, more finance is provided by shareholders (the owners). Although the gearing ratio rises to 41 per cent in 2017, HCP is still not highly geared. During 2017 HCP increased its borrowing to pay for its export drive. This was planned and the investment seems to be successful. This is because the ROCE has increased and the gearing fell again to 35 per cent the following year. It is likely that the gearing ratio will continue to fall if the export drive continues to be a success.

4 Assess the usefulness of ratio analysis to a company like Hasaranga Coconut Products. (12 marks)

Ratio analysis can help to assess the performance of a business more precisely. It can be used to analyse the profitability, capital structure and solvency of a business. Ratios can also be used to make comparisons. For example, HCP can compare the ROCE for 2018 with the ROCE for the previous three years using the data in Table 5. This will help to show whether the firm is making progress over time. Ratios can also be compared to those of other businesses. This might help to show how a business is performing in relation to its rivals, for example.

However, stakeholders need to be aware of the limitations of ratio analysis. For example, a great deal of care must be taken when making comparisons using ratios. It is very important to compare 'like with like'. Care must be taken when comparing ratios from the same company over time. Many companies remain in the same industrial sector over time, but some can become more varied and change very quickly. Equally, some companies remain the same size over time, while others grow or shrink quickly. Such factors can affect the way in which ratios can be used as a measure of performance. For example, in this case HCP has grown from supplying a national market to one that now supplies international markets. Because the new shareholders have applied pressure on the company to grow more quickly, the size of the company may now increase more rapidly.

We must be careful when comparing ratios between companies at a point in time. Comparing the ratios of two companies that make broadly the same products is likely to say something about their relative performance. However, comparing the ratios of a supermarket chain with a cement manufacturer is unlikely to be helpful in most cases. For example, the two companies will have different working capital needs and different profit margins.

Even companies operating in the same industry can have 'subtle' differences. In this case, HCP might want to compare its performance with another coconut processing company. However, there may not be a company that has exactly the same business interests.

Ratios are based on financial accounts, such as the statement of financial position and statement of comprehensive income. Therefore, ratio analysis is only useful if the accounts are accurate. One factor that can affect the quality of accounting information is the change in monetary values caused by inflation. Rising prices can misrepresent comparisons made between different time periods. For example, in times of high inflation, asset values and revenue might rise rapidly in monetary terms. However, when the figures are adjusted for inflation, there might be no increase in real terms.

There is also the possibility that the accounts have been 'window dressed'. Accounts must represent a 'true and fair record' of the financial affairs of a business. Legislation and financial reporting standards place limits on the different ways in which a business can present financial information. These limits are designed to stop fraud and misrepresentation. However, businesses can legally adjust their accounts to present different financial pictures. This is known as window dressing.

The statement of financial position is an outline of the business at the end of the financial year, so it might not be representative of the business's circumstances through the whole of the year. For example, if a business experiences its peak trading activity in the summer, and it has its year end at a time when trade is slow, figures for stock and debtors will be unrepresentative.

Finally, ratios only use quantitative information, but some important qualitative factors may affect the performance of a business. These factors may be ignored by ratio analysis. For

example, in the service industry the quality of customer service may be an important performance indicator. Ratio analysis cannot easily explain such information.

In conclusion, financial ratios are a useful tool to analyse the financial performance and position of a business. However, it would not be wise for a company like HCP to rely on ratios alone and fail to appreciate their limitations.

19 HUMAN RESOURCES

ACTIVITY 1

CASE STUDY: JENGRIL LTD

1 Calculate the labour productivity on the kettle line at Jengril Ltd for each year between 2014 and 2018.

	2014	2015	2016	2017	2018
Total output (number of kettles)	23 200	24 800	24 700	25 300	24 900
Average number of employees	11	12	13	14	14
Labour productivity (number of kettles)	2109.1	2066.7	1900	1807.1	1778.6

2 Explain one possible reason for the pattern of labour productivity on the kettle production line between 2014 and 2018.

The answers in (1) show that labour productivity on the kettle production line at Jengril Ltd has become worse over the period. The number of kettles produced by each worker has fallen from 2109.1 in 2014 to 1778.6 in 2018. This would be quite a concern for the business because, in 2014, three fewer staff were employed and more kettles per worker were being produced.

One possible reason for this might be that the quality of the tools, machinery and equipment used by the workers may be getting worse. If tools, machinery and equipment are too worn, they may become unreliable. For example, machinery might break down, which could stop production for a period of time. This might prevent workers from doing their jobs. Another possible reason is that workers have become demotivated. Their wages might not have been keeping pace with inflation, which means that their living standards are falling.

ACTIVITY 2

CASE STUDY: OXCENT.COM

1 Calculate the annual staff turnover at oxcent.com's warehouse between 2014 and 2018.

	2014	2015	2016	2017	2018
Staff turnover	25.8%	27.3%	30.9%	24.6%	18.1%

2 Calculate the annual absenteeism rate at oxcent.com's warehouse between 2014 and 2018 (assume that each employee can work 240 days per year).

	2014	2015	2016	2017	2018
Annual staff absence rate	1.51%	1.52%	1.59%	1.3%	1.02%

3 Assess whether the decision to change working practices in 2016 was a good one for oxcent.com.

Between 2014 and 2016, staff turnover rose at the warehouse from 25.8 per cent to 30.9 per cent. This is an increase of nearly a fifth. Also, these rates are significantly above the national average of 15.6 per cent (in 2015).

However, in 2016 staff turnover started to fall and by 2018 it was down to 18.1 per cent – much closer to the national average. Staff absence also rose in the period between 2014 and 2016 from 1.51 per cent to 1.59 per cent. However, these figures are still below the national average of 1.8 per cent. Again, after 2015 the figures improved. Staff absence fell to 1.02 per cent in 2018. This is much below the national average.

The improvements in both staff turnover and absenteeism rates at oxcent.com's warehouse suggest that the decision to introduce new working practices was a good one. After their introduction, fewer staff left the business and the number of days taken off sick was reduced significantly.

The decision to consult staff on the introduction of those practices may have helped. It is often said that staff are more likely to co-operate with change if they are involved in the way the changes are introduced.

EXAM PRACTICE

CASE STUDY: THE SEAVIEW RESTAURANT, LIMASSOL

1 Calculate the labour turnover rate for the Seaview Restaurant between 2014 and 2017. (4 marks)

	2014	2015	2016	2017
Staff turnover	29.20%	39.30%	44.40%	59.70%

2 Calculate the absenteeism rate for the Seaview Restaurant between 2014 and 2017. Assume that each employee (full-time equivalent) works 300 days a year. (4 marks)

	2014	2015	2016	2017
Absenteeism rate	9%	12%	15%	19%

3 Explain one limitation of using labour turnover rates to help assess performance at the Seaview Restaurant. (4 marks)

The calculations in (1) show that the labour turnover rate at the Seaview Restaurant has worsened steadily over the time period from 29.2 percent to 59.7 per cent. This is a sharp rise and the rates were probably higher than the national average in 2014. However, the method used to calculate labour turnover may be limited. One reason is because of the difference in labour turnover between part-time and full-time workers. Labour turnover amongst part-time workers will be higher than that of full-time workers, even when doing the same job. In this case, the majority of people employed by the Seaview Restaurant are part-time workers. For example, 48 out of 62 employees were part-time in 2017 – this is 77 per cent. Part-time work in the restaurant trade is very common. This means the labour turnover for businesses that use a larger proportion of part-time workers will be distorted.

4 Explain one reason why it might be difficult to calculate labour productivity at the Seaview Restaurant. (4 marks)

The method used to calculate labour productivity may not be very effective when trying to measure the output of some service providers. Their output is often very difficult to measure. In this case, the output of people working in the Seaview Restaurant might be difficult to measure. It may be hard to measure the output of chefs in the kitchen if they are specialised.

For example, a dessert chef may prepare 105 desserts for diners in one shift. However, some of those desserts would have been prepared in advance, perhaps a day or two before – more, if they are frozen. Also, the dessert chef may also help colleagues earlier on in the service preparing starters or main meals. The precise daily output of each chef would be hard to measure. Also, if the restaurant is very quiet, chefs will not be required to prepare as many meals. This means that their productivity will be low. However, their labour productivity would not be an accurate reflection of their effort.

5 Evaluate whether Christina should use: (a) financial or (b) non-financial methods to improve aspects of staff performance at the restaurant. (20 marks)

It is clear from the calculations in (1) and (2) that the Seaview Restaurant has staff problems.

Labour turnover has increased from a very high 29.2 per cent in 2014 to an unacceptable 59.7 per cent in 2017. Absenteeism rates have more than doubled from a very high 9 per cent in 2014 to 19 per cent in 2017. These are serious problems for the restaurant. Businesses with high staff turnovers lead to high recruitment costs. High recruitment costs will have an impact on profit. High absenteeism rates are cause problems for the running of the business and lead to uncertainty and poor-quality service. These staffing problems have been reflected in the quality of the service at the restaurant. The restaurant reviews, most of which fell into the 3-, 2- or 1-star category (virtually no 4 or 5 stars), pointed to the poor service and lack of staff commitment at the restaurant. Another symptom of staff dissatisfaction was that only half of the staff bothered to fill in the staff survey. Clearly staff motivation and staff commitment are both very low.

Christina, the new manager, understands the importance of dealing with staff issues and has identified two different strategies to deal with the problem. One involves using financial methods and the other non-financial methods. Given that there is a limited budget, Christina has to decide which might be best for the business.

The financial approach involves two clear measures. One is designed to deal with the attendance problem. Christina could provide an attendance bonus where staff receive a three-monthly cash bonus if their attendance was 92 per cent or more. The bonus would be doubled for 100 per cent attendance. This could be very attractive to employees – getting paid more just for turning up! This could prove very popular and solve the problem almost overnight. The second measure was to share the 10 per cent service charge with all staff in the restaurant. This would be an additional payment on top of tips. This measure was designed to generate some staff loyalty. It would also be payable to kitchen staff and would reward all staff for their efforts – since good service would help attract repeat customers. This would really help to boost pay and reward staff for good customer service. Diners might stay longer, spend more and then return. This would benefit all stakeholders.

An alternative approach was to use some non-financial methods to improve staff turnover and reduce absenteeism. These included investment in training – particularly induction training, regular meetings for proper staff consultation, staff empowerment by giving more responsibility to staff and giving them opportunities to make decisions and develop their creative skills. The measures also included redesigning the job roles of the executive chef and the maître d' (these two important members of staff would receive special training to understand the importance of team working, staff empowerment and consultation) and providing free group staff meals before the start of each shift to encourage teamwork and help bond staff members.

Christina cannot use both strategies because she only has a €150 000 budget for this task. The financial approach comes in under budget at €134 000 but the non-financial approach is more expensive and exceeds the budget – €187 000. It would probably be best for Christina to opt for the non-financial approach. One main reason is that staff are already paid above the average for the industry. Arguably, money is not really the problem. The problems causing the high rate of staff turnover and high levels of absenteeism are non-financial. For example, Christina has discovered that there was a lack of consultation, a lack of training and a lack of clear leadership. Most of the junior chefs were unhappy because they had no input into the daily menus. They were not given the opportunity to express themselves creatively. The maître d' said that time was never made for proper staff training and it was quite usual for a new waiter/waitress to be told 'just have a go, you'll soon get the hang of it. You don't need to be a rocket scientist to take orders and carry plates of food to a table.' There was also a lack of communication between staff.

The non-financial measures appear to deal with these problems head on. For example, a formal induction programme for new staff will help make the duties of staff clear and provide them with the knowledge and skills needed to do the job properly. Christina might argue that it is important to remove the reasons for poor staff motivation. However, the cost of these non-financial measures exceeds the budget. Christina will have to use money from other budgets to meet the full cost. But it is likely that the price might be worth paying. With an empowered and highly trained workforce, staff motivation and customer service will improve, trade will pick up and the increase in revenue will help pay for extra spending.

20 KEY FACTORS IN CHANGE

ACTIVITY 1

CASE STUDY: CULTURE CLASH AT KLM AND AIR FRANCE

1 Discuss the problems that Air France-KLM have encountered as a result of the change that occurred when the two companies merged.

One of the biggest changes a business can experience is when it merges with another business. Following a merger, bringing two organisations together can be expensive and can take a long time. Initially, the merger between Air France and KLM seemed to go very well. The business increased its annual pre-tax profits by 33 per cent to €455 million and it was estimated that €115 million of this resulted from exploiting the synergies after the merger. Despite an increase in oil prices – cost-cutting, the merger synergies and an 8.9 per cent increase in passenger traffic all helped to push up profits.

However, several years later it was discovered through a leaked document that there were some internal problems. There were reports of a culture clash between the two airlines. The leaked report said that employees were very demotivated – they were unhappy, frustrated and stressed because their concerns were not considered. It was also claimed that Air France managers focused on the needs of the whole company while their Dutch colleagues were more concerned about what would happen to KLM. KLM managers were accused by the French of thinking that they were ‘super cool’ and more professional than the French. In contrast, KLM managers thought that the French were more concerned about their job security at Air France. Also, Dutch managers were worried about the French economy and saw Air France as a potential problem.

A clash between employees like this can have a negative impact on performance. It creates an atmosphere of distrust, resentment and jealousy. There will be a lack of co-operation between the two sets of employees and the performance of the company is likely to regress. This is a problem that the organisation will have to address very quickly. According to the CEO of the merged group, there were cultural differences and different visions for the future, however, there was also a united will to find solutions that would benefit all interested parties.

2 Explain how the problems associated with merging two different cultures may be minimised.

When two companies merge it is important to plan ahead and implement measures to avoid a possible culture clash between the two organisations – especially when the two companies are from different countries. A business might avoid the harmful effects of a culture clash by taking the following measures. It could identify and analyse cultural differences before a merger goes ahead. This might be done by analysing process flow charts to see how work is done, interview customers to find out their perceptions of the two businesses, interview managers to find out about their styles, and get feedback from the workforce to identify norms and beliefs. It should also communicate with employees to explain the purpose and of the merger and its possible effects, but also gather feedback from the workforce to identify their concerns and feelings. It will also help to define and implement a new culture by making its behavioural norms, the structure of the organisation and the organisation’s strategy clearer. Ideally, the new culture should make employees feel that they are starting a new and better job. Finally, change should be celebrated and accepted. A business should emphasise the benefits and the opportunities that staff might enjoy. For example, if workers can learn

new skills as a result of the merger, they will be more competent and employable in the future.

In this case, it is probably a bit late to implement the measures outlined above. The merger took place several years ago. However, some careful discussions, meetings and negotiations will be required to establish a common culture in Air France-KLM. This might be quite difficult!

ACTIVITY 2

CASE STUDY: CUERO D'IVANA

1 Discuss the advantages of being a small business when managing change.

Small organisations are often owned by a single person, like with Ivana Putella. One of the benefits of sole ownership is that decisions can be made quickly and strategies for change can be implemented quickly. For example, the decision to change the name from Putella's to Cuero D'Ivana was implemented quickly. The benefit is that the business can keep up with the changing demands of the market. Larger organisations can find it more difficult to make even simple changes, and so can miss out on opportunities.

Another benefit of change in a small business is that the leader (often the owner) has a direct impact on their employees. In a small business, the owner is likely to be able to talk to their employees on a daily basis and clearly communicate the vision, strategy and nature of any change that is to be implemented. For example, Ivana wanted to target the premium market. This would have been far easier to communicate to a small group of employees, i.e. those nine in Estepona, than across a larger organisation or even an international company.

Overall, change is much easier in small organisations because employees are more likely to understand the whole organisation and appreciate their part in the change process. By contrast, larger organisations are likely to have subcultures and groups that respond differently to any process of change.

2 Explain one benefit of operating a larger business.

One of the main benefits of operating a larger business is that average costs are likely to fall. This is because as a business grows it is often able to exploit economies of scale. For example, in this case, Ivana Putella may get discounts from suppliers when she buys larger quantities of stock for her shops. This could help to boost profits, or she might decide to lower prices to attract more customers.

EXAM PRACTICE

CASE STUDY: New CEO at Volkswagen

1 Explain one reason why transformative leadership may be important to VW. (4 marks)

One of the key factors that can lead to change is the appointment of a new leader. In this case, VW appointed Herbert Diess as CEO in 2018. Herbert Diess was recruited to VW in 2015, just before the emissions scandal came out, at a time when the VW brand was already struggling. He was appointed to address any alleged poor corporate governance, low profit margins and the sales slowdown in emerging markets such as Russia, Brazil and China. Mr

Diess was employed by BMW motorcycles to monitor the company's supply chains. In this role he earned the nickname 'Kostenkiller' as he managed to make €4 billion of cost savings from suppliers.

His role now is to transform the VW organisation. He has identified a number of key changes that he plans to implement. These will have long-term consequences for the business. For example, he plans to restructure the whole organisation. However, he has the support of the VW chairman. He said that he welcomed 'the speed and rigour with which Mr Diess can implement the transformation process' to bring about the long-awaited far-reaching changes needed at VW. Clearly, Herbert Diess has been appointed as a transformative leader.

2 Discuss the factors that are enabling the changes at VW. (8 marks)

One of the factors leading to change at VW is the emissions scandal. The emissions scandal was probably a symptom of another problem – poor leadership and weak management. It is not surprising, then, that in 2018, VW appointed a new CEO. Someone was needed to change the culture of the organisation.

Another possible driver of change is the need to cut costs. In 2017, VW employed 642 000 people across the world. In contrast, Toyota, the Japanese car maker, only employed 364 000. However, in that same year both manufacturers produced roughly the same number of cars. This suggests that VW employs too many people and that some substantial cost savings could be made by reducing the size of the workforce. However, it would be important to take into account the production techniques used at VW. For example, it may be employing more labour-intensive methods to exploit low labour costs in some of its locations.

Developments in technology and changes in consumer tastes are also likely to result in change at VW. In common with most other global car manufacturers, VW is planning to launch a range of electric cars instead of diesel cars. Many drivers are looking to buy electric vehicles in the future because of concerns about global warming and climate change.

Another big change is likely to occur in the near future when driverless cars are available and marketed. VW plans to encourage developments in autonomous driving technology. Many expect consumers to switch from personal vehicles to driverless models operated by ride-sharing services such as Gett, which is part-owned by VW. VW will also develop partnerships to exploit new technology such as that with Toyota's Hino subsidiary, which was announced in 2018.

3 Evaluate whether or not the changes proposed by VW's new CEO are likely to improve the performance of the business. (20 marks)

Soon after his appointment to CEO, Herbert Diess attended a press conference where he revealed some of the changes he had planned for the business. He said that he will 'forcefully and with focus press ahead' with VW's strategic plan. One of his first jobs will be to restructure the organisation. The restructuring will have a universal impact on the business. The 12 VW brands will be reorganised into three new groups: mass market, premium and super-premium. This should help improve performance by speeding up the decision-making process. Slow decision making can have a negative impact on performance. For example, each new division will be able to make decisions without having to consult other divisions. Consultation can take a long time and opportunities might be missed during the process. The new structure might also make job roles clearer and improve accountability.

Mr Diess also plans to make the organisation more manageable by selling off some big assets. Giant companies like VW, which employ over 600 000 employees, become huge bureaucracies rather than commercial organisations. Controlling and monitoring such vast operations, with factories, offices, warehouses and other operational facilities all over the world, becomes a very serious challenge for managers. In 2015, it was claimed that the CEO of VW did not know about the emissions defeat device. In such a large organisation this might be plausible. It is unlikely that any CEO could be in complete control of so many resources all over the world. Therefore, Mr Diess's plan to sell off some large sections of VW will help to make the business more manageable which should improve performance.

The financial performance of the business will also be improved if more cost-cutting takes place. Mr Diess has a reputation for aggressive cost-cutting. Indeed, he was called the 'Kostenkiller' by the German media as he managed to make €4 billion of cost savings from suppliers. Since VW still employs over 600 000 people worldwide, job cuts are also inevitable in order to save money. However, they will help to improve VW's profitability.

Mr Diess's plans will also help the business to meet changing consumer needs. He plans to oversee VW's change from diesel cars to electric cars. Many drivers are looking to buy electric cars in the future due to concerns about the environment. VW will also embrace developments in autonomous driving technology. Many expect consumers to switch from personal vehicles to driverless models operated by ride-sharing services such as Gett, which is part-owned by VW. If a business can meet consumer needs effectively its performance is likely to improve.

The proposed changes look as though they are just what VW need. However, there may be problems with their implementation. Such far-reaching changes will have a significant impact on the group's 642 000 employees. As a result, there may be resistance to some of these changes. Stakeholders, in general, may resist change for a number of reasons, such as disagreement with the reasons for or necessity to change, fear of the impact, lack of understanding, disagreement with the process involved in delivering the change, lack of involvement and satisfaction with the current situation that stops improvements. Therefore, senior managers at VW will have to put a lot of effort into managing the changes. Most of all, they will have to be careful when implementing job cuts. Effective communication will be essential. Senior managers must ensure that all stakeholders understand the need for change, the process of change and the possible outcomes at the end of the change. If this communication is successful, then the changes proposed by Mr Diess are likely to improve the performance of VW.

21 CONTINGENCY PLANNING

ACTIVITY 1

CASE STUDY: ALPHA INFOTAINMENT SYSTEMS

1 Describe how just-in-time manufacturing can lead to a crisis which shuts down a factory.

Just-in-time (JIT) manufacturing is where operations take place exactly when they are required. For example, supplies of raw materials and components are delivered just before they are needed – perhaps a couple of hours or less. Although this approach helps to cut costs, such as storage and stock handling, the JIT approach can have problems. In this case, the supplier of infotainment systems was destroyed by a fire. It was the only supplier of this component to the International Motor Corporation. This means that after the fire, the car maker didn't have any infotainment systems, so it had to stop production for three weeks. This cost the corporation €560 million in lost sales. Eventually, the problem was resolved by finding another supplier – but this took time.

2 Discuss whether manufacturers, such as the International Motor Corporation, should hold large inventories of components and raw materials to avoid the problem experienced in this case.

Holding large stocks of components would have prevented the problem described above. Following the fire at Alpha Infotainment Systems, the International Motor Corporation could have drawn on stocks so that production could continue. Stocks could have been drawn down until the supplier resumed deliveries. This might have avoided the closure of factories owned by the International Motor Corporation. It would also have stopped other suppliers to the car maker closing, who were unable to supply the assembly plants because they were shut.

On the other hand, holding large amounts of inventory is expensive. JIT has proven to be effective for many businesses in reducing costs and ensuring an efficient operation. It could be argued that an unexpected break in supply due to a fire is an unusual event. It is rarely likely to happen. Holding large amounts of components to guard against an event that may never happen might be considered an extreme strategy. However, the International Motor Corporation has now expanded its supplier base to ensure it is not affected by such a risk again. Therefore, ensuring a more efficient system of JIT with alternative suppliers might be a more effective solution to the problem, than holding large quantities of inventories.

3 Explain how contingency planning may have helped the International Motor Corporation.

Some businesses use contingency planning to help deal with crises, such as the break in supply caused by a fire, in this case. Contingency planning is a strategic planning method designed to identify possible crises that a business might experience. It will work out how to protect the business from their worst consequences. It is a disciplined approach to dealing with uncertainty in the future. Companies like the International Motor Corporation can use contingency planning to help make some of the future uncertainties clearer in business, identify risks and opportunities, and prepare for their eventuality. It might be used to teach managers how crises may start to happen, develop and affect the business. Finally, it might

help managers to understand the causes and effects of change in business and how to manage them.

In this case, since the International Motor Corporation was using a JIT approach to production, contingency planning might have helped the business predict that such an event (a break in supply) might occur. It might also have forced the businesses to think about solutions to such a problem in advance. This might have avoided the factory closing.

ACTIVITY 2

CASE STUDY: UBER

1 Discuss the possible impact that the sudden loss of CEO, Travis Kalanick, might have on Uber.

People leave businesses all the time. This may not be a problem but losing key members of staff can cause difficulties – especially if businesses have not prepared for this.

In this case, Uber's founder and CEO, Travis Kalanick left the company unexpectedly in 2017. It was not clear whether the Kalanick's resignation was good or bad for Uber. One very important investor in Uber, Tusk Ventures, was worried. Bradley Tusk said that Uber would soon find a capable CEO to deal with the HR problems that were affecting the company.

However, he said that Uber would need to do more if it was going to shape the future of global transportation and compete with companies like Google, Apple, Tesla and Facebook. Tusk said that someone brilliant – with vision and relentless determination – was needed to compete with such high-profile operators. According to Tusk, Kalanick was that person. Uber had been planning an IPO, but after Kalanick resigned, the timing was not right for the company. We will have to wait to see if Uber can fulfil the potential that it showed under the leadership of Kalanick.

2 Analyse how a business such as Uber might protect itself from the sudden loss of an important member of staff.

Businesses can prepare for the loss of key members of staff. This is called succession planning. Succession planning will also help to develop the staff needed to fill posts as the business expands.

Without succession planning, a business might promote a person who is not equipped to do the job. Or, a business might recruit an unknown outsider at a far greater risk and expense. Some research suggests that CEOs appointed from internal sources tend to do better than those from outside. Some key steps involved in the succession planning process include identify the characteristics a successor should possess, deciding how the successor will be found, having a rigorous selection process, making the decision, communicating the decision and implementing a training and preparation plan.

The person appointed will need to be trained and prepared for the final transition into the post when needed. This may involve 'shadowing' the person who currently occupies the position for a period of time. It might also involve going on specialist courses to develop the skills and knowledge needed.

EXAM PRACTICE

CASE STUDY: THE EDO OIL COMPANY (EOC)

1 Explain what is meant by contingency planning. (4 marks)

Contingency planning is not about trying to predict future events or crises. It is a strategic planning method designed to deal with crises brought about by uncertainties. Businesses may experience events or crises that could affect their activities. Examples include a fire that destroys premises, a breakdown in the internal back-up system that stores business information, or the sudden retirement of a CEO.

Contingency plans help a business to work out how to protect itself from the worst consequences of a crisis. They also help with how to exploit any opportunities that might present themselves. It is a disciplined approach to dealing with uncertainty in the future.

2 Discuss the possible reasons why EOC demanded a review of its contingency planning. (8 marks)

In 2018, EOC decided to review its contingency planning. The task was given priority status and allocated a lot of funding. There were growing threats that meant the EOC urgently organised their review. For example, in recent years, there has been an increasing number of cyberattacks around the world. In 2017, a number of organisations around the world were hit by the WannaCry ransomware attack. People and organisations lost control of their computer systems. There have also been problems with personal data being stolen from businesses. Another threat to an oil company like EOC was the expected increase in sales of electric cars. Globally, many large car-manufacturers are preparing to meet the expected surge in demand for electric vehicles. If the surge materialises, the demand for gasoline for cars is likely to fall sharply. EOC would be negatively affected.

EOC's future performance could also be affected by volatile oil prices. This is because its revenues would be directly affected by global oil price changes. It is impossible to predict the global price of oil. It has fluctuated remarkably in recent years. For example, according to Figure 3, it was \$140 in 2008 and just \$30 in 2016. These huge fluctuations impact heavily on those operating in the oil industry. Sharp price fluctuations make it very difficult to predict future revenues and cash flows. This has a disruptive effect on planning and investment decisions.

It is threats like these, and others, and the possibility of opportunities as well, that make contingency planning important. EOC need to be prepared for such threats, and other sudden changes resulting in crises, to minimise their negative impact.

3 Assess the possible importance of a risk mitigation plan to a company such as EOC. (12 marks)

Risk mitigation plans identify, assess and prioritise risks in business. They also plan responses to deal with the impact of these risks to the operation of the business. In general, a business like EOC can use a number of mitigation strategies to reduce the damage caused by serious disruptive events, such as a cyberattack or dramatic fall in the oil price. For example, EOC could avoid drilling for oil in areas that experience earthquakes. This means they will set up in locations that are not likely to experience natural hazards. Businesses can take out insurance policies to cover losses resulting from disasters. For example, it may be possible to take out 'business interruption cover'. A business can protect itself from

cyberattack by ensuring that data stored on computers is as secure as possible and that back-up systems are adequate. Other measures might include organising back-up power, such as a generator. This will ensure that vital machinery and other equipment can still be used in the event of a power interruption. This means that valuable assets, such as expensive machinery and tools, are protected as much as possible. It is also important that a business has access to emergency funding and that adequate communication channels are set up to deal with crises.

Risk mitigation helps a business to deal with crises by producing a business continuity plan. A business will want to minimise disruption if an incident happens. After taking care of human life, one of the most important priorities is to get the business 'up and running' again. Some firms produce business continuity plans. These plans show how a business will operate after a serious incident and how it expects to return to normal in the quickest time possible.

The first stage in such a plan is to carry out a business impact analysis. This will identify those functions and processes that are essential to the running of the business. This involves gathering information so that appropriate recovery strategies can be designed. The process also involves identifying the financial consequences of such incidents, like loss of revenue, customer defection, increased costs, penalties and disruption to business plans. This information may be gathered by using questionnaires and workshop sessions with appropriate employees. Once the information has been gathered it must be analysed, reviewed and if necessary updated to reflect changing circumstances.

The second stage will be to produce recovery strategies. These are the actions taken to restore the business to a minimum acceptable level after an incident. This will involve identifying the resources needed, such as people, facilities, equipment, utilities, IT and materials to aid recovery. An example of a recovery strategy includes setting up an agreement with another business to share resources and support each other if either one experiences serious disruption. Another example is to contract work out to third parties. There are many others.

The third stage involves developing a detailed plan to ensure that the recovery strategies are carried out in an organised way. Finally, once the recovery plan has gained approval it is necessary to design testing exercises and train staff in their roles during the execution of the recovery plan.

In the case of EOC, some of the threats identified are not likely to be sudden. For example, the growth in the use of electric vehicles and renewable energies has been known for some time. Risk mitigation is not really designed to deal with such events. However, cyberattacks, extreme price volatility and the possible consequences of isolation are events that could result in crises that would benefit from risk mitigation. For example, a business continuity plan might be very helpful to deal with a cyberattack.

Unit 4

GLOBAL BUSINESS

22 GROWING ECONOMIES

ACTIVITY 1

CASE STUDY: ITALY AND THE DEMOCRATIC REPUBLIC OF CONGO (DRC)

1 Which of these two nations is the most developed? Explain your answer.

Italy is an example of a developed country. According to the data in Table 2, people in Italy experience a high literacy rate of 99.2 per cent, a high life expectancy of 82.3 years and high average levels of income at \$38 000 p.a. These are all characteristics of developed economies. In contrast, the DRC is very much a developing nation. It has low literacy levels (77 per cent), low life expectancy (57.7 years) and low income per head (\$800).

2 Explain why there are differences in the size of the economic sectors in each of these two countries.

The pie charts in Figure 2 show that sources of GDP for Italy and the DRC are very different. For example, Italy only generates 2.1 per cent of its GDP from agricultural activity. This compares to 21.1 per cent for the DRC. Most of Italy's GDP, 73.9 per cent, is generated from the sale of services. In contrast, the DRC only generates 45.9 per cent of its GDP from the sale of services.

Finally, the proportion of GDP generated by industry is just 24 per cent for Italy and 33 per cent for the DRC. These patterns are typical for a developed country like Italy and a developing country like the DRC.

3 Explain why a business might prefer to market its goods in an emerging economy rather than a developed economy.

When businesses are looking to develop new markets, it is possible that they would prefer to enter a market in an emerging economy rather than that of a fully developed economy. The main reason for this is that economic growth rates are generally much faster in emerging economies than in developed economies. For example, economic growth in India was 7.2 per cent in 2017. In Japan, growth was only 1.2 per cent in the same year (according to the data in Figure 1).

Businesses often prefer emerging markets since they are likely to grow more quickly than more mature markets. Therefore, a business should be able to increase profits and dividends. Consumers in emerging markets tend to experience new wealth and, as a result, they want to buy more goods and services to help improve their living standards. Businesses are keen to exploit such spending patterns.