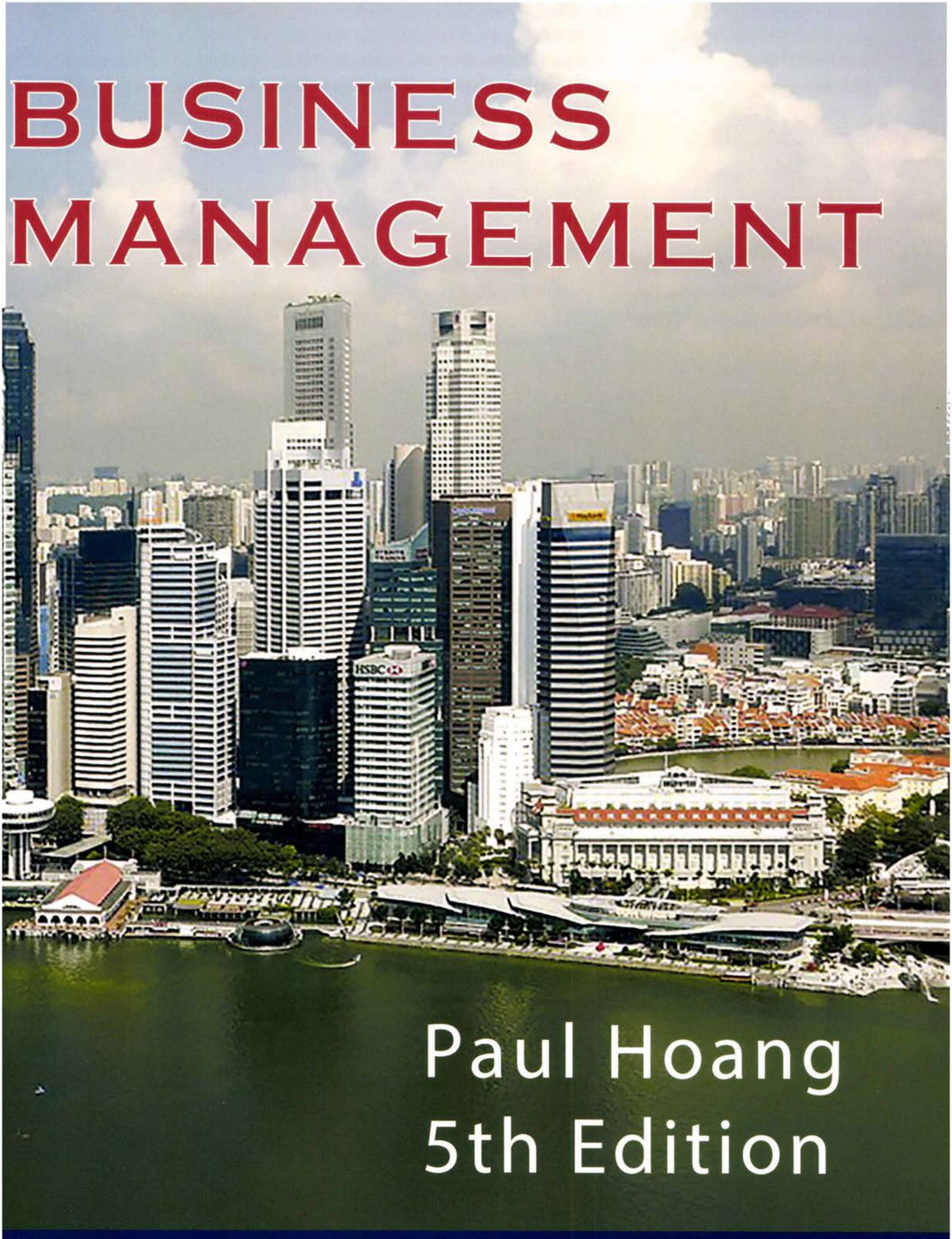
BUSINESS MANAGEMENT



Paul Hoang

5th Edition

FOR USE WITH THE I.B. DIPLOMA PROGRAMME

INTERNATIONAL BACCALAUREATE

Business Management

FIFTH EDITION

Paul Hoang

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Dedication

Dedicated to Kin, Jake, and Luke, for always.

About the author

Paul Hoang has taught Economics and Business Management for over 25 years. He has held the position of Vice Principal and IB Diploma Programme Coordinator at an internationally renowned IB World School in Hong Kong. He was previously Head of Department at two schools in London. He is also an examiner for multiple examination boards. Paul is a highly experienced IB Educator, with over 15 years of experience as an IB Workshop Leader, having led workshops in Business Management, Economics, TOK and the Extended Essay in Europe, Asia Pacific, and the USA.

Paul is Site Author of *InThinking Business Management*, which is used by the majority of IB World Schools. Paul is also Subject Leader for IB Economics and IB Business Management at *ManageBac*. He serves as a partnering consultant for *IB School Improvement*, focusing on the use of assessment data to enhance teaching and learning. He has also been an educational consultant at his alma mater, The Institute of Education, University of London, UK.

Aside from work, Paul is a qualified 2nd Dan World Taekwondo instructor and enjoys play 5-a-side football on a regular basis. Being a Londoner, he is a passionate follower of Arsenal Football Club, but realizes no one is perfect! Most important though, Paul enjoys spending family time with his wife and two sons.

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Paul Hoang with some of his Business Management students

Author's acknowledgements

I would like to thank Roz and Richard Paisey, Ian and Pauline Ashworth, Margo Goodchild, Pastor Harry Lucenay, Sangu Ngan, and Lisa Hoang. You have all shaped me in more ways than you will ever know. I am forever grateful for all the things that you have done for me and the family.

I would also like to thank my publishers at IBID Press: Rory McAuliffe who believed in me and gave me the opportunity to undertake this project, back in 2007 when we published the first ever textbook for the IB Business Management course; Fabio Cirrito for his guidance and trust in my approach; and to Millicent Henry and Jodie Henry for their endless hours of proof-reading, editing, and words of encouragement. I could not have completed this project without their on-going advice and support. It has been a real pleasure and privilege to have worked with you all for over 15 years.

Paul Hoang

How to use this book

At a glance

- This book follows the format of the IB Business Management syllabus (first examination in 2024). It is a dedicated text for both the Standard Level (SL) and Higher Level (HL) courses.

- Units and sections that only apply to HL students are clearly highlighted.

- The textbook contains 230 examination-style questions. Case studies from around the world have been used in these questions to signify the international nature of IB Business Management.

- There are 115 examination tips that appear throughout the text.

- Over 145 Theory of Knowledge questions are integrated in the text.

- 740 key terms (definitions) clearly defined.

- 125 key concepts links throughout the textbook.

- 60 ATL Activities are also included as part of the IB teaching and learning pedagogy.

- 70 Business Management Toolkit links have been included in the 5th edition.

- This book is not intended to be read chronologically; the format simply matches the order in the IB Business Management syllabus guide. Your teachers will be able to guide you further.

- All currencies are expressed in American dollars (USD). Where case studies refer to other currencies, these have been converted into the USD equivalent for ease of comparison

Features of each chapter

- The contents at the beginning of each chapter shows the specific aspects that are covered, based on the Assessment Objectives (AO) in the syllabus guide.

- Exam-style questions appear throughout the textbook. These are based on examination-style questions to give you plenty of practice.

- Each Unit has linkages to the four key concepts that are integral to the nature and essence of the IB Business Management course: creativity, ethics, strategy, and change (CESC). This serves to ensure that both SL and HL students have a more holistic appreciation and understanding of Business Management through the four conceptual lenses.

- Review questions test your understanding of the contents covered in each chapter. These are based on the chronological order of the text, making it easier for you to follow and check your own understanding.

- Integration of the Business Management Toolkit (BMT) appear throughout the textbook. There are right parts to the BMT for SL students and a total of fifteen tools in the BMT for HL only students.

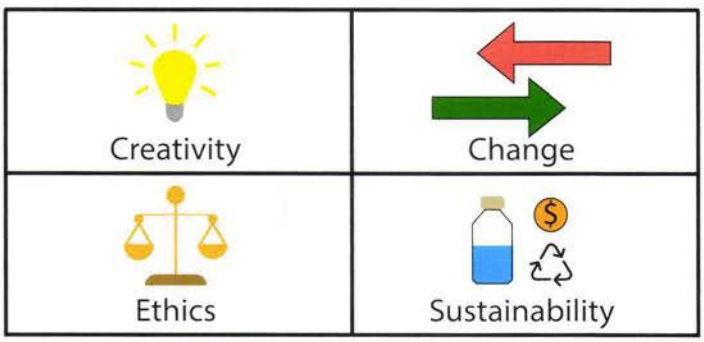
- Key terms are summarized and defined at the end of each chapter. The key terms appear in alphabetical order to make searching easier. There are 740 definitions in the textbook.

About this book

This is the fifth edition of Paul Hoang's bestselling Business Management textbook for the IB Diploma Programme (first exams 2024).

The content has been revised throughout to match the new syllabus (first teaching 2022). Features of the 5th edition include:

- More than 230 exam-style questions, with full mark schemes available to support teachers and students.
- 740 key terms identified and clearly defined.
- Chapter review questions for student reflections.
- Clear links to the four key concepts in the Business Management course: Change, Ethics, Sustainability and Creativity (CESC). These concepts help students to think about Business Management in a more holistic, interdisciplinary and critical way



The new "CESC" concepts in Business Management

- More than 110 examination tips and over 40 common mistakes to avoid in the exams.
- 145 Theory of Knowledge (TOK) questions are integrated throughout the textbook, along with 60 ATL Activities to engage students in their learning and making connections of the tools, theories and techniques in Business Management.
- Over 100 short case studies are included to encourage students to apply their learning to the context of real-world business organizations.
- Coverage of the Business Management Toolkit (BMT), with 40 exam practice questions for this component of the course.
- Advice for concept-based learning (CBL), the Internal Assessment (for SL and HL), the external assessments (Papers 1, 2 and 3), as well as the Extended Essay in Business Management.

An accompanying **Answer Book** is available from IBID Press with full mark schemes for all exam practice questions in the 5th edition textbook (http://www.ibid.com.au/business-management/).

Testimonials

"This textbook is, unquestionably, the standard to which all other books attempt to measure up."
Marc Brothers, Indonesia

"Thank you very much for this textbook – I really, truly appreciate this! From everything that I have seen and read, Paul Hoang is the leader within the IB Business Management field."
Pam Monte Zosa, Uruguay

"Let me please reiterate my thanks for your wonderful book. My students and I are enjoying it immensely - it reads and flows so well."
Bettina Hoar, USA

"Sincere thanks to Paul as this textbook makes the students' lives (and ours too!!) so much easier, being so well tailored to the IB requirements, with excellent and relevant real-world examples."
Roxie Burnes, United Kingdom

"Simply the best textbook for the IB Business Management course – my students just love the book!"
Matt Temp, Canada

"If you are teaching this subject at an IB school, there is no other choice – it has to be Paul Hoang's textbook, you will not regret it. I cannot recommend his work enough, it is now in the 5th edition and better than ever and has helped my students out tremendously."
Fabrice Vanegas, Thailand

"Your book is my absolute favourite for IB Business Management! Honestly, I wouldn't be without it. It adds so much extra than the typical course textbook – thank you!"
Helen Staniland, UAE

"I would like to offer my gratitude to you for your amazing book, which has helped me to understand the many aspects of Business Management. Your case studies really make the understanding of everything much easier. We have been using your textbook from Day 1 and honestly surviving IB BM would have been impossible without it!"
Yatharth Dhoot, Tamil Nadu, India (IB DP student)

"Can I just start off by saying that you are my idol! Your chapter on marketing in the business management textbook for IB students inspired me to pursue marketing in my future studies... I would really like to thank you for putting all your effort into this book and giving us IB students a very clear and helpful book. I would not have been able to get through this BM course without your in depth explanations and up-to-date and relatable examples. This book has also helped us understand concepts easily. I really appreciate you for being an inspiration to us young students and helping us realise our dreams"
Neha Bhojwani, IB student

"I've studied your Business Management book at the British International School Vietnam while completing the IB Diploma. I am a great enthusiast of your work."
Evan Planchon, IB student

"Hoang's textbook is the best when it comes to complex ideas and really going in depth. The questions inside the book really helped with my exams."
Sohm Naran, IB student of Harare International School, Zimbabwe

"In my opinion, nothing beats Paul Hoang's textbook. It's easy to understand from a student perspective and prepares them for the exams."
David Dachpian, Poland

"Your textbook does an excellent and thorough job of explaining everything."
Jennifer Jones, Norway

"We study with your excellent book. It has so useful tips and everything is said so clearly. Thank you for that!"
Pia Hartonen, Finland

"My IB Business Management class has been using your book for the past 2 years now. I just want to give my thanks for writing this amazing book. It is truly a life saver. Thank you."
Edward Liu, Hong Kong

"There is only one textbook that I would recommend - Paul Hoang's."
Dr. Rima Puri, Senior IB Examiner

"We used your Business Management textbook for HL class. The book was our companion during our sleepless nights as it guided us through our IA and EE. Both of us are majoring in business in universities now and we just wanted to say that your book has helped tremendously and prepared us in our current studies. Thank you for your contributions to our academic success. We hope you continue to motivate future students with your exceptional works."
Sam Castillo (University of Colorado) and Eunice Lee (University of Washington)

"We have been purchasing your textbook for more than 10 years and believe it is the most valuable textbook for IBDP Business Management students."
Shirley Zhang Zheng, Head of Individuals and Societies, Shanghai Pinghe School, China

"Paul Hoang - Thanks so much ... your book is hands down the best."
Maria Manos

"This resource is absolutely brilliant, containing a variety of exercises to test students' learning and understanding. It saves me so much time, and my lessons are planned much more efficiently with this resource to rely on. Just brilliant!"
Harry Butch, Indonesia

Contents

Topic 5: Operations management

Business Management Toolkit (BMT)

Chapter 1

Unit 1.1 - What is a business?

"It does not take much strength to do things, but it requires a great deal of strength to decide what to do."
Elbert Green Hubbard (1856 – 1915), American author and philosopher

Contents

1.1 What is a business?	
SL/HL content	**Depth of teaching**
The nature of business	AO1
Primary, secondary, tertiary and quaternary sectors	AO2
Challenges and opportunities for starting a business	AO2

The nature of business (AO1)

A **business** is a decision-making organization involved in the process of using inputs to produce goods and/or to provide services (see Figure 1.1). *Inputs* are the resources that a business uses in the production process, such as labour and raw materials. This process generates *outputs* (also known as products). Management guru Peter Drucker said that *"there is only one valid definition of business purpose: to create a customer"* by creating goods and services that meet the needs and wants of customers.

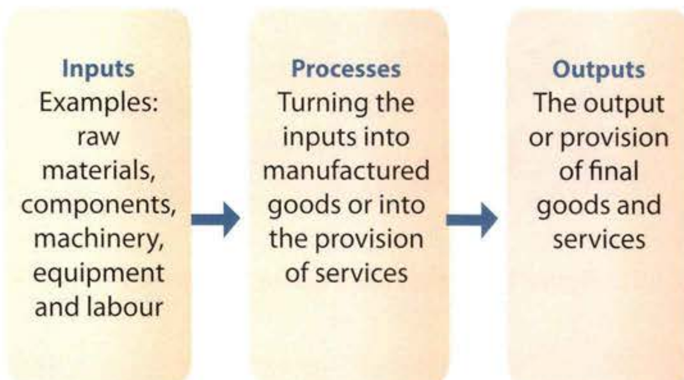


Figure 1.1. The production process

The term **product** can refer to both goods and services. **Goods** are physical products, such as smartphones, clothes, books and food. **Services** are intangible products, such as haircuts, public transport, education and healthcare. Businesses can also provide goods and services to other organizations, such as freight transportation, distribution and insurance.

An **entrepreneur** is the individual who plans, organizes and manages a business and its operations, taking on financial risks in doing so. The term was coined by Richard Cantillon (1680 - 1734) an Irish-French economist. Entrepreneurship describes the trait of business leaders who tend to be distinctive in their temperament, attitude and outlook who drive the business to achieve its organizational goals. Successful entrepreneurs tend to be creative, innovative and highly passionate. They search for and exploit business opportunities by forecasting and/or responding to changes in the marketplace.

The nature or purpose of business activity is to generate **added value**. This occurs when there is a positive difference between the selling price of a product and the cost of producing the good or service. Added value exists when products are appealing to customers, so they are willing to pay a higher price for such items.

Management guru Peter Drucker (1909 - 2005) famously said that the only purpose of a business is to create customers, i.e. the role of businesses is to combine human, physical and financial resources to create goods and services in order to satisfy the *needs* and *wants* of people, organizations and governments. **Needs** are the basic necessities that people must have to survive, such as food, water, warmth, shelter and clothing. **Wants** are people's desires, i.e. the things they would like to have, such as a larger home, a new smartphone, an overseas holiday or a birthday cake.

Figure 1.2 - Cakes are a desire, not a need

Case study 1.1 - Steve Jobs

Steve Jobs (1955 - 2011), the co-founder of Apple, did not graduate from university because his adopted parents could not afford the tuition fees. Instead, he took the risk of setting up Apple with two friends (Steve Wozniak and Ronald Wayne) in 1976. However, Ronald Wayne sold his share of the company within a couple of weeks for (just) $2,300. Jobs went on to reinvent computing, music and mobile phones, making Apple the highest valued company in the world, just two months before he died. *Forbes* estimated the wealth of Jobs to be over $8.3 billion.

Common mistake

The terms **customer** and **consumer** are often used interchangeably by students, although they have different meanings. Make sure you can distinguish between the two terms and use them in the right context - *customers* are the people or organizations that purchase a product whereas *consumers* are the ones who actually use the product. These may be the same entity (e.g. someone who buys and eats a meal), but not necessarily such as parents (customers) who buy presents for their children (consumers).

Box 1.1 - Types of products

- **Consumer goods** are products sold to the general public, rather than to other businesses. They can be further categorised as *consumer durables* (products that last a long time and can be used repeatedly, such as electronic devices, motor cars, jewellery, clothes and home furniture), or *non-durables* (those that need to be consumed shortly after their purchase as they do not last or cannot be reused, such as fresh food items, beverages, medicines and newspapers).

- **Capital goods** (or **producer goods**) are physical products bought by businesses to produce other goods and/or services. Examples include buildings (premises), computers, machinery, tools and specialist equipment.

- **Services** are intangible products provided by businesses. The service is not tangible, but the results or experiences are, such as healthcare, transportation, dining, sports (recreation), legal advice, financial guidance and education.

For a business to operate effectively, tasks must be carried out by various functional areas (or departments). These interdependent functional areas are human resources, finance and accounts, marketing and operations management. The nature of business requires these main functional areas to work together in order to achieve the organization's goals.

1. **Human resource management** – The human resources (HR) department is responsible for managing the personnel of the organization. This includes roles such as human resource planning, organizational structures, management

and leadership, motivation and demotivation and dealing with industrial/employee relations (see Chapters 7 - 13).

2. **Finance and accounts** – The finance and accounts department is responsible for managing the organization's money, ensuring compliance with legal requirements (such as filing of corporate taxes) and informing those interested in the financial position of the business (such as shareholders and potential investors). Finance and accounts topics are covered in Chapters 14 - 22.

3. **Marketing** – The marketing department of a business is responsible for identifying and satisfying the needs and wants of customers. It is ultimately in charge of ensuring that the firm's products sell. This is done through a series of activities such as market research, promotion, pricing, branding and distribution. The nature of marketing as a business function is covered in Chapter 23 - 34.

4. **Operations management** – This functional area of a business is responsible for the process of converting raw materials and components into finished goods, ready for sale and delivery to customers. Examples of production include the extraction of crude oil, car manufacturing and the provision of travel and tourism services. Operations management topics are covered in Chapters 35 - 43.

A large organization is able to allocate resources to each of these four functional areas, making their roles easily identifiable. In a small business, owned by just one person, each function would need to be carried out by the same person. In practice, the interrelated nature of four functional areas of a business mean that the operations management department relies on effective marketers to promote and sell their products. Equally, marketers can only do their jobs if they have well-made products to sell and the necessary financial resources to do so.

Question 1.1 - The business of education

Education is big business. Schools can earn **revenue** from numerous sources, such as tuition fees (for fee-paying schools), grants from the government and fund-raising events. They might also lease out their facilities (such as classrooms, sports facilities, drama studios and swimming pools) during the evenings, weekends and school holidays.

Schools use these revenues to finance their **costs**, such as staff salaries, utility bills and the maintenance of the buildings. In addition to school fees, parents might also have to pay for items such as school uniform, textbooks, stationery, sports equipment and food.

(a) Distinguish between *revenue* and *costs*. *[4 marks]*

(b) Examine how business functions operate in an organization such as a school. *[6 marks]*

Primary, secondary, tertiary and quaternary sectors (AO2)

Businesses can be classified according to the stage of production (or chain or production) that they are engaged in. These stages are categorized as (i) primary, (ii) secondary, (iii) tertiary and (iv) quaternary sectors.

(i) Primary sector

Businesses operating in the primary sector are involved with the extraction, harvesting and conversion of natural resources. Examples include agriculture, fishing, mining, forestry and oil extraction. Primary sector business activities tend to account for a large percentage of output and employment in low-income countries. Businesses operating in the primary sector in high-income countries use mechanisation and automation, such as combine harvesters, tractors and automatic watering systems.

As countries achieve sustained economic growth and development, there is less reliance on the primary sector in terms of employment and national output, partly because there is little added value in primary sector production. For example, low-income countries can only sell tea leaves and coffee beans at relatively low prices. Nevertheless, the primary sector is important for all countries. For example, even though less than 4% of France's national output comes from the primary sector, the country benefits immensely from its agricultural exports sold all around the world.

Figure 1.3 - Agricultural farming is part of the primary sector

(ii) Secondary sector

Businesses that operate in the secondary sector are involved in manufacturing or construction. Examples include clothes manufacturers, publishing firms, breweries and bottlers, construction firms, electronics manufacturers and energy production companies. The output is then sold to customers, such as other businesses, governments, foreign buyers or domestic customers.

Medium-income countries tend to have a dominant secondary sector that accounts for a relatively large proportion of their country's national output. Economists argue that the secondary sector is the wealth creating sector because manufactured goods can be exported worldwide to earn income for the country. Value is added to the natural resources used during the production process. For example, the mass production and export of motor vehicles and consumer electronic products has helped economies such as Taiwan (China) and South Korea to prosper. However, automation and mechanisation in modern societies have caused a decline in many secondary (manufacturing) industries in terms of employment.

Figure 1.4 - Construction is part of the secondary sector

(iii) Tertiary sector

Businesses that operate in the tertiary sector specialize in providing services to the general population and other organizations. Examples of industries in the tertiary sector include retailing, transportation and distribution, banking, finance, insurance, healthcare, leisure and tourism and entertainment.

Note that physical goods can be transformed in the process of providing a service. This happens in a restaurant when the chef prepares a meal with fresh ingredients. Nevertheless, the focus is on the people who are providing the service - the chef and the waiting staff who serve the diners - rather than on the tangible product itself.

In high-income countries, the tertiary sector tends to be the most substantial sector in terms of both employment and output as a percentage of *gross domestic product* (the value of the country's output each year). For example, in the USA and UK, around 80% of the labour force work in the tertiary sector. The decline of the manufacturing sector in high-income countries also signifies their growing reliance on the tertiary sector.

Figure 1.5 - Public transportation is part of the tertiary sector

(iv) Quaternary sector

This is a sub-category of the tertiary sector. Businesses that operate in the quaternary sector are involved in intellectual and knowledge-based activities that generate and share information. Examples include information communications technology (ICT), research and development (R&D), consultancy services and scientific research. For example, pharmaceutical companies invest heavily in R&D to create innovative products, develop new production methods, improve efficiency and to tap into markets. The quaternary sector exists mainly in high-income countries as it requires a highly educated workforce. It is also the sector in which high-tech and e-commerce businesses invest for further growth and evolution.

Figure 1.6 - Information Communications Technology (ICT) is part of the quaternary sector

The four business sectors are linked through the **chain of production** which tracks the stages of an item's production, from the extraction of raw materials used to make the product all the way through to it being delivered to the consumer (see Figure 1.1).

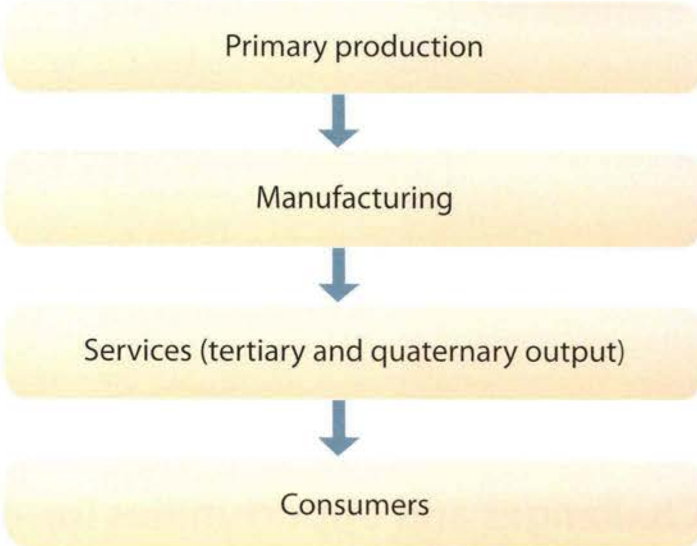


Figure 1.7 - The chain of production

All four business sectors are *interdependent* because each sector relies on the others to remain in existence. For example, raw materials such as crude oil, would not be extracted if there was no need for oil refinery whilst there would not be any need for oil refiners if there were no customers for the oil, such as motorists and airline companies in the tertiary sector. Likewise, firms in the secondary sector rely on their suppliers for stocks to ensure that their production targets are met. Businesses are also interdependent as they all need energy, ICT facilities, manufactured producer goods, financial services and management consultants.

High-income countries are able to exploit the tertiary and quaternary sectors as the main contributors to national output and employment. Businesses such as Apple and Samsung see themselves as operating in the services sector (they outsource production of their smartphones and computer hardware to manufacturers such as Foxconn). Apple realise that there is more added value in the tertiary and quaternary sectors - rather than receiving one-off payments from selling manufactured equipment, it can receive a flow of revenue from offering after-sales services such as maintenance and support services.

Question 1. 2 - Production Sectors

Study the data below and answer the questions that follow. A, B and C represent three countries: France, Bangladesh and the Philippines (although not necessarily in that order).

Structure of employment (%)

	A	B	C
Agriculture	33	4	45
Manufacturing	15	24	30
Services	52	72	25

(a) Identify the countries A, B and C. *[3 marks]*

(b) With reference to the data above, explain your answer to Question 1.2 (a). *[6 marks]*

https://en.wikipedia.org/wiki/List_of_countries_by_sector_composition_of_the_labor_force

Challenges and opportunities for starting a business (AO2)

Results from around the world consistently show that around 20-25 per cent of new businesses fail to survive their first year. A new business is likely to face challenges which must be dealt with immediately to prevent them from escalating and threatening its survival. The challenges for starting up a business include any combination of the following:

- **Lack of finance** - All businesses need finance for the purchase of *fixed* assets, such as premises, buildings, machinery and equipment. However, start-up firms and most owners of new or small businesses do not have the credentials to secure sufficient funding without major challenges. Even if entrepreneurs are able to some borrow money, the funds may be insufficient or the relatively high interest charges might seriously affect the cash flow position of the business (see Chapter 20). Hence, new sole traders (see Chapter 2) often have to remortgage their own homes to raise the finance needed, thereby offering the lender more *collateral* (financial security) in case they fail to repay the loan).

- **Unestablished customer base** - A major challenge facing new businesses is attracting customers, i.e. building a broad and loyal customer base. The problem is intensified when there are well established competitors that already operate in the market. Customer loyalty is built over a long period of time, which may require marketing know-how and large amounts of money.

- **Cash flow problems** - Financing *working capital* (the money available for the daily running of a business) is a major challenge for many business start-ups. A business might have a lot of stock, such as raw materials, semi-finished output or finished goods that it cannot easily turn into cash. Customers might demand a lengthy credit period (typically between 30 to 60 days) enabling them to buy now and pay later, so the business will not receive the cash payment until the credit period is over. However, during this time, the business still needs to pay for its on-going costs such as wages, rent, utility bills, taxes and interest payments on bank loans.

- **Marketing problems** - Marketing challenges arise when businesses fail to meet customer needs, thereby resulting in poor sales and a lack of profitability. Supplying the right products to the right customers at the right price is especially crucial for new businesses. However, small and new businesses might lack the expertise to do this. Quite often, the key to small business success is to identify a *niche* (or gap) in the market and then fill it. For example, back in the 1990s, Amazon identified huge opportunities of using the Internet as a channel of distribution for books and other products. European airline carriers such as easyJet and Ryanair identified early on the niche market for no-frills (budget) air travel.

- **People management problems** - Business start-ups may lack experience in hiring the right staff with all the necessary skills. This can lead to poor levels of labour productivity and the need to retrain staff or to rehire people, all of which can be very expensive and time consuming. Moreover, new businesses might not know the ideal organizational structure (see Chapter 8) or the most practical methods of staff motivation (see Chapter 10) that best suits their organizational needs.

- **Production problems** - It can be challenging for business start-ups to accurately forecast levels of demand so they are more likely to either over produce or under produce. Overproduction tends to lead to stockpiling, wastage and increased costs (see Chapter 40). By contrast, underproduction leads to dissatisfied customers and a loss of potential sales.

- **Legalities** - It is necessary for businesses to comply with all necessary legislation, including business registration procedures, insurance cover for staff and buildings, consumer protection laws and rules about intellectual property such as copyrights, patents and trademarks (see Chapter 42). The paperwork and legal requirements of setting up a new business can be cumbersome, confusing, time consuming and expensive. Any oversight could result in the business having to pay compensation or financial penalties. This would obviously damage the already vulnerable cash flow position of business start-ups.

- **High production costs** - New businesses are likely to have high set-up costs (see Box 1.2) and running costs due to the large amount of money needed to purchase or pay for capital equipment, machinery, stocks (inventory), rent, advertising, insurance and so forth. Smaller businesses will also be at a cost disadvantage as they cannot benefit from economies of scale (see Chapter 5). By contrast, economies of scale allow larger and more established businesses to benefit from lower average costs of production due to the size of operations, such as being able to get discounts from their suppliers for large bulk purchases or being able to borrow money at a lower interest rate because of their larger size and financial collateral.

Box 1.2 - Examples of start-up costs for a new business

- Buildings, such as alterations, fixtures and fittings and insurance costs.
- Capital equipment, such as office furniture, telephones, computers, Wi-Fi, machinery, tools and motor vehicles.
- Human resources, such as recruitment, induction and training costs.
- Legal and professional fees, such as the costs of solicitors, licenses and permits.
- Marketing costs, such as market research, advertising and promotional campaigns.
- Premises, such as purchase costs, mortgage deposit payment or rental deposit costs.

- **Poor location** - Businesses face a dilemma in the location decision: busy areas offer the highest potential number of customers, but the premises in these areas will also cost the most (see Chapter 38). Fixed costs, such as rent or mortgage payments, account for a large percentage of total costs for many businesses. An aim for any new business is to reach break-even as soon as possible, by keeping fixed costs down. This is one reason why many entrepreneurs set up small businesses that operate initially from their own homes (which also has some tax advantages). Jeff Bezo, the founder of Amazon, started his online business in his garage. Of course, this option is not suitable for businesses where location (see Chapter 38) plays a key factor in business survival.

- **External influences** - All businesses, irrespective of size or how long they have been in operation, are prone to exogenous shocks (see Chapter 46) that create a challenging trading environment, such as a global financial crisis or the outbreak of a pandemic. However, larger and more established firms tend to be better resourced to handle these external influences. Hence, new businesses face the added challenge of being more vulnerable to external shocks which also means the potential for business failure is greater.

Figure 1.8 - The COVID-19 pandemic caused havoc for businesses across the world

However, there are many potential opportunities for starting up a business. These opportunities can be remembered by the mnemonic GET CASH©.

- **Growth** - Entrepreneurs tend to benefit personally when there is an appreciation in the value of their businesses, especially as property and land tend to increase in value over time. This is called *capital growth*. It is quite common for the capital growth of a business to be worth more than the value of the owners' salaries. Bill Gates, who co-founded Microsoft in 1975, made his fortunes mainly from the capital growth of Microsoft, the world's largest software maker.

- **Earnings** - The Chinese have a saying that "*You can never get rich earning money from working for someone else.*" That is because the potential returns from setting up your own business can easily outweigh the costs, even though the risks are high. It is common that entrepreneurs earn far in excess of salaries from any other occupation that they might otherwise pursue. Tim Cook, CEO of Apple, is reported to have an annual remuneration package of around $265 million whilst Elon Musk, Tesla's CEO, is paid around $595 million a year!

- **Transference and inheritance** - In many societies, it is the cultural norm to pass on assets, including businesses, to the next generation. Many self-employed entrepreneurs view their business as something that they are able to pass on (transference) to their children (inheritance) to give them a sense of financial security that might not be possible if they chose to work for someone else. The Walton family (the richest family in the world with an estimated wealth of over $215 billion) own over 50% of the shares in Walmart, the world's largest retailer. The Mars family is the second wealthiest family, with an estimated wealth of $120 billion. Mars Inc., a privately held company (see Chapter 2) that produces confectionary, processed foods and veterinary services is a multigenerational family business that was founded in 1911.

- **Challenge** - Some people might view setting up and running a business as a personal challenge. It is this challenge that drives them to perform and what gives them particular satisfaction. Being successful in business boosts self-esteem. This is perhaps one reason why multi-billionaires such as Warren Buffet, Carlos Slim and Li Ka-shing continued to work past the official retirement age.

- **Autonomy** - Working for someone else means exactly that. Employees have to follow the instructions and rules set by the organization that they work for, such as the conditions of employment, working hours, employment benefits and holiday entitlement. Conversely, being self-employed means that there is autonomy (independence, freedom of choice and flexibility) in how things are done within the organization. Essentially, this opportunity refers to the benefits of being your own boss.

- **Security** - Similarly, there could be a greater sense of job security for someone who is their own boss. By contrast, employees can be dismissed, made redundant or even replaced by technology. Although the risks are great, being self-employed also makes it potentially easier to accumulate personal wealth (financial security) to provide higher funds for (early) retirement.

- **Hobbies** - Some people might want to pursue their passion or to turn their hobby and interests into a business opportunity. Successful entrepreneurs have a passion for what they do and this is made easier if the nature of the work is directly related to their personal interests. Top selling author, J.K. Rowling is an example. Jamie Oliver, the celebrity chef, has set up several of his own restaurants. Internet entrepreneur Mark Zuckerberg became the world's youngest billionaire when he was just 23 years old, having co-founded Facebook and becoming the company's CEO.

In summary, people set up their own businesses due to the opportunities to satisfy their personal desires - such as to fulfil a personal vision, to have the opportunity to achieve success, to be their own boss or simply to live a more extravagant lifestyle (if and when the business becomes a 'success'). However, a significant number of new businesses fail to survive. There are three inter-related reasons or challenges behind this: a lack of cash in the business, poor cost control and substandard or weak management and leadership.

Key concept

How important is **creativity** for business success?

Theory of Knowledge (TOK)

Reflect on the opportunities for starting up a business. How do *reason* and *emotion* interact to affect the decision-making process? Is *emotion* or *reason* more important in this process?

Theory of Knowledge (TOK)

To what extent is luck an essential part of being successful in business? How does this impact the knowledge needed to succeed as an entrepreneur?

Business Management Toolkit

Discuss how the use of a business plan (see Chapter 48) can help entrepreneurs to tackle the challenges and opportunities of starting a business.

What is a business? and the key concepts

Business activity is the process of turning inputs (land, labour, capital and enterprise) into outputs (finished goods and services) in order to meet the needs and wants of different customers. Irrespective of the country or culture, all businesses strive to add value in the production and provision of goods and services as part of their sustainable business strategy.

The reasons for setting up a business can vary from one country and culture to another. For example, only a few legal procedures are needed to establish a business in Singapore, Hong Kong (China) and New Zealand, thus promoting an entrepreneurial culture where creative and innovative businesses can thrive. In other places, such as Chad, Libya and Myanmar, a risk-taking entrepreneurial culture is not so apparent, so there is relatively little change and sustainability is more of an issue.

Essentially, the nature of business activity is to satisfy the needs and desires of customers whilst fulfilling the organization's own objectives, such as profit, growth and corporate social responsibility (see Chapter 3). In the long run, all businesses must generate profit or surplus in order to survive, although there will be similarities and differences in how for-profit and not-for-profit organizations go about doing this (see Chapter 2). Complexities in the global corporate world mean that change, ethics and creativity are central to the sustainability of businesses.

Case study 1.2 - Paul Buchheit and Gmail

Creativity and the ability to adapt to change are crucial skills to compete successfully in the corporate world. Paul Buchheit, an employee of Google, is credited as the creator of Gmail. In 2001, he programmed the first working version of Gmail in just one day(!) and was the lead developer. He left Google in 2006 and worked at Facebook until 2010. In 2011, Buchheit won The Economist Innovation Award for the computing and telecommunications field.

Key concept

Discuss the extent to which **sustainable** business practices can enhance an organization's chances of financial success.

REVIEW QUESTIONS

1. What is a business?
2. How do goods and services differ from each other?
3. How do needs and wants of consumers differ from each other?
4. How do customers and consumers differ from each other?
5. What are the four functional areas of a business?
6. What are the four business sectors of the economy?
7. How does a business add value to its goods and services?
8. What is meant by the chain of production?
9. What are the main challenges for business start-ups?
10. What are the main opportunities for business start-ups?

KEY TERMS

Adding value is the practice of producing a good or service that is worth more than the cost of the resources used in the production process.

Businesses are organizations involved in the production of goods and/or the provision of services.

Consumers are the people or organizations that actually use a product.

Customers are the people or organizations that buy the product.

Entrepreneurs are the people who manage organize and plan the resources needed for business activity in pursuit of organizational objectives. They are risk takers who exploit business opportunities in return for profits.

Entrepreneurship refers to the collective knowledge, skills and experiences of entrepreneurs.

Goods are physical products produced and sold to customers, such as laptops, books, contact lenses, perfumes and children's toys.

Needs are the basic necessities that a person must have to survive, including food, water, warmth, shelter and clothing.

Primary sector refers to businesses involved in the cultivation or extraction of natural resources, such as farming, mining, quarrying, fishing, oil exploration and forestry.

Production is the process of creating goods and/or services, adding value in the process.

Quaternary sector is a sub-category of the tertiary sector, where businesses are involved in intellectual and knowledge-based activities that generate and share information, such as research organizations.

Secondary sector refers to businesses concerned with the construction and manufacturing of products.

Services are intangible products sold to customers, such as the services provided by airlines, restaurants, cinemas, banks, health and beauty spas, schools and hospitals.

Tertiary sector refers to businesses involved with the provision of services to customers.

Wants are people's desires, i.e. the things they would like to have, such as new clothes, smartphones, overseas holidays and jewellery.

Figure 1.9 - Holidays are common wants (desires)

Chapter 2

Unit 1.2 - Types of business entities

"To open a business is very easy; to keep it open is very difficult."
- Chinese Proverb

Contents

1.2 Types of business entities	
SL/HL content	**Depth of teaching**
Distinction between the private and the public sectors	AO2
The main features of the following types of organizations: • Sole traders • Partnerships • Privately held companies • Publicly held companies	AO3
The main features of the following types of for-profit social enterprises: • Private sector companies • Public sector companies • Cooperatives	AO3
The main features of the following types of non-profit social enterprises • Non-governmental organizations (NGOs)	AO3

Distinction between the private and the public sectors (AO2)

Organizations that operate in the **private sector** are owned and controlled by private individuals and businesses, rather than by the government. They differ in size, ranging from those owned and run by just one person, to large multinational companies that operate across the world. The main aim of most, although not all, private sector organizations is to earn **profit** for its owners, i.e. the positive difference between a firm's **sales revenue** (the money earned from selling its products) and its **costs** (production expenditures such as wages and rent).

Organizations that operate in the **public sector** are under the ownership and control of the government. They typically provide essential goods and services that would be underprovided or inefficiently provided by the private sector, e.g. health care, education, social housing and the emergency services. Organizations that are partially or wholly owned by the government are called **public sector companies** (or **state-owned enterprises**, such as the UK's Transport for London, Singapore Airlines, Airports Authority of India and Canada Post (postal services).

Figure 2.1 - Emergency services are provided by the public sector

Case study 2.1 - Australia Post

Australia Post (www.auspost.com.au), established in 1809, is a state-owned enterprise providing postal services. It employs more than 35,000 people across its network of over 4,330 retail outlets, enjoying revenues in excess of AUD7.5bn (USD5.45bn).

Reasons for public sector business activity include:

- To ensure that everyone has access to basic services such as education, health care, museums, public parks and public libraries.
- To avoid wasteful competition as the government is able to achieve huge *economies of scale* (cost savings from operating on a large magnitude) in the provision of certain services, such as postal services and national defence.
- To protect citizens and businesses through institutions such as the Police and the courts that govern the country's law and order system.
- To create employment opportunities, e.g. governments tend to be a large employer of teachers, doctors and nurses.
- To stabilise the economy, e.g. many private sector commercial banks were *nationalised* (bought by the government) during the global credit crisis of 2008 to prevent further financial turmoil. Government intervention throughout the COVID-19 global pandemic also helped to stabilise the world's economies.

Question 2.1 - The private and public sectors

Education, housing and healthcare services can be provided by both private sector businesses and the public sector.

(a) Distinguish between the aims of organizations operating in the public sector and the private sector. *[4 marks]*

(b) Examine how housing provided by a housing cooperative might differ from that provided by a private sector business. *[6 marks]*

Types of organizations (AO3)

The main features of the following types of organizations: (i) sole traders, (ii) partnerships, (iii) privately held companies and (iv) publicly held companies. AO3
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Most businesses that operate in the private sector aim to make profit. After all, a business can only survive in the long term if it is profitable. Profit-based business entities differ in terms of *ownership* and *control* (you do not have to run a business simply because you own it), how they raise finance and how the profits are distributed. The four main types of profit-based organizations are sole traders, partnerships, privately held companies and publicly held companies.

(i) Sole traders

A **sole trader** (or **sole proprietor**) is an individual who owns his/her personal business. The owner runs and controls the business and is the only person held responsible for its success or failure. It is the most common type of business ownership across the world. Examples include self-employed decorators, plumbers, mechanics, restaurateurs, private tutors and freelance photographers.

Sole traders may choose to work alone or they might employ other people to help run the business. Sole proprietorships are often small family-run businesses and can be set up with a relatively small amount of capital. Start-up capital is usually obtained from personal savings and borrowing.

Figure 2.2 - A sole trader is a business entity owned by a single person

An important legal point about sole traders is that the business is **unincorporated.** This means the *owner* is the same legal entity as the *business* itself. As there is no legal difference between the business entity and the owner, the sole trader could lose his/her personal possessions if the business collapses (as the owner is personally responsible and liable for all the debts of the business).

Many well-known companies started as sole traders. For example, Chanel (The House of Chanel) was started by Coco Chanel in 1910 and has a huge global presence today. Marks & Spencer was set up in 1904 by partners Michael Marks and Thomas Spencer (who originally operated as sole traders). Multinational retailer Tesco was started in 1919 as a sole proprietorship by Jack Cohen. In 1945, Sam Walton started his business with personal savings of $5,000 and a $20,000 loan from his father-in-law and went on to establish Walmart as the world's largest retailer.

Case study 2.2 - eBay

The eBay concept was created in 1995 by entrepreneur Pierre Omidyar in response to difficulties his fiancée encountered when she was trying to sell collectibles such as PEZ candy dispensers. Omidyar started a sole proprietorship, using a prototype called Auction Web, to sell these and other goods to a growing online community. Three years later, in 1998, eBay became a publicly held company, making Omidyar a billionaire at the age of 31.

Table 2.1 - The advantages and disadvantages of sole proprietorships

Advantages of sole proprietorships	Disadvantages of sole proprietorships
Few legal formalities - Sole traders are quite easy to set up and start-up costs are usually much lower in comparison to starting other types of business entities.	**Unlimited liability** - As an unincorporated business, there is no limit to the amount of debts that a sole trader is legally responsible for if the business fails.
Profit taking - The sole trader is the only owner and therefore receives all of any profits earned by the business. This gives the sole trader an incentive to work hard and to become successful.	**Limited sources of finance** - Sole traders often find it difficult to secure funds beyond personal savings. Growth can also be problematic due to the lack of sources of finance available to sole traders.
Being your own boss - Sole traders do not take orders from anyone, have flexibility in decision-making (such as dictating their own working hours) and self-esteem from being successful.	**High risks** - Statistically, sole proprietorships have the largest risk of failure. The presence of larger and more established firms creates a huge threat to the profits and survival of smaller businesses.
Personalised service - Sole traders can provide a personalised service to customers. Larger businesses might not have the time to get to know all their customers, so their services often become generic and impersonal.	**Workload and stress** - Owners often have to do their own accounts, marketing and human resource management. The sole trader is unlikely to be equally effective in these different roles, so there is added workload and stress.
Privacy - Unlike other types of business entities, sole traders enjoy privacy as they do not have to make their financial records available to the general public, i.e. the owner enjoys confidentiality (although the accounts can be scrutinised by the relevant tax authorities).	**Limited economies of scale** - A sole trader is not able to exploit the benefits of large-scale production, so their prices might be less competitive compared with those of larger rivals. This tends to reduce the competitiveness and profits for the sole proprietor.
Quicker decision-making - There are no other owners to consult, so sole traders can make decisions quickly and independently based on their own needs and preferences.	**Lack of continuity** - The running of the business can be jeopardised if the owner is not present. If the owner decides to go on holiday or becomes ill, the business might have problems in continuing.

Question 2.2 - Flowers by Cam

Cam Tran is a **sole trader** who operates a small florist shop called Flowers by Cam in Montpellier, France. She arranges and delivers flowers to local hospitals, hotels and schools in the local area. At times, she receives large orders for weddings and funerals. She is also busy as a single mother of two school-aged children.

(a) Define the term *sole trader*. *[4 marks]*

(b) Examine the costs and benefits to Cam Tran operating her business as a sole trader. *[6 marks]*

(ii) Partnerships

A **partnership** is a for-profit private sector business owned by two or more persons. For **ordinary partnerships**, the maximum number of owners is 20 (although this can vary from one country to another). The few exceptions to this rule include professions such as solicitors and accountants where issuing shares is prohibited.

Like sole traders, partnerships are financed mainly from the personal funds of each owner. However, partners can pool their funds together to raise more finance than sole traders. They can also raise money from owners who do not actively take part in the running of the partnership but have a financial stake in it. These investors are called **silent partners** (or **sleeping partners**) and are eligible for a portion of any profits earned by the partnership. At least one owner must have unlimited liability, as partnerships are unincorporated businesses, but typically all partners share this liability.

Although it is not a legal requirement, most partnerships create a formal legal agreement between each of the partners. Without a contract, profits or losses must be shared equally amongst the partners who have the same rights in the running of the business.

If a legal contract is drawn up, known as a **deed of partnership** (or **partnership deed**), then it is likely to include:

- The amount of finance contributed by each partner
- The roles, obligations and responsibilities of each partner
- How profits or losses are to be shared between the partners
- Conditions for introducing new partners
- Clauses for the withdrawal of a partner
- Procedures for ending the partnership.

Figure 2.3 - Partnerships consist of two or more owners

Table 2.2 - The advantages and disadvantages of partnerships

Advantages of partnerships	Disadvantages of partnerships
Financial strength - Partnerships have more financial strength than sole proprietorships as there are more owners who can invest in the business, yet they are still fairly easy to set up. In general, it is also easier for partnerships to secure external sources of finance due to the lower risks.	**Unlimited liability** - Legally, partnerships are responsible for their debts 'wholly or severally' meaning the debts can be repaid by either one partner (wholly) or shared among the partners (severally). The rare exception is with *limited liability partners* who have been elected to have limited liability.
Specialisation and division of labour - Unlike sole traders, partners can benefit from shared expertise, shared workload and moral support. For example, a law firm might have partners who specialise in corporate law, divorce law and criminal law. As a result, its client base is likely to be much larger.	**A lack of continuity** - Problems may exist if a partner leaves the firm or passes away because the partnership deed becomes invalid, i.e. it has to be set up again. It is possible to accommodate some changes in a deed of partnership, although solicitors will need to spend time (and money) on drafting the new contract.
Financial privacy - Like sole proprietorships, partnerships do not have to publicise their financial records. Therefore, they can enjoy a fair degree of financial privacy.	**Prolonged decision-making** - In comparison to sole traders, decision-making is likely to take longer as there are more owners involved. Disagreements and conflict might also occur.
Cost-effectiveness - Partnerships can be more cost-effective than sole traders as each partner specializes in certain aspects of their business, thus raising labour productivity and operational efficiency.	**Lack of harmony** - Disagreements and conflict within partnerships is common, but there must also be mutual trust. Each partner is legally and financially accountable to all others, so a mistake made by one person can reduce the profits for every partner.

Unlimited liability exists to prevent sole traders and partners from making careless and irresponsible decisions in managing their businesses. It makes private individuals accountable for their actions and decisions. However, the risk of loss of private property and personal possessions can deter sole traders and partners from taking risks, choosing to make safe decisions instead.

Question 2.3 - EXP

EXP is a small Chinese restaurant with take-away service located in London. It was established in 2016 by partners Keith and Tonina Hoang. EXP is run as a **partnership** with each partner having 50% of the stake in the business. They have a workforce of 12 people, including chefs, counter staff and delivery crew. EXP relies heavily on local customers but faces competition from nearby pizza outlets and Indian and Italian restaurants.

EXP's popularity has grown with a loyal customer base. Keith and Tonina had to discontinue with the distribution of take-away menus in the local area as EXP is already operating near full capacity. Keith and Tonina thought it best to maintain the quality of their food and the punctuality of their home deliveries to maintain the reputation that they have established.

(a) Define the term *partnership* in the context of business entities. *[2 marks]*

(b) Explain **two** advantages of running EXP as a partnership. *[4 marks]*

(c) Discuss the costs and benefits of EXP remaining as a small business. *[10 marks]*

(iii) Privately held companies

Companies are businesses owned by their shareholders. Shareholders are individuals or other businesses that have invested money to provide share capital for a company or corporation. Corporations are sometimes called **joint-stock companies** because the shares of the business (or 'stock' as they are sometimes known) are jointly held by numerous entities.

Companies are *incorporated* businesses, i.e. there is a legal difference between the owners of the company (the shareholders) and the business itself. The company, being a separate legal entity, has its own legal rights and duties. For example, the company, rather than the owners, would take those who infringe copyright and patent laws to court. It also means that companies have **limited liability** - shareholders do not stand to lose personal belongings if the company goes into bankruptcy or liquidation (see Chapter 19). The maximum a shareholder can lose is the value of his/her investment in the company. This is to safeguard investors - imagine an ordinary individual having to share the debts of a large multinational company that s/he had invested in!

Setting up a company can be complicated and expensive, e.g. there are rules and regulations that must be obeyed for shares to be sold on the **stock exchange**. A stock exchange is a marketplace for trading stocks and shares of publicly held companies (or public limited companies). Examples include the London Stock Exchange (LSE) and the New York Stock Exchange (NYSE).

One reason for such legislation is to protect investors who buy shares in businesses that they do not run or control. A **Board of Directors** (BOD) is elected by shareholders to run the company on their behalf. Directors are elected because of their skills and expertise and because shareholders do not necessarily want to get involved in the daily running of the company. The BOD is held responsible for the running of the company but is held accountable to the shareholders. In most cases, each share held equals one vote, so the more shares held by an investor the more voting power they have. In reality, individual shareholders tend to have very little say as it is the large institutional investors and directors who hold the majority of the shares in a limited liability company.

Exam tip !

Students often use the words 'business' and 'company' interchangeably. Whilst this can be true, it is important to remember that 'companies' are owned by shareholders, so there can only be two types of companies: privately held companies and publicly held companies. The term 'business' also includes other forms of business entities, such as sole traders and partnerships. In summary then, all companies are businesses but not all businesses are companies.

There are two types of limited liability companies – privately held companies and publicly held companies.

A **privately held company** (or **privately owned company**) is a limited liability company that cannot raise share capital from the general public via a Stock Exchange. Instead, shares are sold to private family members and friends. The shares cannot be bought or sold without the prior agreement from the BOD, so that the directors can maintain overall control of the company.

Box 2.1 - Ten examples of privately held companies

- Aldi - Discount supermarket (Germany)
- Chanel - Fashion and Cosmetics (France)
- Ernst & Young - Accounting (USA)
- Huawei - Consumer electronics and technologies (China)
- IKEA - Home furnishing (Sweden)
- LEGO - Toys (Denmark)
- Mars Inc. - Confectionary (USA)
- Rolex - Prestigious wristwatches (Switzerland)
- PriceWaterhouse Coopers - Accounting (USA)
- Virgin Group - Global conglomerate (UK)

For this reason, many privately held companies are run as family businesses. The business will usually have the word 'Limited' or the letters 'Ltd.' after its name. However, this practice varies from one country to another.

All companies must hold an **Annual General Meeting** (AGM) to allow the owners to have a say (or vote) in the running of the business. There are three main processes at a typical AGM:

- Shareholders vote on *resolutions* (promises or declarations) and the re-election (or sometimes election) of the Board of Directors.
- Shareholders ask questions to the Chief Executive Officer (CEO), Directors and the Chairperson about various aspects of the company.
- Shareholders approve the previous year's financial accounts after the Directors present the annual report containing information about its financial performance.

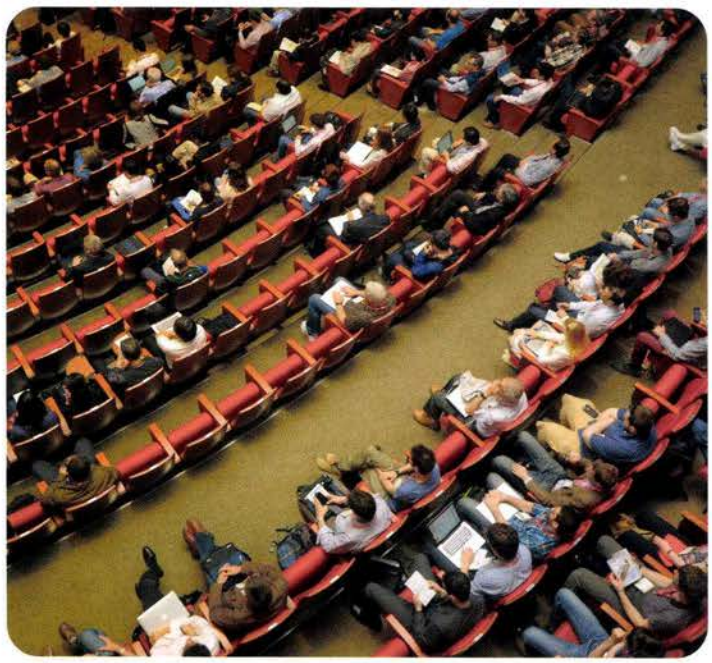

Figure 2.4 - Companies must hold an AGM for their shareholder

Table 2.3 - The advantages and disadvantages of limited liability companies

Advantages	Disadvantages
Raising finance - Companies can raise large amounts of capital by selling shares. There are no interest charges and shareholders are paid dividends only if the company earns a profit.	**Communication problems** - Quite often, as a company becomes larger, services and relationships can become more impersonal to both customers and employees.
Limited liability - As all companies have limited liability, it is easier to attract investors as the risks are relatively low for them.	**Added complexities** - Running a sole-proprietorship or partnership is cheaper and less bureaucratic than running a limited liability company.
Continuity - Unlike partnerships and sole traders, the legal difference between the company and its owners means it can continue to operate as a separate legal entity, even with a change of owners.	**Compliance costs** - Complying with the rules and regulations of being a company add to its running costs. This is particularly the case for publicly held companies due to stock exchange rules and regulations.
Economies of scale - Due to their larger size, companies can benefit from economies of scale (lower unit costs of production as the firms grow). For example, it is usually cheaper for a company to borrow money than it is for sole traders or partnerships as limited companies are less of a financial risk.	**Disclosure of information** - Financial data must be provided to all shareholders. This can be a time consuming and expensive task as auditors have to be hired and Annual Reports have to be published and distributed. Privacy no longer exists, in comparison to that enjoyed by sole traders and partners.
Productivity - Companies can hire directors and specialist managers to run the firm as there is no need for the owners to be directly involved in the daily running of the business. They are also more likely to employ specialist staff such as marketers, lawyers and accountants. Therefore, the output and productivity levels of limited liability companies are generally higher than found in sole proprietorships and partnerships.	**Bureaucracy** - There is far more bureaucracy involved in setting up and running a company, e.g. in the UK, the Companies Act 2006 states that a minimum of £50,000 ($70,000) must be issued as share capital. Solicitors must be hired to ensure that all documents are legally accurate. Advertising and promoting the company's initial public offering (IPO) adds to the costs. Hosting the AGM is also expensive.
Tax benefits - Sole traders and partnerships pay *income tax* on their profits. By contrast, companies pay *corporation tax* on their profits. The highest income tax rate tends to be greater than the rate for corporation tax. Companies also benefit from a wider range of allowances and tax-deductible costs.	**Loss of control** - Whilst sole traders and partnerships retain control of their businesses, publicly held companies face the potential threat of a takeover by a rival company that purchases a majority stake in the business (as shares are openly available for purchase on a public stock exchange).

Before limited liability companies can begin trading, two documents must be produced and submitted to the appropriate authorities:

- The **Memorandum of Association** - a relatively brief document outlining the fundamental details of the company, such as its trading name, its main purpose, the registered business address and the amount of share capital invested.
- The **Articles of Association** (or **Articles of Incorporation**) - the longer of the two documents, stipulating the internal regulations and procedures of the company, such as the rights, roles and power of the BOD and shareholders. Administrative issues are also covered, such as procedures of the Annual General Meeting (AGM), the processes for the appointment of directors and how profits will be distributed.

Once the authorities are satisfied with the above documents and an application fee has been paid, a **Certificate of Incorporation** is issued to the company. This license recognises the business as a separate legal entity from its owners (shareholders) and allows the business to start trading as a limited liability company.

Question 2.4 - Mars Inc.

Mars is a global confectionery and food processing manufacturer with annual sales in excess of $37bn. Perhaps more surprisingly and unusual for a business of this size, Mars is entirely owned by the Mars family, as a **privately held company** - making it one of the largest family-owned businesses in the world. the company employs more than 130,000 people.

The company started with Franklin Clarence Mars (1883-1934) back in 1911 when he and his wife Ethel started making and selling a variety of butter-cream candies in their home in Washington, USA. In 1920, Frank and his son Forrest Edward Mars produced the *Milky Way* bar - known in Europe and other parts of the world as the 'Mars bar'. It was an immediate success.

Today, the portfolio of Mars brands includes Snickers, Wrigley, M&M's and Twix. Having diversified into pet foods, its brands also include Pedigree, Whiskas, Cesar and Sheba. Mars brands are recognised and used in almost every country on the planet.

Source: adapted from Mars website (www.mars.com

(a) Define the term *privately held company*. *[2 marks]*

(b) Discuss the decision of the Mars family to keep their business as a privately held company. *[10 marks]*

Publicly held companies

Whilst a **publicly held company** shares many similarities with a privately held company, it is able to advertise and sell its shares to the general public via a Stock Exchange. It often carries the letters 'PLC' after its name, but again this practice varies between regions (see Box 2.2). Box 2.3 shows examples of publicly held companies.

Box 2.2 - Abbreviations for publicly held companies

- Australia — Pty. Ltd. (short for 'proprietary limited company')
- Germany — AG (short for 'AktienGesellschaft' meaning 'shareholder corporation')
- Nigeria — Ltd. (short for 'private limited company')
- Sweden — AB (short for 'Aktie Bolag' meaning 'limited liability company')
- UK — PLC (short for 'public limited company')
- USA — Inc. or Corp. (short for 'incorporated' or 'corporation')

Flotation is the term used to describe when a publicly held company first sells all or part of its business to external investors (shareholders). This process is known as an **initial public offering** (IPO). The IPO makes the publicly held company *listed* (or registered) on a public stock exchange. Flotation helps to generate additional sources of finance for the company. For example, the Agricultural Bank of China raised $22.1 billion in proceeds from its IPO in 2010, the second-largest IPO of all time. The second largest IPO took place in 2014 when Alibaba Group raised $25 billion on the New York Stock Exchange (NYSE). In 2019, Saudi Aramco broke the IPO record by raising $25.6 billion on the Tadāwul Saudi Stock Exchange.

Figure 2.5 - The NYSE is on Wall Street, Lower Manhattan in New York City

Box 2.3 - Ten examples of publicly held companies

- Apple - Technology (USA)
- Coca-Cola Company - Beverages (USA)
- HSBC - Banking (UK and Hong Kong SAR)
- Michelin - Tyre manufacturer (France)
- MTN Group - Mobile telecommunications (South Africa)
- Nike, Inc. - Sportswear and sports equipment (USA)
- Philips - Electronics conglomerate (Netherlands)
- Samsung - Electronics (South Korea)
- Vodafone - Telecommunications (UK)
- Volkswagen Group - Automobiles (Germany)

Case study 2.3 - Google

On 19th August 2004 Google Inc. floated on the NASDAQ stock exchange following its flotation, thereby becoming a public limited company and raising $2.7bn in the IPO. The shares floated at $85 each but had reached over $600 by 2014 (an increase of over 605% in ten years). By November 2021, Google's share price hit a(nother) peak of $3,037 which represents a rise of 3,473% since its IPO.

The largest shareholders of publicly held companies tend to be institutional and commercial investors, i.e. companies have shares in other companies. For example, Porsche is the majority shareholder of German automaker Volkswagen, which in turn owns a majority of the shares in Audi, Bentley, Bugatti, Lamborghini, SEAT and Skoda.

Nevertheless, shareholders of companies face potential risks, despite their liability being limited. Unprofitable companies cannot distribute any dividends. The share price is likely to fall as a result, causing negative capital growth. Shareholders also place their trust in the Board of Directors and senior management team to run the company on their behalf, although the interest of directors, managers and shareholders might conflict (see Chapter 4). For example, managers and directors might decide to improve pay and conditions to address concerns from the workforce, but this could reduce the amount of funds available for dividends paid to shareholders.

Common mistake

It is incorrect to state that privately held companies are smaller than publicly held companies because this is not necessarily the case. IKEA, LEGO, Huawei, PricewaterhouseCoopers and Mars are all market leaders in their respective industries.

Business Management Toolkit (HL only)

Discuss how the use of Porter's generic strategies (see Chapter 53) can support strategic decision-making in private sector business organizations.

For-profit social enterprises (AO3)

The main features of the following types of for-profit social enterprises: (i) private sector companies, (ii) public sector companies and (iii) cooperatives.

Social enterprises are revenue-generating businesses with social objectives at the core of their operations. Whilst commercial for-profit businesses strive to return a profit for their owners, for-profit social enterprises strive to return a surplus for social gain rather than personal gain.

Social enterprises can be operated as a non-profit organization or as a for-profit company. Either way, all social enterprises have two main goals:

1. To achieve social objectives and
2. To earn revenues in excess of their costs.

After all, social entrepreneurs (those who use businesses to solve social issues) cannot deliver the social good they desire if they do not manage the financial health of their business. Their success in helping others depends on their ability to operate as a sustainable business, i.e. without a surplus or profit, there is no business for the greater good.

Case study 2.4 - Grameen Bank

In 1983, social entrepreneur Muhammad Yunus established the Grameen Bank in Dhaka, Bangladesh. Grameen Bank, often referred to as the 'bank for the poor' was set up to provide small loans (known as microfinance) to those living in poverty so that they would be able to become financially self-sufficient. Instead of operating like commercial banks, the Grameen Bank does not require any collateral (financial security) from its borrowers.

According to its website (https://grameenbank.org/), over 97 percent of borrowers are women. The Grameen Bank has assets in excess of $2.8bn and employs more than 20,000 workers. Its success as a social enterprise meant that Dr. Muhammad Yunus received the Nobel Peace Prize in 2006 and the Presidential Medal of Freedom award bestowed by US President Barack Obama in 2009.

The main benefits of social enterprises are:

- They use any financial surplus to benefit others in society, beyond personal rewards for shareholders and owners.
- They create employment opportunities, thereby improving the economic and social landscape of local communities.
- They are run in a transparent way, providing tangible benefits in addition to having a clean corporate conscience in the strive to achieve its social mission.
- There are three main types of for-profit social enterprises: (i) private sector companies, (ii) public sector companies and (iii) cooperatives.

(i) Private sector companies

Private sector for-profit social enterprises operate in a similar way to traditional for-profit businesses, but it is what these organizations do with their profits or financial surplus that sets them apart. For-profit social enterprises reinvest or donate any surplus to create positive social change. Furthermore, private sector for-profit social enterprises use ethical business practises to achieve their social aims related to the needs of local communities and societies.

This means that such private sector companies earn their revenues and financial surpluses in socially responsible ways. To benefit the society, a social business organization conducts activities related to the society. Unlike charities that rely on donations, private sector for-profit social enterprises need to earn a financial surplus in order to survive and operate as a sustainable business. Earning a financial surplus is also important to enable these social enterprises to expand their business activities and outreach programmes.

Private sector for-profit social enterprises produce goods or provide services in the same way as for-profit commercial organizations. They can also be established as different legal entities that operate in the private sector, such as private or publicly held companies or as cooperatives. They also compete with other businesses that operate in the same market.

Both private and public sector for-profit social enterprises have three broad aims, commonly referred to as the triple bottom line. The triple bottom line is an accounting framework coined by John Elkington in 1994, consisting of:

1. *Economic aims* – to earn a profit (or surplus) and to reinvest this surplus back in the business for societal benefits.

2. *Social aims* – to provide benefits to people in society, such as jobs opportunities in the local community and to support less-advantaged members of society.

3. *Environmental aims* – to protect the planet, by operating in environmentally friendly and sustainably responsible ways.

(ii) Public sector companies

Public sector for-profit social enterprises are state-owned enterprises run in a commercial way. They are formed by the government through legal means and regulated as they participate in commercial business activities for financial gain. These public sector companies are owned by the government, whether wholly or partially. They help to raise much-needed government revenues yet provide essential services that may be inefficient and undesirable if left solely to the private sector. Examples of such business entities include some national airline carriers, airport authorities, transport operators, telecommunications companies and operators of postal services.

Examples of public sector companies run as for-profit social enterprises include:

- Australia Post is the Australian government's business entity that provides postal services, with over 4,330 outlets throughout Australia.
- Egyptian National Railways (ENR) is the national railway of Egypt, operated by the state-owned enterprise Egyptian Railway Authority.
- Ontario Niagara Parks Commission manages the Canadian side of Niagara Falls, with focus on reformed land use and sustainable tourism.
- Televisión Nacional de Chile (TVN) is the leading Chilean public service television broadcaster, founded in 1969.
- Temasek Holdings is a Singaporean state-owned enterprise that owns 56% of the shares in Singapore Airlines.

Case study 2.5 - China Mobile

China Mobile is the world's largest mobile phone operator with over 945.5 million subscribers. Founded in 1997, China Mobile is a state-owned public sector company, with the Government of the People's Republic of China owning 74.25% share of the company. China Mobile is listed on both the New York Stock Exchange and the Hong Kong Stock Exchange, with the government of the People's Republic of China holds over 74% of the publicly traded shares.

Question 2.5 - Hong Kong Disneyland (HKDL)

Hong Kong Disneyland (HKDL) is a theme park with three on-site hotels. The theme park is jointly owned by the Hong Kong Special Administrative Region of the People's Republic of China (the majority **shareholder**) and the Walt Disney Company. HKDL opened on 12th September 2005, having created 36,000 jobs. It is the smallest of all Disneyland theme parks in the world. HKDL did not earn a profit until 2012, declaring a net profit of HK$109m ($13.97m). Analysts estimated that the theme park would generate HK$148bn ($19bn) in net benefits to the economy over a 40-year period as the **public sector company** continues to expand its operations in Hong Kong.

(a) (i) Define the term *shareholder*. *[2 marks]*

(ii) Define the term *public sector company*. *[2 marks]*

(b) Discuss the decision of the Hong Kong Special Administrative Region of the People's Republic of China to expand HKDL as a public sector company. *[10 marks]*

Common mistake

Do not confuse a publicly held company with a public corporation. The former is a limited liability company that operates in the private sector but offers its shares to the general public on a stock exchange. The latter is owned and operated by the government on behalf of the general public or society as a whole.

(iii) Cooperatives

Cooperatives are for-profit social enterprises owned and run by their members, such as employees or customers, with the common goal of creating value for their members by operating in a socially responsible way. All employees (member of the cooperative) have a vote, thus contribute to decision-making. Cooperatives share any profits earned between their members.

Cooperatives operate in various industries, including retailing, financial services, childcare services, housing associations and agriculture (see Box 2.4). Canada, for example, has over 9,000 cooperatives with more than 18 million members and employ more than 150,000 people (www.cooperativedifference.coop/co-operatives-in-canada/). The UK's Cooperative Group is the world's largest consumer-owned business with over 4.5 million members. There are three main types of cooperatives, all of which are democratically owned and controlled:

- **Consumer cooperatives** are owned by the customers who buy the goods and/or services from cooperatives for personal use. Examples include food, credit unions (financial services), childcare, housing and healthcare cooperatives. In most cases, members get access to goods and services at lower prices than those charged by traditional commercial businesses.

- **Worker cooperatives** are set up, owned and organised by their employee members. Examples include cooperatives involved in production and manufacturing, printers, cafés, tourism and communications. By operating as an enterprise, members are also provided with work opportunities.

- **Producer cooperatives** are cooperatives that join and support each other to process and/or market their products. For example, a farmer cooperative might unite to buy equipment, fertilizers and seeds collectively, by pooling their funds. This enables all members to benefit from bulk purchase discounts. Farmer cooperatives are the most common example of producer cooperatives.

Box 2.4 - Examples of cooperatives

- Associated Press - a non-profit multinational news agency headquartered in the USA.
- Aurora Wine Cooperative - a producer cooperative in Brazil.
- Co-operative Bank - a British commercial bank, founded in 1872, with assets of £25.6 billion ($35.8bn).
- Crédit Agricole Group - one of France's largest banks and credit unions.
- Mondragon Corporation - a Spanish worker-cooperative that produces food and industrial products.
- Ocean Spray - a farmer-based cooperative of the popular cranberry and grapefruit juice drinks.
- Sunkist - US farmer-based producer cooperative that makes the famous Sunkist brand of fruit juices.
- Xinjiang Quanliang - a cooperative founded in 1980 for dairy farmers in China, with more than 2.6 million farmer members.

ATL Activity 2.1 (Research and Thinking skills)

Cooperatives operate under the guidelines and principles of the International Cooperative Alliance (ICA), founded in 1895. Investigate the role of the ICA (http://ica.coop/) and how it supports the cooperative movement around the world.

Table 2.4 - The advantages and disadvantages of cooperatives

Advantages of cooperatives	Disadvantages of cooperatives
Incentives to work - Employees have a stake in the cooperative so are more interested in how it performs. This can enhance staff motivation and productivity.	**Disincentive effects** - There might be ineffective managers and employees as cooperatives do not pay high salaries and bonuses as incentives to work.
Decision-making power - Employees have a say in how the business is run. There is a democratic system of members having equal voting rights. This can also improve the members' commitment and employee loyalty.	**Limited sources of finance** - Cooperatives might suffer from a lack of finance as most of them cannot raise funds through a stock exchange. Sources of finance are often limited to the amount contributed by their members.
Social benefits - Cooperatives are run on socially responsible principles leading to gains for other members of society rather than only for the owners. Thus, cooperatives create social gains that can be enjoyed by the wider community.	**Slower decision-making** - Decisions are likely to be slowed down (delayed) as all members of the cooperative work in a democratic way and are involved in the decision-making process. Every member has a voice in the organization.
Public support - A key advantage of social enterprises such as cooperatives is that there tends to be public support, i.e. people (including customers) want to help them succeed because they believe in the cause the cooperative stands for.	**Limited promotional opportunities** - Cooperatives tend to have flatter organizational structures (see Chapter 8), so there are fewer opportunities for employees to progress in their professional careers.

Note: As cooperatives operate in the private sector, they are an example of private sector for-profit social enterprises.

ATL Activity 2.2 (Research and Thinking skills)

Investigate the various types of for-profit social enterprises such as co-operatives in your country. Choose one organization and research its mission and objectives and how it operates. Be prepared to share your findings with the rest of the class.

Non-profit social enterprises (AO3)

The main features of the following types of non-profit social enterprises: non-governmental organizations (NGOs)

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Non-profit social enterprises are businesses run in a commercial-like manner but without profit being the main goal. Instead, non-profit organizations use their surplus revenues to achieve their social goals rather than distributing the surplus as dividends to its shareholders or owners. As former British Prime Minister Sir Winston Churchill (1874 - 1965) said, "*We make a living by what we get, but we make a life by what we give.*"

Examples include public libraries, state schools, museums, government hospitals and social services. Well-known non-profit social enterprises include Habitat for Humanity, Oxfam, the Red Cross and the World Wide Fund for Nature. The main type of non-profit social enterprises is non-governmental organizations (NGOs), including international charitable organizations.

Figure 2.6 - NGOs strive to make the world a better place

Exam tip !

The term 'non-profit organization' does not mean that the business does not strive to earn a profit or surplus but that this money must be retained in the organization for its self-preservation and growth. *Profit* is the reward that is distributed to the owners or investors of a business in return for risking their money in the business. By contrast, non-profit organizations (NPO) retain this surplus in the business. For example, many private fee-paying schools are NPOs because any surplus that they make is reinvested in the schools to enhance their facilities and improve teaching and learning.

Non-governmental organizations (NGOs)

The United Nations (UN) defines **non-governmental organizations** (NGOs) as "private organizations that pursue activities to relieve suffering, promote the interest of the poor, protect the environment, provide basic social services or undertake community development". They are private sector not-for-profit social enterprises that operate for the benefit of others rather than primarily aiming to earn a profit. Examples include Médecins Sans Frontières (Doctors Without Borders) and Friends of the Earth.

The term 'non-governmental organization' was coined in Article 71 of the UN Charter that was formed in 1945. An NGO, sometimes referred to as a **private voluntary organization** (PVO), can be any kind of organization so long as:

1. it is independent of the government or direct public sector influence and
2. it is not-for-profit.

Many NGOs are very large organizations, such as Oxfam (global poverty alleviation), Greenpeace (environmental protection), Amnesty International (human rights) and the United Nations International Children's Fund or UNICEF (children's welfare). They are run by a group of senior managers and trustees, similar to a limited liability company's board of directors.

There are two main types of NGOs:

- **Operational NGOs** are established from a given objective or purpose. These NGOs tend to be involved in relief-based and community projects, such as Oxfam and UNICEF.
- **Advocacy NGOs** take a more aggressive approach to promote or defend a particular cause, striving to raise awareness and support through direct action (such as lobbying, public relations and mass demonstrations), such as Greenpeace and Amnesty International.

Case study 2.6 - The Bill & Melinda Gates Foundation

The Bill & Melinda Gates Foundation was set up in 2000 to enhance healthcare and reduce extreme poverty around the world. It is the largest non-profit private sector social enterprise in the world. The Foundation is controlled by its three trustees (the people at the top of the organization): Bill Gates, Melinda Gates and Warren Buffett - the three most generous philanthropists in the USA. According to CNBC, Bill and Melinda Gates have donated over $50 billion to the Foundation.

Theory of Knowledge (TOK)

Can we 'know' if for-profit organizations do not care about society as much as non-profit social enterprises?

Business Management Toolkit

Examine the impact of changes in the external environment on non-governmental organizations. You may find it useful to refer to Chapter 46 (STEEPLE analysis) before attempting to answer this question.

Types of business entities and the key concepts

There are various factors that affect the strategic choice of business entity, including:

- **Amount of finance** - Sole traders and partnerships need less start-up capital than a publicly held company. A change in the legal status of a business will usually require more finance (see Chapter 14).
- **Size** - The larger and more complex the business operations, the more likely it is to be a limited liability company (corporation). Sole traders, for instance, find it unnecessary or unaffordable to hire a large workforce or to operate a tall hierarchical structure (see Chapter 8).
- **Limited Liability** - The desire to have limited liability, in order to protect the personal possessions of the owners, can affect the choice of legal status of a business entity.
- **Degree of ownership and control** - Those who wish to retain control and ownership of a business may prefer to stay relatively small as sole traders or even as privately held companies.
- **The nature of business activity** - The type and scale of business activity can influence the legal status of an organization, e.g. mainstream aircraft and motor vehicle manufacturers rely on external sources of finance (see Chapter 14), so are likely to be formed as publicly held companies.
- **Change** - As a business grows and evolves (see Chapter 6), it may need additional sources of finance and human resources. Thus, the type of organization and its legal status are likely to change.

Figure 2.7 - Some businesses choose to remain small

Key concept

With reference to an organization of your choice, examine how **change** has influenced its business strategy and choice of legal business entity.

Key concept

Discuss the role of **creativity** in creating **sustainable** competitive advantages for a business organization of your choice.

REVIEW QUESTIONS

1. How does the private sector differ from the public sector?
2. What is a sole trader?
3. What are the advantages and disadvantages of a sole trader as a business entity?
4. What is a partnership?
5. What are the advantages and disadvantages of a partnership as a business entity?
6. What is a privately held company?
7. Why is the concept of limited liability important for owners of a company?
8. What is a publicly held company?
9. How does a privately held company differ from a publicly held company?
10. What are the advantages and disadvantages of limited liability companies as a form of business entity?
11. What are social enterprises?
12. What are the differences between private and public sector for-profit social enterprises?
13. What are cooperatives?
14. What are the advantages and disadvantages of cooperatives as a form of business entity?
15. What is a non-governmental organization (NGO)?

KEY TERMS

Cooperatives are for-profit social enterprises set up, owned and run by their members, who might be employees and/or customers.

A **company** (or **corporation**) refers to a limited liability business that is owned by shareholders. A certificate of incorporation gives the company a separate legal identity from its owners (shareholders).

Deed of partnership is the legal contract signed by the owners of a partnership. The formal deeds specify the name and responsibilities of each partner and their proportion of any profits or losses.

Incorporation means that there is a legal difference between the owners of a company and the business itself. This ensures that the owners are protected by limited liability.

An **initial public offering** (IPO) occurs when a business sells all or part of its business to shareholders on a public stock exchange for the first time. This changes the legal status of the business to a publicly held company.

Limited liability is a restriction on the amount of money that owners of a company can lose if the business goes bankrupt, i.e. shareholders cannot lose more than the amount they invested in the company.

Non-governmental organizations (NGOs) are private sector not-for-profit social enterprises that operate for the benefit of others rather than primarily aiming to earn a profit, such as Oxfam and Friends of the Earth.

Partnerships are a type of private sector business entity owned by 2-20 people (known as partners). They share the responsibilities and burdens of running and owning the business.

The **private sector** is the part of the economy run by private individuals and businesses, rather than by the government, such as sole traders, partnerships, privately held companies and publicly held companies.

A **privately held company** is a business owned by shareholders with limited liability but whose shares cannot be bought by or sold to the general public on a Stock Exchange.

A **publicly held company** is an incorporated limited liability business that allows shareholders to buy and sell shares in the company via a public Stock Exchange.

The **public sector** is the part of the economy controlled by the government. Examples include state healthcare and education services, the emergency services, social housing and national defence.

A **sole trader** is a self-employed person who runs the business on his/her own. This mean s/he has exclusive responsibility for its success (profits) or failure (unlimited liability).

Social enterprises are revenue-generating businesses with social objectives at the core of their operations. They can be for-profit or non-profit business entities, but all profits or surpluses must be reinvested for that social purpose rather than being distributed to shareholders and owners.

A **stock exchange** is a marketplace for trading stocks and shares of publicly held companies (or public limited companies). Examples include the London Stock Exchange (LSE) and the New York Stock Exchange (NYSE).

Unlimited liability is a feature of sole traders and ordinary partnerships who are legally liable or responsible for all monies owed to their creditors, even if this means that they have to sell their personal possessions to pay for their debts.

Figure 2.8 - Sole traders and partnerships have unlimited liability

Chapter 3
Unit 1.3 - Business objectives

"If you are working on something exciting that you really care about, you don't have to be pushed. The vision pulls you."
- Steve Jobs (1955 - 2011), Co-founder and former CEO of Apple

Contents

1.3 Business objectives	
SL/HL content	**Depth of teaching**
Vision statement and mission statement	AO2
Common business objectives including: (i) growth, (ii) profit, (iii) protecting shareholder value and (iv) ethical objectives	AO3
Strategic and tactical objectives	AO3
Corporate social responsibility	AO2

Introduction to Business Management

CORE

Vision statements and mission statements (AO2)

Having a *vision* means to have an image of an ideal situation in the future. A **vision statement** therefore outlines an organization's aspirations (where it wants to be) in the distant future. For example, "To *be the leading sports brand in the world*" is the vision of Adidas, the German sportswear and sports equipment giant. Vision statements typically relate to the attainment of success, i.e. visualisation of what success would look like. Martin Luther King Junior's famous "*I have a Dream*" speech (28th August 1963) shows how having a clear vision can bring about fundamental and inspirational change.

Having a *mission* means to have a clear purpose. A **mission statement** tends to be a simple declaration of the underlying purpose of an organization's existence and its core values. For example, a school might set its mission as "the provision of wide opportunities and achievement for all." Unlike business objectives, the mission statement does not have a distinct time frame and tends to be qualitative rather than quantitative. A well-produced mission statement is clearly defined and realistically achievable. It provides a sense of direction, guides decision-making and unifies all people and corporate cultures within the organization in an attempt to achieve the overall vision.

Figure 3.1 - Adidas is Europe's largest sports apparel company

Although vision and mission statements are quite often confused, they do serve complementary purposes. The main differences are:

- The vision statement addresses the question 'what do we want to become?' whereas the mission statement deals with the question 'what is our business?'
- Vision statements are focused on the very long-term, whereas mission statements can focus on the immediate time period.
- Hence, mission statements are updated more frequently than vision statements.
- Vision statements do not have to be actual targets that must be achieved (this is the purpose of setting mission statements). Instead, vision statements allow people to see what *could* be.
- The mission statement tends to outline the values of the business, i.e. its beliefs and guiding principles that set the framework for how managers and employees operate on a daily basis.
- Mission statements are therefore about what the business does 'each and every day' and why it does this, whereas vision statements are about 'some day' (in the distant future).

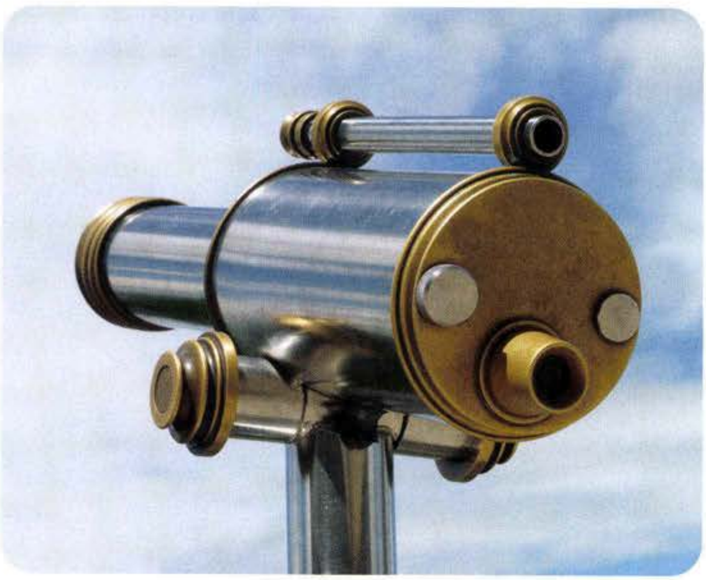

Figure 3.2 - Vision enables firms to know their long-term aspirations

Box 3.1 - Purpose and characteristics of mission statements

1. Defines the organization, i.e. what it is
2. Outlines what the organization aspires to be (in line with its vision statement)
3. Emphasises the organization's core values
4. Broad enough to allow for growth and evolution in a creative and sustainable way
5. Distinguishes the organization from others in the market
6. Serves to evaluate current business activities
7. Phrased clearly so that it is understood by all.

ATL Activity 3.1 (Thinking and Communication skills)

The IB's mission states that: *"The International Baccalaureate aims to develop inquiring, knowledgeable and caring young people who help to create a better and more peaceful world through intercultural understanding and respect."*

In groups of 2 or 3, discuss and reflect on the extent to which the IB Business Management curriculum addresses all aspects of the IB mission statement.

Despite the advantages of having vision and mission statements, there are some limitations. Some critics argue that such statements are no more than a public relations stunt. After all, the ultimate purpose of most businesses, they argue, is to maximize profits and protect shareholder value. Constructing meaningful vision and mission statements can also be very time consuming; it is difficult to draft a statement that caters for all the dynamics of a business and meets the needs of every stakeholder group. Even the best thought-out statements might not be supported by everyone, such as employees on part-time or temporary contracts. In such cases, it can be a lengthy process to convert people's beliefs and behaviour.

ATL Activity 3.2 (Thinking skills)

Reflect on your own school's vision or mission statement. To what extent is it applicable and appealing to all stakeholder groups of the school? To what extent is the vision or mission statement evident in the daily operations of your school?

ATL Activity 3.3 (Research skills)

Investigate the personal mission statements of famous leaders such as Benjamin Franklin, Mahatma Gandhi, Martin Luther King Jr. and Ludwig van Beethoven. Then have a go at reflecting on and/or discovering your personal values to build your own mission statement. A good starting point is FranklinCovey's mission statement builder website (https://msb.franklincovey.com).

Question 3.1 - Vision and mission statements

Examples of organizational vision and mission statements include:

- To be the most successful premium manufacturer in the industry - BMW
- The company exists to benefit and refresh everyone it touches - Coca-Cola
- To organise the world's information and make it universally accessible and useful - Google
- Creating the finest ice cream - Häagen-Dazs
- Inspire and develop the builders of tomorrow - Lego
- To help people and businesses throughout the world realise their full potential - Microsoft
- A just world without poverty - Oxfam
- To make people happy - Walt Disney Company

Source: Company websites

(a) Define the term **mission statement**. *[2 marks]*

(b) With reference to the above examples, explain the role of vision and mission statements in business organizations. *[4 marks]*

Common business objectives (AO2)

Common business objectives including: (i) growth, (ii) profit, (iii) protecting shareholder value and (iv) ethical objectives. AO3

Objectives are the goals or targets an organization strives to achieve. They are generally specific and quantifiable (measurable) and are set in line with the organization's mission statement. Without having clear business objectives, organizations have no real sense of direction or purpose. It is rather like getting into a taxi and not knowing where you want to go! Organizational objectives are important for three reasons:

- To *measure and control* – Business objectives help to control a firm's plans as they determine the parameters for business activity. Essentially, objectives provide the basis for measuring and controlling the performance of the business as a whole.

- To *motivate* – Business objectives can help to inspire managers and employees to reach a common goal, thus helping to unify and motivate the workforce. They also encourage managers to think strategically, i.e. to plan for the long term success of the business.

- To *direct* – Business objectives provide an agreed and clear focus (or sense of purpose) for all individuals and departments of an organization. As the foundation for decision-making, organizational objectives are used to devise appropriate business strategies.

Common business objectives, as specified in the syllabus, include: (i) growth, (ii) profit, (iii) protecting shareholder value and (iv) ethical objectives.

(i) Growth

The growth of a business is usually measured by an increase in its sales revenues or by its market share (the firm's sales revenue expressed as a percentage of the industry's total sales revenue). Growth is essential for the survival of a business in an ever-changing and competitive world, especially with the exposure of businesses to mergers and takeovers (see Chapter 6). The failure to grow may result in declining competitiveness and threaten the firm's sustainability.

Figure 3.3 - Growth is essential for business survival

(ii) Profit

Traditionally, the main business objective of most private sector organizations is to maximize profits. Profit provides an incentive for entrepreneurs to take risks in setting up and running a business. For incorporated businesses (Chapter 2), a proportion of the profits (called **dividends**) is distributed to their shareholders.

Without a profit motive, owners and investors find it difficult to justify the existence of the business. Milton Friedman (1912 - 2006), recipient of the Nobel Prize in Economics in 1976, said that "*there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits.*"

Key concept

Is it only ever possible for businesses to be profitable if they are **creative** and **ethical**?

(iii) Protecting shareholder value

This business objective is about generating long-term value for shareholders (owners) of the business. Protecting and maximizing shareholder value is about earning a profitable return for shareholders in a sustainable way.

Most shareholders do not typically get involved in the day-to-day operations of the company, so rely on directors, managers and employees to protect their interests. The board of directors is ultimately and directly responsible for protecting and managing shareholders' interests in the company. Shareholder value is the result of the business strategy the board of directors pursues. A challenge for the directors is to balance short-term profits (in the form of dividends) with an investment in the long-term value of the company.

Figure 3.4 - Directors are responsible for protecting shareholder value

Key concept

Discuss why **change** might be essential for businesses to protect shareholder value.

(iv) Ethical objectives

Ethics are the moral principles that guide decision-making and business strategy. They are concerned with what is considered to be right or wrong, from society's point of view. For example, the use of direct marketing techniques aimed at children is banned in many countries as this is deemed to be unethical. The existence of health and safety legislation helps to prevent the exploitation of employees.

Business ethics are therefore the actions organizations that are considered to be morally correct employ. An ethical business acts morally towards its workers, customers, shareholders and the natural environment. For example, an ethical employer would ensure all employees are given sufficient rest breaks during the day. Examples of ethical objectives that are in line with the use of circular business models (see Chapter 51) include:

- Disposal of waste in an environmentally safe manner.
- Fairer conditions of trade with low-income countries.
- Increased recycling of waste materials.
- Reducing pollution by using more environmentally friendly technologies and production processes.

Box 3.2 - Examples of unethical business behaviour

- *Financial dishonesty* occurs if a business mismanages its finances, such as the deliberate misrepresentation of its financial accounts (which is also illegal). There might also be moral issues, such as extravagant business expenses incurred by the directors (unethical but not illegal).
- *Environmental neglect and damage* often occur as business activity can create harmful consequences to the natural environment, such as environmental pollution and the depletion of non-renewable resources.
- *Exploitation of workers* occurs if employers mistreat employees through the deliberate neglect of their welfare. Many multinational companies have been criticised for the poor pay and working conditions offered to staff in low-income countries, for example.
- *Exploitation of suppliers* happens when large businesses take advantage of their suppliers, forcing them to cut prices. This is controversial, especially when the business is exploiting suppliers in low-income countries or when the savings are not passed onto consumers in terms of lower prices.
- *Exploitation of consumers* takes place if firms knowingly sell products that have harmful side-effects, such as tobacco, alcohol and gambling services. Large firms with few, if any, competitors might abuse their market power by charging customers excessively high prices.

Case study 3.1 - Unethical discrimination

- In 2006, Indian Airlines (now merged with Air India) was heavily criticised by the mass media for grounding female flight attendants for being too overweight to travel. They were told to lose weight or risk losing their jobs.
- In 2010, female workers at Hooters, an American fast-food chain, filed lawsuits against the company of claims of weight discrimination, after at least one worker was placed on weight probation.
- In 2021, the Norwegian women's beach handball team was fined by the European Handball Federation for refusing to play in bikini bottoms (opting instead to wear non-regulation shorts similar to those worn by male athletes) at the European Beach Handball Championships. According to the governing body of the sport, this broke the uniform regulations in the rules of the game.

Case study 3.2 - The ethics of fast food

Faced with negative exposure in best-sellers like Fast Food Nation and movies such as *Super-size Me* (https://goo.gl/mvGa2h), fast-food giant McDonald's responded to public demand for improvements by changing its product portfolio to include fresh salads and other healthier alternatives.

To achieve their ethical objectives, an increasing number of businesses have adopted an **ethical code of practice** and publish this in their annual reports. The code of conduct refers to the documented beliefs and philosophies of the business. It is important because people need to know what is considered acceptable or not acceptable within an organization, such as guidelines and expectations on employee behaviour. These values might differ from one individual to another and from one business to another. Hence, a code of ethics, such as having personal integrity and consideration for others, can provide a framework for consistency and uniformity in the workplace.

Table 3.1 - The advantages and limitations of having ethical objectives and practices

Advantages	Limitations
Improved corporate image - Acting ethically and in a socially responsible way can help to enhance the corporate image and reputation of a business. Conversely, the media will report unethical business behaviour which could seriously damage the firm's corporate image.	*Compliance costs* - The costs of being socially responsible are potentially very high. For example, producing organic agricultural products is far more expensive than growing and harvesting genetically modified crops due to the additional time and money involved.
Increased customer loyalty - Customers are more likely to be loyal to a business that does not act immorally. For example, The Body Shop has established a large customer base worldwide based on its ethical policy of not testing its products on animals.	*Lower profits* - If compliance costs cannot be passed onto consumers in the form of higher prices, the firm's profitability is likely to fall. An ethical dilemma for the business exists when ethical decision-making involves adopting a less profitable course of action.
Cost cutting - Ethical behaviour can help to cut certain costs, e.g. being environmentally friendly can reduce the amount of (excess) packaging. Ethical objectives and strategies can help the firm to avoid *litigation costs* (expenses associated with legal action taken against a business) that might otherwise arise from unethical and irresponsible activities.	*Stakeholder conflict* - Not all stakeholders are keen on the firm adopting ethical objectives, especially if this conflicts with other business objectives such as profit maximization. Speculative shareholders and investors may be more interested in short-term profits than the firm's long-term ethical stance. So, managers may be pressurised into pursuing other goals.
Improved staff morale and motivation - Ethical behaviour can help a business to attract and retain highly motivated staff. People are more likely to be proud of the firm they work for if it acts ethically and within the law. This also helps to improve productivity and employee loyalty.	*The subjective nature of business ethics* - Views about what is considered right or wrong depend on the beliefs and principles held by individuals and societies. Legislation can help to provide guidelines about what is socially acceptable, but even these are somewhat subjective in nature.

ATL Activity 3.4 (Thinking skill)

Scenario: You see a teacher drop her wallet in the school corridor, but the teacher doesn't realise she's done so. There are no other people around. What should you do?

Being principled is one of the aspects of the IB Learner Profile. The answer will depend upon the values or moral principles that you feel are important. These could be determined by numerous situational factors such as:

- Integrity - how honest you are.
- Sympathy - how you feel, if anything, about the teacher losing her wallet.
- Empathy - if you have experienced losing your own valuables, you will have a better understanding of the feelings of the teacher.
- Loyalty - the teacher could be your favourite teacher or someone you really respect.
- Conscience - whether the student has any concerns or feelings of guilt.
- Justice - you might think the teacher is rather careless and should learn the hard way!

Key concept

Discuss the value of **ethical** business objectives.

Key concept

Is it practical for a business to simultaneously protect shareholder value *and* strive to achieve **ethical** objectives?

Theory of Knowledge (TOK)

Using any two concepts from the TOK course, discuss how it is possible to 'know' what is right for managers to do.

ATL Activity 3.5 (Research skills)

Investigate how ethical business behaviour can improve the corporate image of a business **and** strengthen customer loyalty. Be prepared to share your findings with the rest of the class.

Business Management Toolkit (HL only)

Discuss how the use of force field analysis (see Chapter 55) can help managers and decision makers to determine their priorities and business objectives.

Strategic and tactical objectives (AO3)

Strategies are the medium to long-term plans of action to achieve the *strategic objectives* of an organization. **Tactics** are short-term methods used to achieve an organization's *tactical objectives*. Both strategy and tactics serve matching purposes, i.e. how a business intends to get to where it wants to be. Once a business has decided on its short- and long-term goals, it can then decide on the most suitable methods to achieve these targets.

Tactical objectives are short-term goals that affect a section of the organization. They are specific goals that guide the daily functioning of certain departments or operations, such as to raise sales revenue of a certain product line by $10m within the next year or to keep staff turnover below 10%. Tactical objectives tend to refer to targets set for the next 12 months or sooner. Such objectives might include:

- **Survival** - New and unestablished businesses are likely to encounter a number of problems (see Chapter 2) such as a lack of brand recognition, a small customer base and/or intense rivalry from existing firms. Hence, survival becomes a key tactical objective. Survival can also be important for more established organizations during an economic recession (see Chapter 46). For example, the global financial crisis of 2008 and the COVID-19 pandemic threatened the survival of many businesses across all industries. Alternatively, if a business becomes a takeover target (see Chapter 5), then its survival as it currently exists could easily become the key tactical objective.

- **Sales revenue maximization** - New businesses strive to maximize their sales revenue to establish themselves in the marketplace. Sales staff and agents, such as those selling insurance or real estate, favour this tactical objective as their earnings are linked to the value of sales revenue. However, sales revenue is not the same as profit (the surplus that remains after all costs are paid). In the long-term, a firm with high sales revenue but low or no profit will struggle to survive.

Strategic objectives are the longer-term goals of a business, such as profit maximization and growth explained above. Additional examples of interrelated strategic objectives are outlined below (but note that these vary between businesses, based on their own circumstances and priorities):

- **Market standing** - This refers to the extent to which a business has presence in the industry. For example, Microsoft has high market standing as the market leader in the computer software industry. Walmart has high market standing for being the world's largest retailer. Toyota has market standing as the world's largest car producer. Apple has high market standing due to its innovative products and designs. The Body Shop has high market standing for being a socially responsible business. Having high or good market standing brings competitive advantages for these businesses.

- **Image and reputation** - Businesses may strive to enhance their image and reputation. A bad image, perhaps portrayed by the media, can turn customers against a firm's products and services and tarnish the corporate image of the business. Increasingly, businesses strive to deliver improved levels of customer service, offer better facilities and deliver superior after-sales care. Employees are more likely to be motivated and proud if the business has a positive corporate image. This helps to attract and retain high-calibre employees and managers. Suppliers also prefer to do business with organizations that are reputable and reliable.

- **Market share** - Businesses may strive to increase their market share over time. Market share is measured by expressing the firm's sales revenue as a percentage of the industry's total sales. The higher the firm's market share, the greater its market dominance and ability to compete against rivals in the industry.

In practice, businesses have a combination of strategic objectives, which are subject to change from time to time, such as survival being a key strategic objective if a firm is threatened by a hostile takeover (see Chapter 5). The organizational culture (see Chapter 11) and whether a business operates in the private or public sector (see Chapter 1) are also factors that affect the aims and objectives it sets.

It should be noted that business objectives have the potential to conflict. For example, employees may demand better pay and working conditions which may subsequently reduce profits, at least in the short-term. Nevertheless, in the pursuit of success, managers must base their strategy on achieving the organizational objectives. As American media mogul William Randolph Hearst (1863-1951) said, "*You must keep your mind on the objective, not on the obstacle.*"

Question 3.2 - Lenovo

Chinese multinational technology company Lenovo acquired the personal computers division of IBM in 2005. Lenovo's goal was to establish itself outside of the Asian market by owning IBM's globally recognized brands such as ThinkPad laptops. Lenovo is committed to four key values:

- Customer service
- Trust and integrity
- Teamwork across cultures
- Innovation and entrepreneurial spirit.

Lenovo strives to increase its market presence by sponsoring key sporting events and teams, such as McLaren, the British Formula One (Grand Prix) Team, the Williams Formula One racing team, the National Basketball Association (NBA) and the 2008 Beijing Olympic Games. In 2012, Lenovo became the official sponsor of the National Football League (NFL), its largest sponsorship in America. Its **strategy** has helped the company to gain **market share** around the world.

Source: adapted from www.lenovo.com

(a) (i) Define the term *strategy*. *[2 marks]*

(ii) Define the term *market share*. *[2 marks]*

(b) Explain why is it important for Lenovo to specify its organizational objectives. *[4 marks]*

(c) Examine the barriers that might prevent Lenovo meeting its objectives. *[6 marks]*

Key concept

To what extent should business objectives incorporate **creativity**?

Theory of Knowledge (TOK)

Some people argue that by targeting children, especially in an era of growing child obesity in many parts of the world, parents face unnecessary pressure to buy their children fast food products. Do you consider McDonald's marketing of its 'Happy Meal' as simply creative or unethical? Justify your answer.

Corporate social responsibility (CSR) (AO3)

Corporate social responsibility (CSR) is the conscientious consideration of ethical and environmental practise related to business activity. A business that adopts CSR acts morally towards all of its various stakeholder groups (see Chapter 4) and the well-being of local communities and society as a whole. For example, McDonald's employees regularly go on litter patrol to collect rubbish (including trash not generated by McDonald's customers) in the vicinity of their restaurants. It also gets involved in local community fund-raising events such as supporting charity runs. Lenovo, China's largest computer maker, commits 1% of its pre-tax income to good causes as part of its CSR policy. During the global COVID-19 pandemic, Eric Yuan (CEO of Zoom) gave away the premium version of Zoom's videoconferencing software to schools, completely free of charge, to help educators and students affected by school closures.

Figure 3.5 - Many businesses support local community events such as charity runs

Box 3.3 - Examples of CSR

- Providing accurate information and labelling - This can help consumers to make more informed decisions. For example, food manufacturers might provide truthful nutritional information.
- Adhering to fair employment practices - Firms can fulfil their corporate social responsibilities to their employees by providing decent working conditions, fair remuneration and training and development opportunities. Conversely, some multinational companies have been criticised for exploiting child labour by hiring under-aged workers in low-income countries.
- Having consideration for the environment - Businesses may seek to use more recycled materials in the production process, recycle a greater proportion of their waste materials and aim to reduce any pollution or environmental damage caused by their activities.
- Active community engagement - This includes voluntary and charity work and other ways to help give something back to society. Examples include sponsoring and participating in local community events.

Media exposure in many countries has meant that large multinational companies are expected to donate part of their profits to charity. Customers are more careful about spending money on products from socially irresponsible firms. Investors are more wary of placing their money with unethical firms, such as those that employ child labour. Through pressure group action and educational awareness, climate change and environmental damage are huge concerns of governments and citizens around the world, so businesses are changing their objectives to reflect their part in the protection of the planet. Businesses that continue to pollute and damage the environment are likely to earn themselves a poor corporate image with devastating consequences. Hence, society's changing perception of what is considered socially moral will directly affect an organization's view of its own corporate social responsibilities and business objectives.

Figure 3.6 - Businesses have a moral obligation to protect the planet

The nature of CSR is rather subjective - what is considered 'right' or 'wrong' is largely based on public opinion. The subjective nature of CSR also means that attitudes may change over time. What was once considered socially acceptable, such as advertising campaigns targeted specifically at young children, may no longer be the case. Environmental protection was not a major issue prior to the 1980s. Some countries do not think it is necessary to impose a national minimum wage, whilst others feel that such regulation prevents some businesses from paying unethically low wages to their employees. The advertising of tobacco products is considered socially immoral in many parts of the world (where advertising of tobacco products is banned), but this is not the case in other countries.

CSR is further complicated when businesses operate in different countries. This is because what might be considered acceptable in one country might be totally undesirable in others. For example, Serbia, Bangladesh and Russia are huge consumers of tobacco, so cigarette advertising is less stringent than in other countries such as the UK and Singapore. Australia and Canada judge environmental concern as a key indicator of CSR, whereas India and China place less emphasis on environmental protection.

Businesses have long realised that a good reputation (how others view the organization) can give them an important competitive advantage. According to *Fortune* magazine, the top 500 American firms donate over 2% of their post-tax profits to charity. This might be due to their goal or desire to act in a socially responsible way, or it could be due to the fear of negative publicity caused by non-compliance. Acting in a socially responsible way can help to improve a firm's reputation, but the compliance costs will add to its expenses. For employees and investors to support the organization to meet its ethical objectives, they must be convinced that CSR is in their best interest too.

Question 3.3 - CSR at McDonald's and Burger King

Ronald McDonald House Charities (RMHC) is a **non-profit organization**, created by McDonald's. The charity's mission statement is to *"directly improve the health and well-being of children"*. Operating in 64 countries and regions, RMHC has helped to make a difference to millions of seriously ill children and their families. *Source*: www.rmhc.org

Burger King, the world's second largest fast-food chain and the largest rival of McDonald's, has used humanely sourced meats and eggs since 2007. This means Burger King gives priority and better deals to suppliers that provide cage-free chickens and free-range pigs. Burger King operates two national charitable organizations: the Have It Your Way Foundation (which focuses on hunger alleviation, disease prevention and community education) and the McLamore Foundation (providing scholarships to students since 2000). *Source*: www.bkmclamorefoundation.org

(a) Define the term *non-profit organization*. *[2 marks]*

(b) In the context of the above case studies, explain the meaning of ethical business behaviour. *[4 marks]*

(c) Distinguish between vision and mission statements. *[4 marks]*

(d) Discuss whether acting ethically ultimately provides McDonald's and Burger King with competitive advantages. *[10 marks]*

Key concept

Justify whether protecting shareholder value or corporate social responsibility (CSR) is a more **sustainable** business objective.

Theory of Knowledge (TOK)

Does the lack of awareness and knowledge of ethics allow businesses to neglect their morale obligations as a business entity?

Despite the driving forces for setting ethical objectives, whether a business acts in a socially responsible way depends on several interrelated factors:

- The involvement, influence and power of different stakeholder groups, such as pressure groups and the government.
- The corporate culture and the firm's attitude towards CSR and ethical objectives.
- Societal expectations, i.e. the general public's awareness and concerns for CSR issues.
- Exposure and pressure from the mass media.
- Experience - quite often it takes a crisis (see Chapter 41) or bad experience to precipitate attention to CSR.
- Compliance costs, i.e. the human and financial resources and costs needed to implement CSR policies.
- Laws and regulations, i.e. legislation that govern how firms conduct themselves in a socially responsible way.

ATL Activity 3.6 (Research skills)

Seconds from Disaster: The *Deepwater Horizon* is an excellent documentary that looks at the events of the Deepwater Horizon rig in the Gulf of Mexico. BP's attempts to cut back on safety checks ultimately resulted in the world's largest accidental marine oil spill, costing the company billions of dollars in lost revenues and fines.
Watch the video here: https://bit.ly/3JcaTcL

Question 3.4 - Walmart

Walmart is the world's largest retailer and largest private sector employer in America. The company has, on numerous occasions, been fined millions of dollars by the US government for violating air and water pollution legislation. This obviously harmed the image of the global retailer, with the media alleging that 8% of customers had stopped shopping at Walmart as a result of its neglect of the environment.

Labour unions have criticised Walmart's unethical business practices which have caused **labour turnover** rates of around 70% in some stores. Walmart has also been taken to court for alleged cases of not paying some employees for overtime, forcing them to work without proper rest breaks and discriminating against female workers for pay and promotion.

(a) Define the term *labour turnover.* *[2 marks]*

(b) State **two** possible barriers to a business, such as Walmart, behaving in a corporate socially responsible way. *[2 marks]*

(c) Discuss whether it is morally correct for businesses such as Walmart to put profits before the environment and the welfare of their employees. *[10 marks]*

Theory of Knowledge (TOK)

In reality, is it possible to determine whether CSR is genuine altruism or selfish acts used to improve a firm's corporate image for its personal gain? Does this even matter?

Theory of Knowledge (TOK)

Does the study of Business Management tend to steer people towards ethical or self-centred decision-making? Does this matter?

Business Management Toolkit

Using real-world examples, discuss the role of corporate social responsibility in relation to circular business models (see Chapter 51).

Business objectives and the key concepts

There are various factors that can cause the objectives of a business to change, requiring creative responses to these factors. Some of the **internal factors** (those within the control of the organization) that can cause a change in business objectives to ensure its strategies are sustainable include:

- *Corporate culture* (the accepted norms and customs of an organization) - Firms with a flexible and adaptable organizational culture are more likely to have creative objectives that change over time.

- *Type and size of organization* (see Chapter 2) - Any change in the legal status of a business entity is likely to cause a change in its objectives. With a separation of ownership and control, such as in the case of publicly held companies, various stakeholder objectives need to be considered, including managerial objectives (such as higher bonuses) and shareholder objectives (such as higher dividend payments from higher profits).

- *Private versus public sector organizations* - Unlike most private sector firms, most public sector organizations (see Chapter 2) do not strive for profit maximization but to provide a service to the general public.

- *Age of the business* - Newly established firms tend to have survival as their key objective, whereas established businesses might strive for growth and higher market share.

- *Finance* - The amount of available finance will determine the scope of a firm's objectives. For example, a huge sum of money is needed if the business objective is to expand into overseas markets.

- *Risk profile* - If managers and entrepreneurs have a relatively high willingness and ability to take risks, then more ambitious objectives are likely to be set, such as diversification strategies to enter new markets with new products (see Chapter 45).

- *Crisis management* - Businesses may face internal crises such as unexpectedly high staff absenteeism and labour turnover rates, falling productivity and motivation problems, liquidity problems (see Chapter 19), or issues about quality standards (see Chapter 37).

External factors (those beyond the control of the organization) can also change the objectives of a business to ensure its strategies are sustainable. These factors include:

- *State of the economy* - The state of the economy (see Chapter 46) can change business objectives. For example, an economic boom (when national income and employment are high) provides many business opportunities whereas a recession (when unemployment is high and consumption is low) can threaten business survival.

- *Government constraints* - Some government rules and regulations can limit creativity and what a business might strive to achieve. For example, environmental protection laws can limit the ability of firms to profit maximise due to the higher costs of compliance.

- *The presence and power of pressure groups* - Pressure groups, such as environmental protection groups, can force a business to review its approach to ethics through their lobbying activities. Pressure groups may harm a company's corporate image if it is not adopting a socially responsible and sustainable approach to conducting business.

- *New technologies* - New technologies and creativity can generate many new business opportunities, thus change business objectives. Innovative firms such as Samsung were able to exploit digital technologies to dominate the smartphone and smart TV industries. The use of e-commerce technologies has also revolutionised how most businesses operate.

Figure 3.7 - Digital boarding passes provide cost-saving benefits to airlines

A change in any of the above internal or external factors is therefore likely to change an organization's objectives over time. For instance, if a public sector organization is privatized (sold to the public sector), then the business may change its strategic objective from providing an affordable service to one of profit maximization. Therefore, business strategy (the tools used to achieve a firm's objectives) will subsequently change. A change in the strategic direction of a business will automatically require a change in business strategy to achieve its revised objectives. Changes in society's expectations of businesses, such as their ethical practices, will also directly affect their objectives and strategy. Finally, organizations also change their objectives over time simply because the original goals have been achieved so new ones need to be set for a sustainable future.

Exam tip !

Whist there is little, if anything, that a business can do about **changes** in the external environment, successful businesses alter their tactics and strategies to adapt to such changes. Also, remember that positive changes can occur from the external environment, thus creating business opportunities (see Chapter 46).

Theory of Knowledge (TOK)

Is it reasonable for an employee or an organization to be deceitful for the benefit of charity?

Theory of Knowledge (TOK)

Some analysts argue that it is not the role of managers to decide what is right or wrong. This is because managers do not use or risk their own money when making decisions about what they personally believe to be socially responsible. Instead, managers are employed to run a business on behalf of the owners who seek profit, rather than using money in socially responsible ways such as donating money to charity.

How can managers and decision makers know what is the right thing to do?

Key concept

With reference to an organization of your choice, discuss how **creativity** and **change** influence business objectives.

Key concept

Examine the impact of **ethics** on the business objectives of an organization of your choice.

Key concept

How important are corporate social responsibilities (CSR) and ethical business objectives for the **sustainability** and success of a business?

Key concept

For an organization of your choice, examine why business objectives might **change** over time.

REVIEW QUESTIONS

1. How do mission and vision statements differ from one another?
2. Why are objectives important to business organizations?
3. What does it mean for a business to protect shareholder value?
4. What is meant by ethical objectives?
5. How does growth differ from profit as business objectives?
6. How do strategic objectives differ from tactical objectives?
7. What is corporate social responsibility (CSR)?
8. What are the advantages and disadvantages of business acting in a socially responsible way?

Figure 3.8 - Ethics and CSR are important for the long-term success of a business

KEY TERMS

Corporate social responsibility (CSR) is the conscientious consideration of ethical and environmental practice related to business activity. A business that adopts CSR acts morally towards all of its various stakeholder groups and the well-being of society as a whole.

An **ethical code of practice** is the documented beliefs and philosophies of an organization, so that people know what is considered acceptable or not acceptable within the organization.

Ethical objectives are organizational goals based on moral guidelines, determined by the business and/or society, which direct and determine decision-making.

Ethics are the moral principles that guide decision-making and business strategy. Morals are concerned with what is considered to be right or wrong, from society's point of view.

A **mission statement** refers to the declaration of an organization's overall purpose. It forms the foundation for setting the objectives of a business.

Objectives specify what an organization strives to achieve. They are the goals of an organization, such as growth, profit, protecting shareholder value and ethical objectives.

Strategic objectives are the longer-term goals of a business, such as profit maximization, growth, market standing and increased market share.

Strategies are the various plans of action that businesses use to achieve their targets. They are the long-term plans of the organization as a whole.

Tactical objectives are short-term goals that affect a unit of the organization. They are specific goals that guide the daily functioning of certain departments or operations.

Tactics are the short-term plans of action that businesses use to achieve their objectives.

A **vision statement** is an organization's long-term aspirations, i.e. where the business ultimately wants to be.

Chapter 4
Unit 1.4 - Stakeholders

"Knowledge is of no value unless you put it into perspective."
- Anton P. Chekhov (1860 - 1904), Russian playwright

Contents

1.4 Stakeholders	
SL/HL content	**Depth of teaching**
Internal and external stakeholders	AO2
Conflict between stakeholders	AO2

Internal stakeholders (AO2)

The word 'stake' means to have an interest or to be involved in something. A **stakeholder** is any individual, group or organization with a direct interest or involvement in the operations and performance of a business. Hence, stakeholders are impacted by the activities of the organization. Stakeholders can be categorised as internal or external.

Internal stakeholders are members of the business, namely (i) employees, (ii) managers and directors and (iii) shareholders (owners) of the organization.

(i) Employees

The staff of a business will have a direct stake in the organization they work for. Employees are likely to strive to improve their pay (including other financial benefits), working conditions (such as hours of work and the physical working environment), job security and opportunities for career progression.

Theorists such as Charles Handy (see Chapters 8 and 11) argue that employees are an organization's most valuable asset. It is the staff who produce goods and services for sale; they are the ones who directly communicate with the customers. Consequently, more employers have encouraged their workers to be involved in decision-making. A motivated workforce is more dynamic and loyal. Hence, it is important for businesses to meet the needs of their employees as far as is possible. As American comedian Fred Allen (1894-1956) said, "*Treat employees like partners and they act as partners.*"

British entrepreneur Sir Richard Branson would agree with Charles Handy and Fred Allen. Branson famously declared that he puts his employees first, customers second and shareholders third. He claims that by doing this, both customers and shareholders will benefit. After all, demotivated workers are unlikely to produce good quality products or deliver good customer service (see Chapter 10). Worse, disgruntled staff might take industrial action (see Chapter 13). For example, around 40,000 BMW workers went on a prolonged labour strike at its South Africa car plant in late 2013 causing export sales to fall by 75%. In 2019, a pilots strike at British Airways cost the company lost earnings of €215 million ($245m).

(ii) Managers and directors

Managers are the people who oversee the daily operations of a business. **Directors** are senior executives who have been elected by the company's shareholders to take charge of business operations on behalf of their owners.

Senior managers and directors might aim to maximize their own benefits, such as annual bonuses and other financial rewards (see Chapter 10). Hence, they are likely to aim for profit maximization (see Chapter 3). This would also please the shareholders, helping to safeguard the jobs of top executives. Moreover, senior staff will look at the long-term financial health of their organization. For example, they might aim to retain profits for further investment in the business.

(iii) Shareholders

Limited liability companies (see Chapter 2) are owned by their **shareholders.** This stakeholder group invests money in a company by purchasing its shares. Shareholders (also known as **stockholders**) are a powerful stakeholder group as they have voting rights and a 'say' in how the company is run.

As the owners of the company, shareholders are entitled to a share of its annual profits. Shareholders have two main interests or objectives:

- To maximise *dividends* (a proportion of the company's profits distributed to shareholders).
- To achieve *capital gain* in the value of the company's shares (a rise in the value of the shares).

Common mistake

Many students confuse the terms *stakeholders* with *shareholders,* treating them as the same thing. Shareholders are the owners of a limited liability company so are only one stakeholder group of the business, albeit an important one.

Exam tip !

Some shareholders are internal stakeholders (such as directors or employees who hold shares in the company) whilst others can be external stakeholders (those who own shares in the company but are not directly involved in the daily operations of the business).

Question 4.1 - Nokia and Microsoft

Nokia was once the pride of Europe having been the market leader in the mobile phones industry from 1998 to 2008, enjoying up to 49.4% **market share.** In 2005, the Finnish company sold its one billionth mobile phone. By 2007, its market value was a staggering $150 billion, making it the 5th most valuable brand in the world.

However, the huge popularity of Apple and Samsung smartphones eventually forced Nokia to be sold to Microsoft for 'just' €5.4 bn ($7.3bn) in November 2013. An overwhelming 99.5% of Nokia's 3,900 shareholders voted in favour of the deal after seeing its share price drop by 93% and its market share continually decline to only 3%. The company's 32,000 employees who worked in the mobile phones division were transferred to Microsoft Mobile in early 2014.

(a) Define the term *market share.* *[2 marks]*

(b) Explain the difference between Nokia's *shareholders* and *stakeholders.* *[4 marks]*

(c) Examine how different stakeholder groups are likely to be affected by Microsoft's takeover of Nokia. *[6 marks]*

External stakeholders (AO2)

External stakeholders are not part of the business but have a direct interest or involvement in the organization. These compromise of (i) customers, (ii) suppliers, (iii) financiers, (iv) pressure groups, (v) competitors and (vi) the government.

(i) Customers

Customer care is very important in all aspects of business activity. Marshall Field (1834 - 1906), founder of Marshall Field & Company (a chain of American department stores, which was subsequently acquired by Macy's in 2005) said, "*Right or wrong, the customer is always right.*" Sam Walton (1918 - 1992), co-founder of the world's largest retailer Walmart, also believed in this thinking. He argued that customers can simply choose to spend their money elsewhere, thereby threatening the survival of a business.

In ever competitive markets, businesses have to increasingly listen to the opinions of their customers. Bill Gates, co-founder of Microsoft, built his fortunes by meeting the needs of customers all around the world. He said that dissatisfied customers are the best source of learning for any business.

Therefore, it is vital that businesses pay attention to the needs of their customers. These interests or objectives include having greater choice, better quality products and more competitive prices. Businesses use market research (see Chapter 26) to find out what customers want. For example, many businesses such as fast-food restaurants and hotels use customer 'suggestion schemes' and 'satisfaction surveys' to get feedback from their customers. Complaints and suggestions can then be considered by the management team. Ultimately, these actions signify the organization's desire to keep customers happy and loyal.

Figure 4.1 - Customer feedback can provide invaluable information for businesses

(ii) Suppliers

Suppliers provide a business with stocks (inventory) of raw materials, component parts and finished goods needed for production. They can also provide commercial services, such as maintenance and technical support. Suppliers strive for regular contracts with clients at competitive prices. They also request that customers pay any outstanding bills on time.

Businesses try to establish a good working relationship with their suppliers in order to receive quality stocks on time and at a reasonable price. For example, long-haul airline carriers rely on their catering suppliers to provide sufficient meals for their customers, otherwise flights might have to be cancelled if there is a dispute between the airline and the caterers. A good working relationship can also mean that suppliers offer preferential credit terms, which allows a business to purchase today but pay at a later date, thus improving its cash flow position (see Chapter 20).

(iii) Financiers

Financiers are the financial institutions (such as commercial banks and microfinance providers) as well as individual investors (such as business angels) who provide sources of finance for an organization. They are primarily interested in the borrowing organization's ability to generate sufficient profits and to repay the debts as well as making regular interest payments. Financiers earn money by charging interest on the amount of money borrowed.
However, financiers will want to establish a long-term relationship with the borrower in order to generate subsequent earnings if the business requires subsequent loans for its expansion or daily operations.

(iv) Pressure groups

Pressure groups consist of individuals with a common interest who seek to place demands on organizations to act in a particular way or to influence a desired change in their behaviour. Examples include organizations set up to campaign against smoking, deforestation, the harmful treatment of animals, as well as the protection of the natural environment.
Pressure groups have increasingly influenced the decisions and actions of businesses. They often try to achieve their objectives by influencing government policy, such as lobbying for a change in legislation (see Box 4.1). Some pressure groups, such as Friends of the Earth and Greenpeace, do this by operating on an international level and getting support from the general public who are more aware and concerned about damage to the environment.

Box 4.1 - Actions taken by pressure groups

- *Boycotting* is the refusal to buy products from a certain business as a sign of protest, by creating adverse publicity for the business.
- *Lobbying* means using the power of pressure groups to influence key issues with employers, legal representatives and the government, such as petitioning the government to legislate against socially undesirable business activities.
- *Public Relations (PR)* involves getting positive publicity about a specific opinion or cause. For example, charities often use famous celebrity ambassadors to support their mission. PR helps to raise public awareness and support.
- *Direct action* means a pressure group takes action to achieve its cause, such as staging mass protests or taking legal action against firms that may have behaved illegally.

Case study 4.1 - Pressure group in practice

Environmental pressure groups often help with beach clean-ups

Pressure group campaigns such as anti-smoking or anti-littering have led to support from the general public, mass media and governments in many countries. For example, cigarette advertising is banned in Australia whilst littering carries a heavy financial and imprisonment penalty in Singapore. Animal protection groups, such as the World Wildlife Fund, use ethical marketing techniques to gain positive press coverage.

The local community might also put demands (pressure) on businesses to provide jobs in order to create extra income and spending in the area. It might also pressurise businesses to be accountable for the impact of their activities on the local environment. Many popular holiday destinations, for example, have been negatively damaged by the influx of tourists, such as litter, traffic congestion and ecological damage to beaches and rural areas. Finally, the local community might also put pressure on businesses to sponsor local fund-raising events. These considerations are paramount to the local community's acceptance of businesses operating in their area.

(v) Competitors

Competitors are the rival businesses of an organization. For example, the main rivals of Japan Airlines include Singapore Airlines, Qantas, Cathay Pacific Airways and Air China.

It is common for competitors to also hold shares in the business. For example, Cathay Pacific Airways is partially owned by Air China (which holds 28.2% of the shares) and Qatar Airways (which owns 9.4% of the shares). Another example is Porsche, who owns more than 31% of the shares in Audi (which itself is part of the Volkswagen Group).

As a stakeholder group, competitors are interested in the activities of a business for several reasons. Their objectives include:

- To remain competitive - Businesses need to be aware of and respond to the activities of their rivals.
- To benchmark performance - Businesses will want to compare key performance indicators against their main

rivals (such as sales turnover, profit and market share figures) in order to remain relevant.

- To be creative and innovative - Businesses might benefit from some competition as rivalry can create incentives to keep up to date with changes in the internal and external environments (see Chapter 46), such as new production processes or product launches.

ATL Activity 4.1 (Research skills)

Investigate the great rivalries between the likes of Coca-Cola and Pepsi, Ford and General Motors, Boeing and Airbus, McDonald's and Burger King, or Nike and Adidas.

Be prepared to share your findings with the rest of the class.

(vi) Government

The government is an important external stakeholder as it can have a significant influence on business activity. Its interests include assurances that:

- Unfair business practices are avoided.
- The correct amount of corporate tax is paid from the net profits of the business.
- Health and safety standards are met.
- There is compliance with employment legislation.
- Consumer protection laws are upheld.

Governments might also have a financial stake in a business. For example, Air Albania is 51% owned by the Albania government and 49% owned by Turkish Airlines. The Japanese government owns 53.42% of Tokyo Metro Company. Hence, such governments will have a direct interest in the finance performance of the businesses that they own shares in.

Ultimately though, the government strives to ensure that businesses act in the interest of the general public. It can support businesses in this way by policies such as lowering interest rates and/or taxes to create employment and investment opportunities. The government might also offer incentives to multinational companies (see Chapter 6) to locate in their country, such as subsidised rent and tax concessions. It might introduce initiatives that benefit businesses, such as greater investment in roads and communications networks. However, government intervention can also constrain business activities. For example, Microsoft was broken up into two smaller companies due to numerous lawsuits against the software giant for malpractice and unfair competition.

Key concept

Is it **unethical** for a business to give one group of stakeholders priority over the interests of other stakeholder groups?

Business Management Toolkit

Consider the various stakeholder groups of an organization and why they might be interested in its business plan (see Chapter 48).

Question 4.2 - Stakeholders of schools

(a) In the context of high schools, distinguish between the internal and external stakeholders. *[4 marks]*

(b) Explain how the performance of a high school might impact on any **two** of its stakeholder groups. *[6 marks]*

Conflict between stakeholders (AO2)

Stakeholder conflict refers to differences in the varying needs and priorities of the various stakeholder groups of a business. Such conflicting interests mean that it is not possible for a business to meet all of its stakeholder objectives simultaneously.

Stakeholder conflict exists in situations where people disagree with each other due to differences in their opinions or values, thus creating tension between different stakeholder groups of the organization. Margaret Thatcher (1925 - 2013), the UK's first female British Prime Minister, said that standing in the middle of a road would get you hit by traffic coming from both sides, i.e. some of her decisions pleased certain members of the public but she could not please everyone all of the time. This notion also applies to businesses.

Conflict arises because a business cannot simultaneously meet the needs of all its stakeholders. For example, if shareholders want a greater share of the profits, then this may come about by cutting staff benefits such as profit-related pay and performance-related pay (see Chapter10). However, this would obviously upset employees. Another example is that suppliers would like their corporate customers to pay the full price in one transaction, in order to improve their own cash flow, but businesses would expect to receive discounted prices for regular purchases and for buying in large quantities.

Figure 4.2 - Stakeholder conflict exists due to incompatible goals of different stakeholder groups

A common cause of stakeholder conflict is the remuneration (pay and benefits) of the company's directors. Shareholders and employees might argue that top management are 'overpaid' and that there should be a fairer distribution of profits to shareholders (in the form of dividends) and to staff (improved remuneration for employees). Senior executives would argue however that their compensation needs to be adequate to pay for the higher risks involved in decision-making. They claim that this would ultimately increase profits for the business, leading to larger dividend payments and higher wages in the future.

Key concept

In 2021, the *Economic Policy Institute* reported that CEOs (chief executive officers) of the top 350 companies in the US were paid 351 times more than a typical worker in the country. To what extent is it **ethical** for CEOs to be paid so many more times than the average worker?

Another source of potential conflict is that some stakeholders have more than one role or set of interests in an organization. For example, managers are employees too, whilst some employees might also be shareholders of the company they work for. A customer is also likely to be a member of the local community, so may face conflicting interests. Based on the differing objectives of these stakeholder groups, some degree of conflict is likely to occur.

In deciding how to deal with conflicting stakeholder needs, managers need to look at three key issues:

- *The type of business entity* - A partnership (see Chapter 2) might strive for profit maximization, whereas a non-profit organization is likely to have different priorities. So, the owners in a partnership business might regard customers as the key stakeholder group whereas the local community could be the most important group for a charitable organization. A limited liability company will be accountable to its shareholders (owners), so will have to give them priority.

- *The goals and objectives of the business* - If a firm targets growth and expansion as part of its business strategy, then the proportion of profits allocated to its owners will be less important, at least in the short-term. Instead, the priorities of senior managers and directors are given a higher priority to facilitate the change process.

- *The source and degree of power (influence)* for each stakeholder group - Customers will have more power if the business is selling a product in a mass market where there are plenty of substitutes widely available. Access to the media can also give greater power to pressure groups. Likewise, a united workforce will strengthen the influence of employees via their trade union (see Chapter 13).

ATL Activity 4.2 (Thinking skills)

In 2012, prior to Alibaba's record-breaking $25 billion initial public offering (see Chapters 2 and 15), founder and CEO Jack Ma wrote in a letter to investors "Customers first, employees second and shareholders third."

He explained his reasoning behind this by saying that "If the customer is happy, the business is happy and the shareholders are happy."

Discuss the extent to which you think this is the right prioritization for all businesses?

Exam tip !

Be prepared to answer examination questions about:

- the differences between internal and external stakeholders
- the differences between stakeholders and shareholders and
- the various objectives of different stakeholder groups and how these might conflict with each other.

Business Management Toolkit

To what extent might force field analysis (see Chapter 55) help to resolve stakeholder conflict?

Theory of Knowledge (TOK)

Discuss whether it is possible to 'know' which stakeholder group is the most important to an organization. What knowledge issues would be made in such a case?

Question 4.3 - The Royal Bank of Scotland Group

British banking and insurance company The Royal Bank of Scotland Group (RBS Group) has operations in Europe, North America and Asia. Before the global financial crisis of 2008, RBS Group was one of the largest banks in the world. However, its inability to deal with the turmoil in the financial industry led to the UK government buying over 80% of the company's shares. The share price of RBS Group dropped from £3.54 ($4.95) to just £0.11 ($0.16).

To survive, RBS Group had to sell its 4.26% stake in Bank of China, even though it did not make any profit on the deal. RBS Group holds the record for the largest loss in British corporate history; a staggering £24.1bn ($33.8bn) in 2008.

(a) Outline the meaning of RBS Group having a "stake" in Bank of China. *[2 marks]*

(b) Calculate the percentage change in RBS Group's share price. *[2 marks]*

(c) Outline **two** reasons why the shareholders of RBS Group might be concerned about its performance. *[4 marks]*

(d) To what extent should businesses like RBS Group listen to the views of their various stakeholder groups? *[10 marks]*

Question 4.4 - Škoda Auto

Founded in 1895, *Škoda Auto* is one of the oldest automobile manufacturers in the world. In early 2007, the Czech company, which became part of the Volkswagen Group in 2000, entered China as part of its growth strategy. However, in the same year, its workforce in Europe went on strike over concerns regarding the **remuneration** of employees.

It was reported that industrial action cost *Škoda Auto*, the country's largest exporter, 60 million crowns ($2.9m) per day in lost output. Nevertheless, China became Škoda's main market; by 2013, the company had produced its 1 millionth car in China. Today, one in four Škoda cars is sold in China.

(a) Identify **two** external stakeholder groups of *Škoda Auto*. *[2 marks]*

(b) Define the term *remuneration*. *[2 marks]*

(c) Outline **one** source of conflict between *Škoda Auto's* various stakeholders. *[2 marks]*

(d) Examine how the conflict outlined in your answer above could have been minimized. *[6 marks]*

Stakeholder conflict is a potentially ever-present phenomenon. However, modern management thinking suggests that there are mutual benefits in simultaneously meeting the competing or conflicting needs of different stakeholder groups. For example, addressing the needs of both employees and managers can lead to a highly cohesive, motivated and loyal workforce with low rates of staff absenteeism and labour turnover. This can lead to improved customer relations, a better corporate image, higher market share and greater profits in the long-term. As a result, shareholders will also be pleased. Furthermore, greater output might also lead to more employment opportunities in the local community. Hence, it is argued that meeting the needs of all stakeholder groups can be achieved, although this might only occur in the medium to long-term.

Question 4.5 - Royal Dutch Shell

Royal Dutch Shell (or Shell for short) is Europe's largest energy and oil company. It was formed in 1907 by the merger of Royal Dutch from The Netherlands and Shell from the UK. In 2020, the Anglo-Dutch company earned net income of $21.5 billion (that's $2.45m) per hour! This staggering figure obviously drew the attention of Shell's **internal stakeholders.** However, being a global energy and oil company also means that Shell's activities are carefully scrutinised by pressure groups, such as Greenpeace. In 2020, Shell's sales revenue exceeded $180.5 billion (about a fifth of the GDP of the Netherlands).

(a) Define the term *internal stakeholders.* *[2 marks]*

(b) To what extent should a global company such as Shell allow environmental and human rights groups to exert influence on their decision-making? *[10 marks]*

Theory of Knowledge (TOK)

Is it considered unethical if a business chooses to ignore the demands (or needs) of one particular stakeholder group?

Stakeholders and the key concepts

Conflict exists in every organization, at least to some extent, so this needs to be managed carefully. At times, employees will disagree with management decisions about change (see Chapters 7 and 55); customers will be disgruntled, especially if the business acts unethically; suppliers will fail to deliver the right goods on time; shareholders will be unhappy with the performance of the business and so forth. Given the potential mutual benefits of meeting the contrasting interests of various stakeholder groups, conflict resolution is an important aspect of any sustainable business strategy.

However, it is unlikely that a business can fulfil the objectives of all its stakeholders at the same time, all of the time. Nevertheless, it is unrealistic or undesirable to maximize the needs of just one single stakeholder group. If a particular group is not catered for, then it is possible that they will cause interruptions and problems for the business. Most strategies aim for a 'best fit' compromise so that the needs of all stakeholder groups are reasonably addressed.

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The outcome of any negotiation between various stakeholder groups will depend largely on the *culture* of the organization (see Chapter 11) and the *relative bargaining power* of the different stakeholders. For example, large multinational companies such as Honda or Ford have better bargaining power with their suppliers than mechanics operating as sole traders trying to negotiate prices for motor vehicle parts.

A common stakeholder conflict management tool is **stakeholder mapping.** This model considers the relative *interest* of stakeholders and their relative *power* (or influence) on businesses, as shown in Figure 4.3.

		Level of interest	
		Low	*High*
Level of power	*Low*	**A** (minimum effort)	**B** (keep informed)
	High	**C** (keep satisfied)	**D** (maximum effort)

Figure 4.3 - Stakeholder mapping

Stakeholder mapping lets managers assess how to deal with changing and conflicting stakeholder objectives. Whilst it is extremely difficult to please all stakeholders at the same time, managers can prioritize their actions by using this model. Stakeholders in quadrant A are unlikely to receive much attention from the decision makers. Conversely, those in quadrant D will receive the most attention as they are the key stakeholders of an organization. Stakeholders in quadrant B need to be kept informed whilst those in quadrant C must be kept satisfied, perhaps by consulting them on strategic decisions.

In reality, managers will deal with stakeholder conflict in different ways depending on their management and leadership style (see Chapter 9) and the organizational culture (see Chapter 11). For example, paternalistic leaders would argue that although customers are vital to any business, it is the needs of employees that have to be considered first. They believe that by hiring the right people and devoting time and money to train and develop employees, workers will automatically deliver a first-rate service to their customers.

Furthermore, external stakeholders such as pressure groups have become increasingly effective in influencing business activity through changes in digital social media platforms. Due to public awareness of the detrimental effects of globalization (such as the exploitation of child labour or the impact of business activity on global warming and sustainability issues), organizations are finding it ever more difficult to simply ignore ethical business behaviour and the associated pressures from external stakeholder groups.

Business Management Toolkit

To what extent might the use of force field analysis as a business management tool (see Chapter 55) help with resolving stakeholder conflict?

Theory of Knowledge (TOK)

Are the values and beliefs of some stakeholders more important than those of others?

Key concept

Does organizational **change** always lead to conflicting stakeholder objectives?

Key concept

With reference to an organization of your choice, examine how business **ethics** impact both internal and external stakeholders.

REVIEW QUESTIONS

1. What is a stakeholder?
2. How do internal stakeholders differ from external stakeholders?
3. Who are the main internal stakeholders of a business?
4. What examples are there of external stakeholders?
5. What is the difference between a stakeholder and a shareholder?
6. Why are shareholders a potentially powerful stakeholder group?
7. Why might competitors be considered as external stakeholders?
8. What is the role of the government as a stakeholder group in business activities?
9. What is meant by stakeholder conflict?
10. How might a business resolve stakeholder conflict in the workplace?

KEY TERMS

Conflict refers to situations where stakeholders have disputes or differences regarding certain issues or matters. This can lead to arguments and tension between the various stakeholder groups.

Customers are the clients of a business. As a key external stakeholder group, customers seek to have value for money, such as competitive prices and good quality products.

Directors are senior executives who have been elected by the company's shareholders to address business activities on behalf of their owners.

Employees are the staff of an organization. They have a stake (an interest and involvement) in the organization they work for.

External stakeholders are individuals and organizations not part of the business but have a direct interest in its activities and performance. Examples include customers, suppliers and the government.

Financiers are the financial institutions and individual investors who provide sources of finance for an organization. They are interested in the organization's ability to generate profits and to repay debts.

Government refers to the ruling authority within a state or country. As an external stakeholder group, the government is interested in businesses complying with the law with regards to the conduct of business activities.

Internal stakeholders of a business are members of the organization, namely the employees, managers, directors and shareholders (owners) of the business.

The **local community** refers to the general public and local businesses that have a direct interest in the activities of an organization, namely to create jobs and to conduct business activities in a socially responsible way.

Managers are an internal group of stakeholder responsibly for overseeing the daily operations of the business.

Pressure groups consist of individuals with a common concern (such as environmental protection) who seek to place demands on organizations to act in a particular way or to influence a change in their behaviour.

Stakeholder conflict refers to differences in the varying needs and priorities of the various stakeholder groups of a business.

Stakeholder mapping is a model that assesses the relative *interest* of stakeholders and their relative influence (or power) on an organization.

Shareholders (or **stockholders**) are the owners of a limited liability company. Shares in a company can be held by individuals and other organizations.

Stakeholders are individuals or organizations with a direct interest (known as a *stake*) in the activities and performance of a business, such as shareholders, employees, customers and suppliers.

Suppliers are an external stakeholder group that provide a business with stocks of raw materials, component parts and finished goods needed for production. They can also provide commercial services, such as maintenance and technical support.

Figure 4.3 - Suppliers are an important external stakeholder group

Chapter 5

Unit 1.5 - Growth and evolution

"It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change."
- Anton P. Chekhov (1860 - 1904), Russian playwright

Contents

1.5 Growth and evolution	
SL/HL content	**Depth of teaching**
Internal and external economies and diseconomies of scale	AO2
The difference between internal and external growth	AO2
Reasons for businesses to grow	AO3
Reasons for businesses to stay small	AO3
External growth methods: • Mergers and acquisitions (M&As) • Takeovers • Joint ventures • Strategic alliances • Franchising	AO3

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Economies and diseconomies of scale (AO2)

Internal and external economies and diseconomies of scale

A major reason why businesses aim to grow is to benefit from **economies of scale**. This refers to lower average cost of production as a firm operates on a larger scale due to an improvement in its productive efficiency. Economies of scale can help businesses to gain a competitive cost advantage because lower average costs can mean a combination of lower prices being charged to customers and a higher profit margin earned on each item sold.

The **average cost** (AC) is the cost per unit of output. It is calculated by dividing total costs (TC) by the quantity of output (Q), i.e. AC = TC ÷ Q. For example, if total costs of producing 10,000 shirts is $78,000 then the cost of each shirt is $7.80.

Average cost consists of two components: **average fixed costs** (AFC) and **average variable costs** (AVC). AFC is calculated by dividing the total fixed cost (TFC) by the level of output, i.e. AFC = TFC ÷ Q. Similarly, AVC is calculated by dividing the total variable cost by the level of output, i.e. AVC = TVC ÷ Q.

The average fixed costs of a firm will decline continuously with larger levels of output. This is because the TFC remains constant but is spread over an increasing amount of output, i.e. the same (fixed) costs are being divided by a larger number (level of output) as shown in Figure 5.1.

As a firm operates on a larger scale, economies of scale are experienced, up to the **optimal level of output** (where average costs are minimised). Thereafter, any further increases in output bring about diseconomies of scale, i.e. higher average costs as output increases

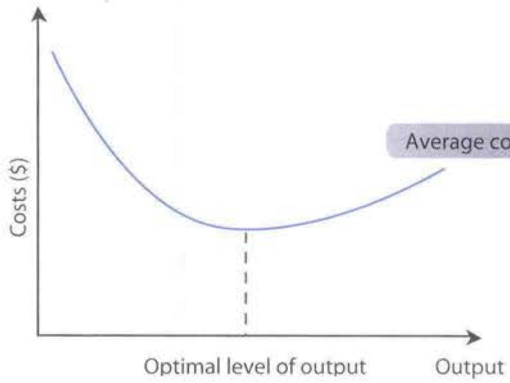

Figure 5.1 - Economies and diseconomies of scale

Firms minimize their costs by operating at the output level where average costs are at their lowest (the optimal level of output). Economies of scale that occur inside the firm and are within its control are known as **internal economies of scale.** Those that occur within the industry and are generally beyond an individual firm's control are known as **external economies of scale**.

Internal Economies of Scale

By operating on a larger scale, a business can reduce its average cost of production due to any combination of the types of internal economies of scale below. The relative importance of each depends on the actual business under consideration.

- **Technical economies** - Large firms can use sophisticated capital and machinery to mass produce their products. For example, due to the huge scale of production, the Philips factory in Shenzhen, China produces complete audio systems within a few seconds! The high fixed costs of their equipment and machinery are spread over the huge scale of output, thereby reducing the average cost of production. Small businesses do not find it feasible or cost-efficient to buy and use such technologies.

- **Financial economies** - Large firms can borrow large sums of money at lower rates of interest compared to smaller competitors because the larger organizations are seen as less risky to financial lenders. In addition, a large and established business looking to borrow money will probably choose a lender that offers the most attractive interest rate, i.e. there is rivalry amongst the financiers to lend to large and reputable businesses. By contrast, smaller firms often struggle to raise external finance and are charged higher interest rates on their borrowing due to the higher degree of risk involved.

Case Study - The Airbus A380

The Airbus 380, the world's largest passenger plane, has 49% more seating capacity than its rival Boeing 787 Dreamliner, yet burns 17% less fuel per seat. Hence, the average cost of fuel for Airbus is lower. This is particularly important for Airline carriers operating in a highly competitive industry where fuel prices account for a large proportion of their costs (the A380 has a fuel capacity of 81,890 gallons or 310,000 litres) and where the price of aircraft is hugely expensive - the Boeing 787 Dreamliner costs over $257m and the Airbus A380 costs $418m per plane! However, low demand from airline carriers (especially following the aftermath of the global COVID-19 pandemic) meant that Airbus ceased to produce the A380 at the end of 2021.

- **Managerial economies** - A sole trader (see Chapter 2) often has to fulfil the functions of marketer, accountant and production manager. As people cannot be equally good at everything, *specialisation* leads to higher productivity. By contrast, large firms divide managerial roles by employing specialist managers. Through growth, a business can avoid a duplication of effort in planning, communication, marketing, distribution and production processes. The higher productivity means that average costs can fall further.

- **Specialization economies** - This is similar to managerial economies of scale but results from division of labour of the workforce, rather than the management. Motor vehicle manufacturers that use mass production techniques benefit from having specialist labour including designers, production staff, engineers and marketers. These specialists are responsible for a single part of the production process and their skills and expertise mean that there is greater productivity thereby helping to reduce the average cost of output.

- **Marketing economies** - Large firms can benefit from a lower average cost by selling in bulk, thus benefiting from time savings and transactions costs. For example, a small retail outlet might sell 1,000 cans of Coca-Cola in a month to hundreds of different customers. This will cost a lot more than the Coca-Cola Company that can sell 1,000 cans in just one transaction to a single customer (such as a supermarket). Global firms such as McDonald's and Nike can spread the high costs of their advertising by using the same marketing campaign across the world (language translation is a minor part of the costs of a global marketing budget).

- **Purchasing economies** - Large firms can also lower their average costs by buying resources in bulk. Note, however, that even relatively small firms can gain from purchasing economies of scale because they also gain discounts for bulk purchases. Of course, the larger the order the greater the bulk discount might be, so there is still an advantage to being big in the corporate world.

- **Risk-bearing economies** - These savings can be enjoyed by *conglomerates* (firms with a diversified portfolio of products in different markets). Conglomerates such as Reliance Industries (see Case study 5.1) can spread their fixed costs, such as advertising or research and development, across a wide range of their operations. Unfavourable trading conditions for certain products or industries can be offset by more favourable conditions in other sectors of the conglomerate. Hence, a loss in one area of their business does not jeopardise the business overall.

Case study 5.1 - Reliance Industries

Reliance Industries is an Indian multinational conglomerate company headquartered in Mumbai, India. It is one of the world's largest conglomerates and India's largest publicly held company. It has strategic business units in markets as varied as energy, financial services, logistics, mass media, natural gas, petrochemicals, retail, telecommunications and textiles.

Common mistake

Many students define economies of scale as 'the benefits of bulk buying'. However, even *small* businesses can buy in bulk; the term refers to the cost-saving or cost-reducing benefits enjoyed by firms engaged in *large* scale operations. Financial, technological and managerial economies of scale are probably far more important in reducing the average cost of production for most businesses than their ability to buy in bulk.

External economies of scale

External economies of scale are cost-saving benefits of large-scale operations arising from *outside* the business due to its favourable location or general growth in the industry. These benefits are also enjoyed by other firms within the industry. Examples of external economies include:

- **Technological progress** increases the productivity level within the industry. For example, the Internet has created huge cost savings for businesses engaged in e-commerce. Online retailers, for example, do not have to be located in central business districts thereby avoiding highly expensive rent.

- **Improved transportation networks** help to ensure prompt deliveries. Furthermore, employees who are late to work due to poor transportation links cost the business money. Customers and suppliers also want convenience (ease of access). Ultimately, congestion and inefficiencies raise business costs and reduce profits.

- An abundance of **skilled labour** might exist in the local area, perhaps through government aided training programmes or reputable education and training facilities in a certain location. This provides local businesses with a suitable pool of educated and trained labour, thereby helping to cut recruitment and training costs (see Chapter 7) without compromising productivity levels.

- **Regional specialisation** means that a particular location or country has a highly regarded and trustworthy reputation for producing a certain good or service. For example, Murano, in Venice, Italy, is famous for its glass products such as vases, jewellery and chandeliers. This allows the industry to benefit from having access to specialist labour, sub-contractors and suppliers, thus helping to reduce the average cost of production for the industry. Its reputation also allows firms in Murano to charge premium prices (see Chapter 28) for its products.

Figure 5.2 - Growth brings benefits such as economies of scale

Internal diseconomies of scale

Contrary to popular belief, businesses can become too large. There comes a 'tipping point' when economies of scale no longer exist. **Diseconomies of scale** are the result of higher unit costs as a firm continues to increase in size. This means that the business becomes outsized and inefficient, so the average cost of production begins to rise (see Figure 5.1). **Internal diseconomies of scale** usually occur due to problems of mismanagement. Examples include:

- As a firm becomes larger, managers may **lack control and coordination** as the span of control (see Chapter 8) is likely to increase and cause communication problems. Ultimately, these difficulties slow down decision-making. Coordination and control problems also occur for organizations with business operations in different locations throughout the world. Workers in larger organizations might feel a sense of alienation, which can harm staff morale (see Chapter 10). These issues add to the firm's costs without any corresponding increase in productivity, thereby raising its unit costs.

- There is likely to be **poorer working relationships** in an oversized business. With a larger workforce, senior managers are more likely to become detached from those lower down in the organizational hierarchy, thereby making them feel distanced or out of touch. This can damage communication flows and the motivation of staff, thereby reducing their productivity and leading to higher average costs.

- Outsized organizations are likely to suffer from the disadvantages of specialization and division of labour. Workers become bored with performing repetitive tasks. With a larger workforce, there may also be scope for slack (inefficiencies and procrastination). This leads to **lower productive efficiency** and hence an increase in the average costs of production.

- The amount of **bureaucracy** (excessive administration, paperwork and company policies) is also likely to increase as a business grows. This makes decision-making more time consuming and adds to production costs but is unlikely to contribute to a proportional rise in the output of goods and services. Bureaucracy can also make communication more challenging, thereby worsening working relationships and again contributing to higher unit costs.

- **Complacency** with being a large and dominant firm with market power or even being the market leader can also cause many problems. Complacency (a lack of awareness of genuine risks or deficiencies) is most likely to reduce productivity thereby raising unit costs of production.

The potential for large firms to experience diseconomies of scale means that some businesses prefer to grow via **franchising** (covered later in this Unit). Multinational companies such as McDonald's and 7-Eleven have used this strategy to expand their businesses and to raise brand awareness (see Chapter 27), without having to face the higher average costs of being large.

External diseconomies of scale

External diseconomies of scale occur once there is an increase in the average cost of production when a firm grows due to factors beyond its control. Such problems affect the whole industry, often because there are just too many firms competing in the market. Hence, average costs of production increase for all businesses in the industry. Examples include:

- Too many businesses locating in a certain area causes land to become even more scarce thereby causing **higher rents**. This adds to the fixed costs of all businesses in the area without any corresponding increase in output. Hence, unit costs will rise. The high demand for businesses to locate in busy districts such as Manhattan (New York City), Shinjuku (Tokyo), The City (London) and Silicon Valley (San Francisco) has resulted in a sustained and continuous rise in the rental value of land in these prime city locations.

- Since workers have greater choice from a large number of employers in the local area, businesses might have to offer **higher pay and financial rewards** to retain workers or attract new staff. This will increase costs without necessarily increasing output, thereby raising average costs of production for all firms in the industry.

- **Traffic congestion** results from too many businesses being located in an area. Deliveries are likely to be delayed due to the overcrowding. This increases transportation costs for businesses, thereby contributing to an increase in unit costs of production.

Figure 5.3 - Traffic congestion is a cause of external diseconomies of scale

The difference between internal and external growth (AO2)

Internal growth occurs when a business grows organically, using its own capabilities and resources to increase the scale of its operations and sales revenue. It is typically financed through a combination of retained profits, borrowing and issuing of new shares. A business can grow internally in several ways such as:

- Changing **price** - More customers tend to buy a product at lower prices. However, if there are very few substitutes for the product, demand is said to be price inelastic (see Chapter 28), so the business will earn more revenue by *raising* prices. For products in highly competitive markets, demand is price elastic so a reduction in the selling price will tend to generate proportionately more sales revenue

- Improved **promotion** - People are more likely to buy a product if they are informed, reminded and/or persuaded about its benefits. The Coca-Cola Company spends around $3bn each year on promoting its products, which is one reason why it is the world's most recognised brand with sales of 1.9 billion servings each day.

- Producing improved or better **products** - Through methods such as market research, innovation and new product development, businesses can produce products that are more appealing to the market, thereby raising their sales. Most newly launched products actually fail, so it is quite common for businesses to improve on the design and/or features of an existing product. Nevertheless, product innovation can be a lucrative source of internal growth.

Case study 5.2 - Apple

Apple's internal growth strategy focuses on new product development and launching new product innovations. Examples include Apple's product launches of the iPod, iPad, iPhone, iMac Pro, MacBook Air, MacBook Pro, Apple TV, Apple Watch, HomePod, AirPod, iTunes and the App Store.

- Selling through a greater distribution network (**placement**) - If a product is widely available, customers are more likely to buy it. One of the world's most expensive production cars is the Lamborghini Veneno, with a selling price of $4.5m (although the most expensive one was sold for $8.27 million). Apart from the price, the Lamborghini Veneno is very limited in supply, so this restricts the potential

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number of customers. Coca-Cola, on the other hand, is widely available throughout the world in different places, such as supermarkets, wholesalers, restaurants, cinemas, aeroplanes and vending machines. Having more retail outlets, despite the higher costs, can also help to achieve internal growth.

- Offer preferential **credit** - Customers are more likely to make a purchase if they are offered the option to 'buy now and pay later'. Allowing customers to pay in regular instalments perhaps over 12 or 24 months for the purchase of expensive products, such as motor vehicles, home furniture or large-screen televisions, can attract more customers to the market. However, businesses must be careful not to offer too much credit as this can affect their cash flow position (see Chapter 20).

- Increased **capital expenditure** (investment spending) - This can be in the form of internal expansion of the business to new locations or the introduction of new production processes and technologies in order to improve productivity. However, investment risks might not pay off, so careful planning and the use of additional tools such as investment appraisal (see Chapter 21) may be required.

- Improved **training and development** - People (employees) are often said to be a firm's most important asset (see Chapter 7). Training and development are important as customers are unlikely to buy from salespeople who have little or no product knowledge. Training and development not only help to make employees more confident and competent in their jobs, but it can also help to motivate the workforce as they feel more valued by the employer (see Chapter 10). This can improve the quality of customer service, thus contributing to greater customer loyalty and higher sales for internal growth.

- Providing overall **value for money** - Businesses that can provide improved value for money are most likely to experience internal growth. Customers tend to look at more than just the price when making purchasing decisions. Other factors may include product quality, after-sales care, brand image, maintenance costs and environmental considerations.

Table 5.1 - The advantages and disadvantages of internal growth

Advantages of internal growth	Disadvantages of internal growth
Better **control and coordination** - It is often easier to grow internally than to rely on external sources. Internal growth also enables the organization to maintain control, whereas external growth can lead to a loss of control and ownership of the business.	**Diseconomies of scale** - Higher average costs of production can arise from internal growth. Hierarchical structures (see Chapter 8) tend to be a feature of internal growth, causing communication problems and slower decision-making as a business grows.
Relatively **inexpensive** - The main source of internal growth is retained profits. There might also be a need to secure interest-bearing loan capital to fund the growth, but there is less risk involved with internal growth as the amount of capital tends to be lower. The higher cost of external growth means that for many firms, internal growth is the only suitable option.	A need to **restructure** - Although a sole trader can control and coordinate the business quite easily, if it grows into a multinational company then the organizational structure has to be changed. Restructuring takes time, effort and money, such as training needs. Specialist managers also have to be hired as the firm and its workforce grows.
Maintains the **corporate culture** - A major problem for mergers and acquisitions is that when two or more firms with very different cultures work together to create a new company. By contrast, internal growth means there are no problems related with culture clashes (see Chapter 11) or conflicting management styles.	**Dilution of control and ownership** - If a firm grows by changing its legal status, say from being a partnership to a publicly held company, the owners (the partners) will have to share decision-making power with the new owners (shareholders). With more owners, decision-making is prolonged and conflicts between the different stakeholders are more likely.
Less risky - Due to the above reasons, internal growth is the easiest and least risky method of growth and evolution for most businesses. Furthermore, internal growth builds on the strengths of the organization, such as its brand value and customer loyalty.	**Slower growth** - Internal growth is slower than external growth. Despite the risks, shareholders may prefer more rapid methods of growth (such as mergers, acquisitions, takeovers or franchising, in order to increase their return on investment.

Question 5.1 - Poundland

British discount retailer Poundland has built a reputation for internal growth. Founded in 1990, Poundland opened its 500th store in 2014 and had more than 800 stores at the start of 2022. Poundland, which sells most of its products for £1 ($1.40) or less, serves 7 million customers each week and has reported annual increases in profits by as much as 29%. Its growth strategy is to focus on expansion in Ireland, the Netherlands and the UK in order to gain greater **market share.**

(a) Define the term *market share.* *[2 marks]*

(b) Describe **two** methods of internal growth that Poundland might have used. *[4 marks]*

(c) Discuss the extent to which internal growth is desirable for a business such as Poundland. *[10 marks]*

External growth (or inorganic growth) occurs through dealings with outside organizations rather than from an increase in the organization's own business operations. External growth usually comes in the form of mergers and acquisitions (M&As), takeovers, joint ventures, strategic alliances, or franchising (all of which are explained below). These growth methods are collectively referred to as the **amalgamation** or **integration** of firms. The advantages and disadvantages of external growth are outlined in Table 5.2

Figure 5.4 - External growth helps to build a firm's market share.

Table 5.2 - The advantages and disadvantages of external growth

Advantages of external growth	Disadvantages of external growth
Quicker than organic growth - External growth tends to be a faster way to grow and diversify as external resources and finances are used.	**More expensive than internal growth** - M&As, JVs, strategic alliances and franchising tend to be more expensive than internal growth methods.
Synergies - Businesses can benefit from a greater pool of skills, knowledge and the expertise of external parties.	**Greater risks** - Inadequate knowledge of new markets and the greater uncertainties of external growth create greater risks.
Reduced competition - External growth is a relatively quick, albeit expensive, method of reducing the degree of competition and raising the firm's market share.	**Regulatory barriers** - External growth, such as acquisitions and takeovers, can be blocked by governments if the move is deemed to be anti-competitive.
Economies of scale - Rapid external growth can help businesses to gain access to larger markets and hence economies of scale from operating on a larger scale.	**Potential diseconomies of scale** - Increased complexities of internal growth can equally cause inefficiencies and hence a rise in average costs.
Spreading of risks - External growth enables businesses to benefit from diversification. Hence, firms face fewer risks overall from failures in any particular aspect of its business operations.	**Organizational culture clash** - It is often difficult to combine different cultures and management styles, especially if external growth leads to a change in the nature and culture of a business.

Question 5.2 - A.S. Watson Group

With a history dating back to 1828, A.S. Watson Group has evolved into the world's largest international health, beauty and lifestyle retailer. It has operations in over 16,000 stores across 27 markets worldwide, with over 5.3 billion customers each year.

A.S. Watson Group employs over 140,000 staff and its **product portfolio** includes some of Asia's best-known brands and retail chains, including Watsons (health and beauty), PARKnSHOP (supermarkets), Fortress (electrical appliances), Watson's Wine and Nuance-Watson airport duty free shops. It is also a major producer and distributor of water products and beverages, including brands such as Sunkist and Mr. Juicy. In Europe, its health and beauty brands include Superdrug, Rossmann, Trekpleister, Drogas and Spektr. Its luxury perfumery cosmetics brands include ICI Paris XL, Marionnaud and The Perfume Shop. Growing the business remains a long-term goal at A.S. Watson Group.

Source: adapted from A.S. Watson Group (www.aswatson.com)

(a) Define the term *product portfolio*. *[2 marks]*

(b) Suggest the type of business entity that A.S. Watson Group might be classified as. [2 marks]

(c) Explain how A.S. Watson Group benefits from synergy by its growth and evolution strategies. [4 marks]

(d) Despite its enormous size and global presence, examine why A.S. Watson Group still aims to grow larger as part of its long-term corporate strategy *[6 marks]*

Business Management Toolkit

Discuss how the use of descriptive statistics (see Chapter 50) can assist decision-makers about internal and external growth strategies.

Reasons for businesses to grow (AO3)

All businesses have an appropriate scale of operation. For instance, the market for smartphones is enormous whereas that for IB textbooks is smaller. The size of a business can be measured in several ways:

- *Market share* - a firm's sales revenue as a percentage of the industry's total sales revenue.
- *Total sales revenue* - the value of a firm's annual sales revenue for a given time period, usually per year. This measure gives an indication of the size of the firm's customer base.
- *Size of workforce* - the total number of employees hired by the business per time period.
- *Profit* - the value of a firm's profits per time period.
- *Capital employed* - the value of the firm's capital investment as recorded on its balance sheet (see Chapter 17).

An increase in the value of any of the above measures would suggest that the firm is growing. Essentially, the size of a business is measured in relative terms by comparing benchmark data to those of its competitors. The interrelated benefits of being a large business organization are show in Table 5.3.

Table 5.3 - Generic benefits of being a large business

Advantages of external growth	Disadvantages of external growth
Economies of scale	These are cost-saving benefits due to operating on a larger scale, which reduces the firm's average cost of production.
Lower prices	Larger firms are able to offer customers greater price discounts through their ability to enjoy economies of scale.
Brand recognition	Familiarity with the brand allows large businesses to sell to a wider market. Many firms are large and established enough to benefit from global brand recognition.
Brand reputation	Larger firms tend to be more trusted due to their brand image and brand reputation.
Value- added services	Larger firms have the resources to provide a wider range of services for their customers, such as longer opening hours and interest-free credit instalments.
Greater choice	Larger firms can provide more choice for their customer. For example, Amazon offers a larger range of books, toys and music compared to a small local book shop, toy store, or music retailer.
Customer loyalty	The above benefits mean that more customers are likely to remain loyal to the business, its products and its brands due to the perceived trust and overall value for money.

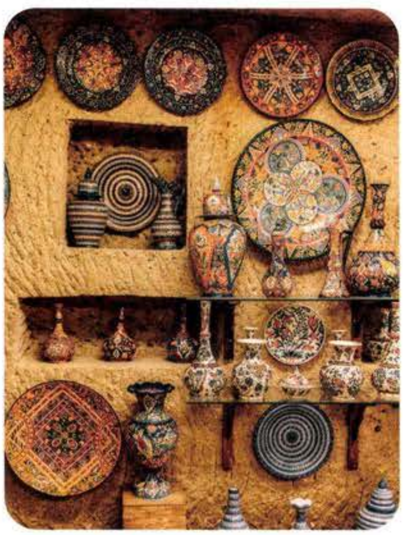

Figure 5.5 - Small firms tend to only sell a limited range of goods

Large companies such as Apple, BMW, Coca-Cola and IKEA design and market their products to a global audience. Consumers around the world easily recognize and trust their brands and products. In the case of McDonald's, even the production processes are largely the same throughout the world; burgers and fries are cooked in exactly the same way irrespective of where the McDonald's restaurant is located in the world. The Coca-Cola brand is one of the most recognized in the world. Thus, these large businesses are able to exploit global marketing and production economies of scale as they grow and evolve.

Case study 5.3 - IKEA

Founded in 1943, IKEA is the world's largest retailer of home furniture, kitchen appliances and home accessories. It was not until 1963 that IKEA opened its first overseas stores in neighbouring Norway and later in 1969 in Denmark. The Swedish company has since grown to over 445 stores in 50 countries and employs more than 225,000 people around the world.

Case study 5.4 - Amazon

Amazon was founded in 1994 by Jeff Bezos, operating the business from his garage in Washington, USA. Originally an online bookstore, the business earned $20,000 in sales revenue per week within its first two months of trading. However, it wasn't until 2001 when the company declared its first profit. Today, the company focuses on a lot more than just books, with operations in e-commerce, cloud computing, digital streaming and artificial intelligence. Amazon has continued to grow with operations across North America, Latin America, Europe, Africa and Asia. It employs over 810,000 workers in the USA and earns over $386bn in annual sales revenue. Today, Bezos is one of the world's wealthiest people.

Business Management Toolkit

Discuss how role of Ansoff's matrix (see Chapter 45) in decision making about organizational growth strategies.

Reasons for businesses to stay small (AO3)

Despite the benefits of being large, small firms can still thrive. The main reasons why businesses may stay small are outlined in Table 5.4.

Table 5.4 - Reasons for staying small as a business

Reason	Explanation
Cost control	Large scale operations can mean that a firm encounters diseconomies of scale due to problems of control, coordination and communication. Owners of small firms might not want to expand as they could face higher unit costs. Growth can also require additional borrowing costs.
Loss of control	External growth through methods such as mergers and acquisitions (M&As) and takeovers may result in the dilution of ownership and control for the original owners.
Financial risks	As the costs of running a large global business are huge (such as the costs of research and development, marketing, recruitment and training), the financial risks are also high. By contrast, owners of small businesses can better manage and control their finances.
Government aid	Financial support in the form of grants and subsidies can be offered to small businesses to help them start up and to develop. Funds for training may also be available for small businesses that provide employment opportunities in the local community.
Local monopoly power	Small businesses may enjoy being the only firm in a particular location, such as a local restaurant, a franchised petroleum retailer, or a small convenience store located in a remote town. Large businesses may be reluctant to locate in remote areas (see Chapter 38), so this provides an opportunity for smaller firms to establish themselves in the area.
Personalised services	Smaller firms are more likely to have the time to devote to individual customers. For example, staff at a small local convenience store can get to know their customers better as employees are not pressurised by high sales targets. By contrast, large supermarkets rely on a high number of customers being served with many using self-checkout services.
Flexibility	Small businesses tend to be more flexible and adaptive to change. If a sole trader runs a beauty salon that is unsuccessful, then s/he might change the business to something completely different, such as a children's toy shop. Large businesses have large financial commitments and conflicting stakeholder objectives (see Chapter 4) which combine to reduce their ability to change in the same way.
Small market size	Some businesses, such as a local hair salon or private tuition firm, are unlikely to attract the attention of large firms due to the very limited size of the market. Large corporations may not find it financially worthwhile to compete with these small local firms, thereby enabling them to thrive.

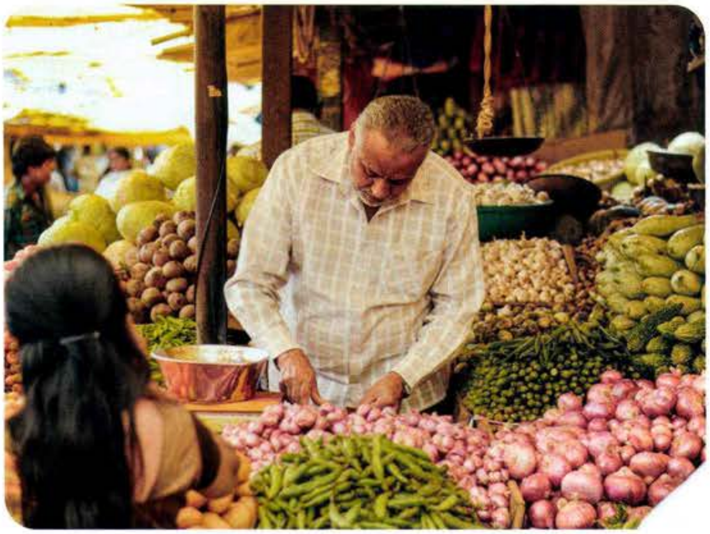

Figure 5.6 - Small businesses can thrive despite the existence and benefits of larger firms

The optimal (most appropriate) size for a business depends on its internal structure, its finances and its aims and objectives. For example, Mars and IKEA are privately held companies (see Chapter 2) as the owners want the businesses to remain in the control of the founding families rather than external owners (shareholders and directors). If a firm operates beyond its optimal size (meaning it becomes too large) then diseconomies of scale will set in, which results in higher unit costs and lower profits.

In reality, a firm might not operate at its optimal level due to a lack of resources. It cannot expand if it does not have appropriate resources and sufficient sources of finance. Furthermore, it cannot increase output if it lacks the productive capacity (see Chapter 40) to do so. The firm will also choose not to expand output if there is insufficient demand, even if producing more means lower average costs.

Question 5.3 - Small versus Large

Businesses come in all different sizes. For example:

- The vast number of businesses are owned by sole traders who only supply a limited number of products.
- Airbus and Boeing dominate the commercial aircraft industry, manufacturing aeroplanes for airline companies only.
- Ferrari and Rolex supply luxury goods to a relatively small consumer market.
- Ford, General Motors and Toyota mass produce their cars to a global market.
- Samsung, Apple and Huawei collectively produce billions of smartphones.
- Burger King, KFC and McDonald's have fast-food restaurants across the world.
- Microsoft supplies computer software for over 90% of the world's personal computers.

Some businesses prefer to stay small. Rolex and Ferrari, for example, deliberately limit growth in their operations. Others, such as McDonald's and Toyota, continually strive for expansion.

(a) Outline why economies of scale might benefit customers. *[2 marks]*

(b) Explain why economies of scale might be inappropriate, undesirable or inaccessible for certain businesses. *[4 marks]*

(c) Explain why so many small firms continue to survive and thrive, despite their limited ability to access economies of scale. *[4 marks]*

(d) To what extent do large businesses operate in the best interest of the general public? *[10 marks]*

Question 5.4 - Hoang Tan

Hoang Tan is a small business specialising in clothing products for men. Established in 2018, Hoang Tan has expanded its operations in two other locations in South Vietnam. However, the owner has struggled to secure external finance for its planned growth in neighbouring countries Laos and Cambodia.

(a) Define the term *growth*. *[2 marks]*

(b) State **two** reasons why banks might be reluctant to fund the expansion plans of *Hoang Tan*. *[2 marks]*

(c) Explain **two** problems that *Hoang Tan* might encounter by operating in new overseas markets such as Laos and Cambodia. *[6 marks]*

Key concept

In a world of uncertainty and continual **change**, is it possible to achieve both growth and profit in a **sustainable** way?

Theory of Knowledge (TOK)

How can managers and business owners know whether growth is beneficial, given the risks and uncertainties involved?

External growth methods (AO3)

External growth methods: (i) mergers and acquisitions (M&As), (ii) takeovers, (iii) joint ventures, (iv) strategic alliances and (v) franchising. AO3

(i) Mergers and acquisitions (M&As)

The phrase 'mergers and acquisitions (M&As)' refers to the consolidation or integration of two or more businesses to form a single company. The new and larger business entity will usually benefit from improved synergies, such as economies of scale and have a larger share of the market(s) that it operates in. M&As also entail a restructuring of the company's organizational structure (see Chapter 8).

A **merger** takes place when two or more firms agree to create a new company with its own legal identity. An example is the merger between the UK's British Petroleum and the US oil company Amoco in 1998 to form 'BP Amoco' - which has since been renamed and shortened to 'BP'. Other examples of large mergers include Daimler Benz and Chrysler (1998), Glaxo Wellcome and SmithKline Beecham (2000), Hewlett-Packard and Compaq (2001), American Airlines and US Airways (2013) and Just Eat and Takeaway.com (2020). The merger usually requires a new company name to be used (given it has a new legal identity), along with a Board of Directors that is composed of executives from both or all the companies involved.

Case study 5.5 - American Airlines Group

On Valentine's Day 2013, US Airways and American Airlines agreed to merge in a deal worth \$11 billion to create the world's largest airline, with 6,700 daily flights and annual revenues of over \$42 billion. The airlines claimed the deal would offer passengers more travel options but probably at higher prices. Government regulators had initially blocked the merger as it was not deemed to be in the best interest of the general public, but the merger was eventually completed in December 2013 with the airlines being renamed American Airlines Group Inc.

An **acquisition** occurs when a company buys a *controlling interest* in another firm with the permission and agreement of its Board of Directors to do so. This means the acquiring company buys enough shares in the target company to hold a majority stake. The acquiring company (purchaser) must buy more than 50% of the target company's shares in order to gain absolute control over it. For example, Google acquired YouTube for just $1.65 billion in 2006 - although this wasn't a bad deal for the co-founders of YouTube who had only been in business for 10 months at that time!

Unlike a merger which usually involves the integration businesses of similar sizes, an acquisition usually occurs between two companies that are not of equal stature - typically, the larger and more financially powerful business acquires the smaller one. For example, Amazon acquired the American supermarket chain Whole Foods Inc. in 2017 for $13.7 billion. Although Whole Foods still operates under its original name, all of its business operations are controlled by Amazon as the parent company.

Mergers and acquisitions create **synergy**. Synergy occurs when the whole is greater than the sum of the individual parts when two or more businesses are integrated. Essentially, synergy creates greater output and improved efficiencies, which is a major reason why organizations seek to grown inorganically. Table 5.5 outlines the benefits and drawbacks of mergers and acquisitions as forms of external growth strategies.

Case study 5.6 - AT&T and WarnerMedia merger

In 2018, American multinational conglomerate AT&T agreed to acquire WarnerMedia, a multinational mass media and entertainment corporation, in a deal worth $43 billion. AT&T is the world's largest telecommunications company and America's largest provider of mobile telephone services. The merger enabled AT&T to gain access to markets under the brands of HBO, Cinemax, CNN and Warner Bros.

Common mistake

Students will often claim that a business needs to buy at least 51% of the shares in another company in order to acquire it. Buying 50% plus 1 share will guarantee the acquisition but this might prove too expensive and is not a necessary condition. Buying a majority stake (which can be less than 50%) will still give the purchaser control of the acquired business.

There are four types of integration or consolidation that can occur in a merger or acquisition:

- **Horizontal integration** is the most common type of M&A, which occurs when there is an amalgamation of firms operating in the same industry. For example, America's Nike acquired the UK's Umbro (both in the sports apparel industry) in 2007 for $580 million. Carlsberg, the Danish beer maker, acquired China's largest beer producer Chongqing Brewery in December 2013. Horizontal M&As do not represent growth in the industry but a larger market share and hence greater market power (dominance), for the integrated business.

- **Vertical integration** takes place between businesses that are at different stages of production. *Forward vertical integration* is the amalgamation or consolidation of businesses that head towards the final stage of production (towards the consumer), such as a coffee manufacturer acquiring a chain of coffee shops. *Backward vertical integration* means a merger or acquisition of businesses towards an earlier stage of production, such as a coffee manufacturer amalgamating with its supplier of coffee beans. This external growth strategy helps the manufacturer to secure lower costs of raw materials.

- **Lateral integration** refers to M&As between firms that have similar operations but do not directly compete with each other. For example, Tata Motors (considered a mass market brand) acquired Jaguar and Land Rover (both considered as luxury brands) in 2008, PepsiCo acquired Quakers Oats Company in 2001, Microsoft bought LinkedIn in 2016 and Meta Platforms (formerly Facebook, Inc.) acquired both Instagram (for a bargain $1bn in 2012) and WhatsApp (for $19bn in 2014).

- **Conglomerate M&As** are the amalgamation of businesses that operate in completely distinct or diversified markets. For example, Berkshire Hathaway owns businesses in a vast range of industries, including insurance, property, clothing, meat products, flight services, home furnishing, news media, confectionery, beverages and carpet making! The company has successfully used M&As as an external growth strategy.

The degree of success of M&As depends on several factors. First, the level of planning involved is crucial. A clear rationale of the benefits of the merger or acquisition must be communicated to key stakeholder groups to gain their support. Success also depends on the aptitudes of senior directors of the companies involved in the M&A. In addition, conflict can easily lead to the demise of M&As. Managers need to exert their negotiation skills and be able to handle the added pressures and responsibilities that they will face. Finally, regulatory problems can also present a barrier to success. The government can step in to prevent M&As taking place in order to prevent the business from having too much market power, if this is deemed to be against the best interest of the general public.

Table 5.5 - The benefits and drawbacks of mergers and acquisitions

Benefits of M&As	Drawbacks of M&As
Greater market share - The integrated company is likely to benefit from having greater market power, higher sales revenues and a larger customer base.	**Redundancies** - Job losses are likely to occur due to cost savings in M&As. For example, the new company will not need two finance or marketing directors.
Economies of scale - Operating on a larger scale helps to lower unit costs of production, thus improving the firm's competitiveness and/or profit margins.	**Conflict** - There are likely to be disputes and differences between the companies involved, so conflict is inevitable even if they eventually agree to the M&A.
Synergy - The integrating firms have access to each other's resources, such as distribution channels, technologies, human resources and management expertise. Hence, they are able to make use of their combined resources to increase productivity, sales revenues and profits.	**Culture clash** - People will need to adapt to the desired corporate culture of the newly formed organization. The M&A, as a new entity, might also entail changes to the company's core values and mission statement. Staff might also need time to adapt to new methods of working.
Survival - M&As are a quick method of growth to protect the survival of a business. As a defensive strategy, it allows the new firm to be in a stronger position to compete with its rivals.	**Loss of control** - The original owners or Board of Directors will lose some degree of control as the new Board will need to be restructured, including the creation of a new management team.
Diversification - Some M&As allow firms to diversify their product mix. This allows them to spread and reduce risks as well as benefit from a larger customer base.	**Diseconomies of scale** - The larger firm might suffer from increased bureaucracy and longer channels of communication, leading to less effective decision-making.
Gain entry into new markets - This can be achieved if the companies involved in the M&A currently operate in different markets.	**Regulatory problems** - Governments may be concerned with and hence prevent, M&As if they create a monopoly with too much market power.

Question 5.5 - The London taxi

In 2013, the producers of the iconic black taxi, London Taxi International (LTI), was sold to China's largest carmaker Geely for just £11.4m ($16m). LTI went into administration in October 2012 after five consecutive years without making any **profit**, with most of its workers losing their jobs.

The **acquisition** safeguarded production in the UK to secure the British association of the London black taxi as a global brand, although *Geely's* factory in Shanghai focuses on building taxis for the left-hand drive market. In a rare move following an acquisition, Geely rehired the workers who were made redundant following LTI's successive losses between 2007 to 2012. LTI was re-branded as the London Electric Vehicle Company in 2017.

(a) Define the term *profit* *[2 marks]*

(b) Define the term *acquisition*. *[2 marks]*

(c) Explain the winners and losers from Geely's acquisition of LTI. [6 marks]

(d) Discuss the driving forces behind Geely's strategic move to acquire LTI. *[10 marks]*

ATL Activity 5.1 (Research skills)

Investigate recent mergers and acquisitions in your country, or a country of your choice. Who were the winners and losers?

Business Management Toolkit

What is the significance of understanding Hofstede's cultural dimensions (see Chapter 54) for the success of international mergers and acquisitions?

(ii) Takeovers

In contrast to acquisitions, **takeovers** occur when a company purchases a controlling stake (majority of the stocks) in another company without the permission and agreement of the company or its Board of Directors. Hence, takeovers are also referred to as **hostile takeovers**.

To entice shareholders of the target company to sell their shares, the offer price for the takeover is likely to be well above the stock market value of the shares.

Takeovers have been used as a method of business growth for a long time. For example, Heineken, the Dutch beer company established in 1864 by Gerard Adriaan Heineken, came to dominate the Dutch brewing industry by taking over many of its competitors. With over 195 years of history, Cadbury was taken over by Kraft Foods in 2010 for a whopping $18 billion; reasonable perhaps considering people spend over $9.5 million on chocolates per hour! In 2017, 21st Century Fox was bought by the Walt Disney Company for $52.4 billion. Box 5.1outlines the main reasons why a certain business might become a takeover target.

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Box 5.1 - Reasons why businesses become takeover targets

- They have growth potential but lack sufficient funds for internal growth.
- They are seen as a small rival that has growth potential.
- They have a widely recognised corporate name or brand but currently face a liquidity or financial crisis.
- They are vulnerable (an easy target for a takeover) due to a drop in profits and subsequent fall in their share price.

Key concept

Can hostile takeovers ever be judged as **ethical** business behaviour?

Question 5.6 - Disney's takeover of Pixar and Lucasfilm

In 2006, The Walt Disney Company (or Disney for short) paid $7.4 billion in a deal to take ownership of Pixar Animation Studios, the firm responsible for movies such as Toy Story, Finding Nemo, Cars and Monsters Inc. Disney said that high demand for Pixar's movie merchandise (such as Buzz Lightyear toys and DVD movie sales) had earned Disney over $3.2 billion.

The real value to Disney's **takeover** of Pixar, however, is the **synergy** that would be created from the integration of the two firms. In 2010, Toy Story 3 became the highest-grossing animated movie of all time, earning over $1bn at the box office. As part of its growth strategy, Disney also acquired Lucasfilm in 2012 and scheduled production of a third trilogy of *Star Wars*, with Episode VII released in December 2015 and Episode IX in December 2019.

(a) Define the term *acquisition*. *[2 marks]*

(b) Define the term *synergy*. *[2 marks]*

(c) Explain **two** potential problems for businesses during an acquisition. *[6 marks]*

(d) Discuss the decision of The Walt Disney Company to acquire other firms such as Pixar and Lucasfilm *[10 marks]*

(iii) Joint ventures

A **joint venture** (JV) occurs when two or more businesses split the costs, risks, control and rewards of a project. In doing so, the parties agree to set up a new legal business entity. For example, Coca-Cola has a JV with San Miguel by shared ownership of Coca-Cola's bottling plant in the Philippines. Since 2003, the German carmaker BMW has had a joint venture with Brilliance Auto in the production, distribution and sale of BMW passenger cars in China. Typically, a JV between two firms will involve a 50:50 split of costs, responsibilities and profits (or losses).

Joint ventures allow organizations to enjoy similar benefits to mergers and acquisitions but without having to lose their individual corporate identities. The advantages of joint ventures include:

- **Synergy** - The pooling of experiences, skills and resources of the collaborating firms in the JV should create synergies. For example, the 50:50 joint venture between Bank of Scotland and Sainsbury's (a commercial bank and a supermarket chain) between 1997 and 2014 meant that both parties could specialize in their area of expertise yet gain access to new technologies and customers to achieve larger profits for both organizations.

- **Spreading of costs and risks** - Financial costs, risks and losses are shared in a JV thereby helping to reduce the financial burden on any single organization. JVs also allow firms to diversify their products, thereby helping to spread the risks associated with growth and evolution.

- **Entry to foreign markets** - Joint ventures are used by companies to enter foreign countries by forming an agreement with local firms. In some cases, national laws make JVs the only option for businesses wishing to enter foreign markets. For example, many foreign companies have entered China and India by creating JVs with local Chinese and Indian businesses.

- **Relatively cheap** - Mergers and acquisitions can be highly expensive as they entail lengthy legal procedures and administrative costs. The cost of a hostile takeover is often unknown. By contrast, JVs are cheaper to establish and are easier to pull out of should this be necessary.

- **Competitive advantages** - Competition is reduced by forming a JV. Companies cooperating in a JV are unlikely to directly compete with each other, yet their pooled resources make them a stronger force against their rivals. Their combined size could also mean that further economies of scale can be enjoyed.

- **Exploitation of local knowledge** - Firms that expand via international JVs can take advantage of each other's local knowledge and reputation. This might not be the case with mergers or acquisitions that are exposed to potential problems of overseas expansion (such as differences in business etiquette, cultural values, languages and local traditions).

- **High success rate** - Joint ventures tend to be friendly and well received by key stakeholder groups. The parties pool their funds and resources, sharing responsibility for their mutual benefit. This positive attitude is more likely to lead to the success of a JV. By contrast, takeovers often fail due to their aggressive and hostile nature.

Joint ventures and strategic alliances (see below) have similar drawbacks. Partners in a JV have to rely heavily on the resources and goodwill of their counterparts. There is also likely to be a dilution of the brands, yet firms spend huge amounts of money trying to develop their own brands (see Chapter 27). Finally, whenever companies work together on a project, there is always the possibility of organizational culture clashes that can lead to operational problems and conflicts for the joint venture.

Question 5.7 - Tiffany & Co. and Swatch Group

In 2007, Swatch struck a **joint venture** deal with jewellery chain Tiffany & Co to make watches together under the brand Tiffany Watch Co. The contract was to last 20 years, giving Swatch the rights to sell watches under the new brand name in Tiffany's retail outlets and other high-end outlets.

However, disputes between the two companies started in 2011 which resulted in Swatch, the world's largest watchmaker, cancelling the collaboration. Swatch had accused Tiffany of blocking the development of their business, having already invested millions of dollars to develop the watches. In 2014, Tiffany & Co. was ordered by the authorities to pay Swatch Group almost $450m in the failed joint venture as well as $9m to cover the legal fees for Swatch.

(a) Define the term *joint venture.* *[2 marks]*

(b) Explain **two** reasons why a merger between Tiffany & Co. and Swatch might not have been appropriate compared to the joint venture. *[4 marks]*

(c) Examine the costs and benefits of the joint venture to Tiffany & Co. and Swatch *[6 marks]*

(iv) Strategic alliances

A **strategic alliance** (SA) is similar to a joint venture in that two or more businesses cooperate in a business venture for mutual benefit. The firms in the SA also share the costs of product development, operations and marketing. However, unlike JVs, forming a strategic alliance means that the affiliated businesses remain independent organizations and do not form a new legal business entity. Typically, there are four key stages to the formation of a strategic alliance:

1. *Feasibility study* - Investigate and establish the rationale, objectives and feasibility of the SA.

2. *Partnership assessment* - Analyse the potential of different partners for the SA, such as what they have to offer to the coalition in terms of both human and financial resources as well as their skills, experiences and areas of expertise.

3. *Contract negotiations* - Discussions take place to determine each member's contributions and rewards, thus forming a mutually acceptable contract.

4. *Implementation* - Operations are initiated with commitment to the contract from all parties involved in the newly created SA.

Figure 5.7 - Strategic alliances are common in the airline industry

The main purpose of a strategic alliance is to gain synergies from the different strengths of each member of the consortium by pooling their resources (to gain from each other's areas of expertise as well as financial support). Two airlines both with half-empty aeroplanes could directly compete or they could collaborate by using a single full aeroplane to cut the costs of airline crew and fuel costs, choosing instead to split the profits for mutual benefit. Strategic alliances also enable members to gain from economies of scale by operating on a larger scale. Furthermore, customers are likely to benefit from the value-added services under a strategic alliance, such as the convenience of access to wider channels of distribution (see Chapter 30).

Case study 5.7 - Star Alliance

Star Alliance was set up in 1997 by five founding airlines: Lufthansa, Scandinavian Airlines, Thai Airways International, United Airlines and Air Canada to share the costs and benefits of airline operations. Its headquarters are located in Frankfurt, Germany.
It was the first ever strategic airline alliance and has grown to 26 members, making it the largest alliance in the industry with a pre-pandemic (COVID-19) passenger count of 762.27 million. The alliance also includes 40 non-voting affiliated airline carriers, which enables the alliance to serve almost every country on the planet.

Business Management Toolkit

What is the significance of cultural dimensions for international takeovers, joint ventures and strategic alliances?

You may find reference to Chapter 54 (Hofstede's cultural dimensions) useful prior to answering this question.

(v) Franchising

McDonald's, Subway, The Body Shop and many others use **franchising** as a method of external growth. A franchise is a form of business ownership whereby an individual or business buys a license to trade using another company's products, name, logos, brands and trademarks. In return for this benefit, the purchaser of a franchise (called the **franchisee**) pays a license fee to the parent company (known as the **franchisor**). The franchisee also pays a **royalty payment** (similar to commission) based on the sales revenue of the franchisee.

The world's largest franchises include 7-Eleven, Baskin-Robbins, Burger King, Hertz, InterContinental Hotels, KFC, Marriot International, McDonald's, Pizza Hut and Subway. The benefits and drawbacks of franchising for franchisors and franchisees are outlined in Tables 5.6 and 5.7.

Case study 5.8 - Burger King

Burger King has used franchising as its key business strategy for growing nationally and internationally. The world's second largest fast-food chain has more than 18,000 outlets, with around 90% of them being franchises.

Its high success rate relies on the know-how, brand recognition and trust of a parent organization coupled with the incentives and enthusiasm of the franchisees to make it a success. Burger King's parent company is *Restaurant Brands International Inc*, which also owns Tim Hortons and Popeyes.

Table 5.6 - The benefits of franchising for franchisors and franchisees

Benefits for the franchisor	Benefits for the franchisee
The company can experience rapid growth without having to risk large amounts of money as the franchisee pays for the rights. Hence, it can be cheaper and faster than internal growth.	There are relatively lower start-up costs because the business idea has already been developed by the franchisor (such as market research, brand development and product development strategies).
It allows the company to have a national or international presence without the higher costs of internal growth or M&As (as the franchisee helps to finance the expansion).	There is relatively low risk because the franchisor has a tried and tested formula, so the chances of business success are statistically high.
The franchisor benefits from rapid growth without having to worry about running costs such as recruitment, training and development, staff salaries and the purchase of stocks (inventories).	It is in the best interest of the franchisor to ensure that the franchise succeeds, so it will provide value-added services to support the franchisee, such as training and advice on financial management.
Franchisors receive royalty payments from the franchisee, usually set as a percentage of the sales revenues. They also usually charge franchisees a 'membership' (registration or joining) fee.	The franchisee is likely to benefit from large scale advertising used by the franchisor, i.e. franchisees receive 'free' advertising and promotion, which also helps to reduce their costs.
Franchisees have more incentives to do better than salaried managers, thereby increasing the chances of success for the franchisor.	Franchisees are still, technically, their own bosses, so have a large degree of autonomy in running their own business, within the parameters of the agreement.

Table 5.7 - The drawbacks of franchising for franchisors and franchisees

Drawbacks for the franchisor	Drawbacks for the franchisee
There is a huge risk in allowing other parties (franchisees) to use the franchisor's name. Unsuccessful franchisees can damage the reputation of the entire franchise business.	Franchisees cannot simply use their own initiative to try out new ideas as they are overseen by the franchisor and the formal agreement. This could hinder the entrepreneurial talents of the franchisee.
It can be difficult to control the daily operations of all franchisees and to get them to meet the quality standards set by the franchisor.	Buying a franchise can be very expensive, yet there is no guarantee that this investment will ever be recouped.
Although franchising is faster than internal growth methods, it is not as quick as other external methods such as M&As.	Franchisees have to pay a significant percentage of their sales revenues to the franchisor.

Question 5.8 - Pizza Hut

Founded in 1958, Pizza Hut is the world's largest chain of pizza restaurants. Within a year of opening, the company launched its first **franchise**. Today, its operations span the globe with over 18,700 restaurants in over 95 countries. The company plans to continue opening more stores in existing and new locations. The company has a dedicated website with everything potential franchisees need to know about becoming a Pizza Hut franchisee.

(a) Define the term *franchise.* *[2 marks]*

(b) Explain **two** reasons for Pizza Hut's decision to use franchising as its main method of growth. *[4 marks]*

(c) Examine the potential problems of Pizza Hut's growth strategy. *[6 marks]*

Exam tip !

Make sure you are able to evaluate the different methods of external growth. A strategy that is suitable for one organization is not necessarily appropriate for others. It is important to put your answers in the context of the business and to consider short- and long-term factors in your evaluation. Reference to Hofstede's cultural dimensions (see Chapter 54) could also be relevant when evaluating growth methods that involve overseas partners.

Growth and evolution and the key concepts

Growth is a strategic objective for many businesses. In an ever-integrated business world, the driving force behind growth and evolution is not simply profit, but sustainable competitiveness - as the Chinese proverb goes *"Be not afraid of going slowly; be afraid only of standing still."*

Mergers and acquisitions (see Chapter 5) are common in today's fast-paced, highly competitive and continually changing business environment. Organizations are increasingly having to 'run faster to stay still', i.e. they have to change and be creative in order to grow and evolve in a sustainable way. This is vital for any business striving to maintain its market share and competitiveness.

Growth and evolution do not always work out, so businesses might strategically choose to shrink in size. This might involve breaking away from a strategic alliance, terminating a joint venture or demerging. Reasons for doing so include:

- Offloading unprofitable sections of the business.
- Avoiding rising average costs and inefficiencies by being too large (caused by internal and external diseconomies of scale).
- Raising cash to sustain operations in other parts of the business that are more profitable.
- Having a clearer corporate focus by concentrating efforts on a smaller range of products or business operations.

Figure 5.8 - Demergers are not uncommon in the business world

For some businesses, growth and downsizing can occur on a cyclical basis. Reductions in the size of a business generate their own problems that need careful change management. For example, there is likely to be a reduction in staffing, so redundancies have to be planned and managed sensitively and ethically. For larger organizations, the costs of staff redundancies can be quite considerable and cause short-term liquidity problems for the business (see Chapter 20).

Key concept

With reference to an organization of your choice, examine how **creativity** has influenced its growth strategy.

Key concept

With reference to a business of your choice, examine how **change** has influenced its evolution as an organization.

Key concept

With reference to an organization of your choice, examine how **creativity** affects its ability to **change** and evolve.

Exam tip !

To broaden your understanding of the complexities that businesses face when operating in overseas markets, read Chapters 6 (multinational companies) and Chapter 46 about the external environment (STEEPLE analysis). Make connections between the contents in this chapter and that in Chapters 6 and 46, with consideration of how the political, legal and social environments affect a firm's growth strategies.

REVIEW QUESTIONS

1. What is the meaning of economies of scale?
2. What is average cost and how is it calculated?
3. What are diseconomies of scale?
4. How might the notion of economies and diseconomies of scale be shown on a diagram?
5. What is meant by the optimal size of a business?
6. What are the main types of internal economies of scale?
7. What are the main types of external economies of scale?
8. How do internal diseconomies of scale differ from external diseconomies of scale?
9. How does internal growth differ from external growth?
10. What are the main reasons why businesses seek to grow?
11. What are the main reasons why some businesses stay small?
12. What are mergers and acquisitions?
13. What is a takeover?
14. How do joint ventures differ from strategic alliances?
15. What are the advantages and disadvantages of franchising as a method of external growth?

KEY TERMS

An **acquisition** is a method of external growth that involves one company buying a controlling interest (majority stake) in another company, with the agreement and approval of the target company's Board of Directors.

Average cost refers to the cost per unit of output.

Backward vertical integration occurs when a business amalgamates with a firm operating in an earlier stage of production, such as a car manufacturer taking over a supplier of tyres or other components.

Conglomerates are businesses that provide a diversified range of products and operate in a range of different industries.

A **demerger** occurs when a company sells off a part of its business, thereby separating into two or more businesses. It usually happens due to conflicts, inefficiencies and incompatibilities following an earlier merger of two or more companies.

Diseconomies of scale are the cost disadvantages of growth. Average costs are likely to eventually rise as a firm grows due to a lack of control, coordination and communication.

Economies of scale refer to lower average costs of production as a firm operates on a larger scale due to gains in productive efficiency, such as easier and cheaper access to source of finance.

External diseconomies of scale occur due to factors beyond its control which cause average costs of production to increase as an industry grows.

External economies of scale occur when an organization's average cost falls as the industry grows. Hence, all firms in the industry benefit.

External growth (or **inorganic growth**) occurs when a business grows and evolves by collaborating with, buying up or merging with other organizations.

Financial economies of scale are cost savings made by large firms as banks and other lenders charge lower interest (for overdrafts, loans and mortgages) because larger businesses represent lower risk.

Forward vertical integration is a growth strategy that occurs with the amalgamation of a firm operating at a later stage in the production process, such as a book publisher acquiring book retailers.

Franchising refers to an agreement between a franchisor selling its rights to other businesses (franchisees) to allow them to sell products under its corporate name in return for a fee and regular royalty payments.

Horizontal integration is an external growth strategy that occurs when a business amalgamates with a firm operating in the same stage of production.

Internal diseconomies of scale occur due to internal problems of mismanagement, causing average costs of production to increase as a firm grows.

Internal economies of scale occur within a particular organization (rather than the industry as a whole) as it grows in size.

Internal growth (also known as **organic growth**) occurs when a business grows using its own capabilities and resources to increase the scale of its operations and sales revenue.

A **joint venture** is a growth strategy that combines the contributions and responsibilities of two or more different organizations in a shared project by creating a separate legal enterprise.

Lateral integration refers to external growth of firms that have similar operations but do not directly compete with each other, such as PepsiCo acquiring Quakers Oats Company.

Marketing economies of scale occur when larger businesses can afford to hire specialist managers, thereby improving the organization's overall efficiency and productivity.

A **merger** is a form of external growth whereby two (or more) firms agree to form a new organization, thereby losing their original identities.

The **optimal level of output** is the most efficient scale of operation for a business. This occurs at the level of output where the average cost of production is minimized.

The **purchaser** refers to the acquiring company in an acquisition or the buyer of another company in a takeover.

Purchasing economies of scale occur when larger organizations can gain huge cost savings per unit by purchasing vast quantities of stocks (raw materials, components, semi-finished goods and/or finished goods).

Risk bearing economies of scale occur when large firms can bear greater risks than smaller ones due to having a greater product portfolio.

Specialization economies of scale occur when larger firms can afford to hire and train specialist workers, thus helping to boost their level of output, productivity and efficiency.

Strategic alliances are formed when two or more organizations join together to benefit from external growth, without having to set up a new separate legal entity.

Synergy is a benefit of growth, which occurs when the whole is greater than the sum of the individual parts when two or more business operations are combined. Synergy creates greater output and improved efficiency.

A **takeover** (also referred to as **hostile takeover**) occurs when a company buys a controlling interest in another firm without the prior agreement or approval of the target company's Board of Directors.

The **target company** refers to the organization that is purchased by another in an acquisition or takeover deal.

Technical economies of scale are cost savings by greater use of large-scale mechanical processes and specialist machinery, such as mass production techniques which help to cut average costs of production.

Vertical integration takes place between businesses that are at different stages of production.

Chapter 6

Unit 1.6 - Multinational companies (MNCs)

"Growth demands a temporary surrender of security."
- Gail Sheehy (1936 - 2020), American author, journalist and academic

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The impact of MNCs on the host countries (AO3)

A **multinational company** (MNC) is an organization that operates in two or more countries, usually with its head office (or headquarters) based in the home country. The terms MNC and **transnational corporation** are often used interchangeably, although some commentators say that a MNC has its head office based in the home country whereas a transnational corporation has regional head offices rather than a single international base. Examples of large MNCs include Apple, Coca-Cola, Louis Vuitton, Nike, Samsung and Toyota, which all stand out within their industries in terms of sales revenue, profits, capital assets and market value.

The rise of MNCs and the ever-growing importance of international trade have intensified globalization. Businesses may strive to become MNCs for several reasons, including the following:

- An **increased customer base** by expanding internationally allows businesses to benefit from higher sales revenue. For example, many businesses (such as KFC, Starbucks, Lamborghini and Walmart) have expanded into China to benefit from the huge customer base.
- Many MNCs expand overseas to benefit from **cheaper production costs**, especially inexpensive labour. For example, the relatively high cost of labour in Germany, partly due to the imposition of minimum wage legislation, has meant that businesses such as Adidas, BMW and Volkswagen have production facilities overseas with access to readily available labour at a more affordable cost.
- As production levels increase, MNCs are able to benefit from **economies of scale** (see Chapter 5). MNCs might also want to locate overseas to benefit from the host country's infrastructure, such as its network of roads, telecommunications and ports. The host country may offer better quantity and quality of land in terms of the amount of space and/or the cost of land. There could also be financial incentives from the host country's government which help to reduce average production costs whilst allowing the MNC to expand into new markets.
- **Brand development** and **brand value** can be enhanced by operating on an international scale. Brand recognition and brand loyalty can also be enhanced by using global marketing strategies. The importance of branding is covered in Chapter 27).

- By producing within a particular country, MNCs can usually avoid any **protectionist policies** that the country might impose (see Box 6.1). This is one reason why many Japanese motor vehicle manufacturers, including Toyota, Honda and Nissan, have established factories in the European Union and North America.

- MNCs are able to **spread risks**. This means that unfavourable market conditions in one country or region of the world might not damage the overall business if it can spread risks internationally. Natural disasters (such as tsunamis), terrorist acts (such as the 9-11 attacks) and diseases (such as swine flu and mad cow disease) have affected different parts of the world. Over-specialization in any one of these regions could have led to a serious reduction in profits for these businesses.

Box 6.1 - Protectionist policies (trade barriers)

- **Tariffs** are a tax on imports, thereby adding to the price of foreign products. This makes imports less price competitive. MNCs can overcome this by establishing production facilities in the tariff-imposing nation.

- **Quotas** are quantitative limits imposed on the sale of imports. This results in a lower supply (or availability) of imported products, thereby forcing up import prices.

- **Restrictive trade practices** are acts that unfairly, although not illegally, discriminate against foreign firms as they do not apply to domestic firms. Examples include rigorous administrative procedures and strict safety standards imposed on imports

The impact of MNCs on the host countries (AO3)

A **host country** is any nation that allows a multinational company to set up in its country. In addition to the reasons for the growth of MNCs (see above), they have varying impacts on host countries, some of which are beneficial whilst others are detrimental.

The positive impacts of MNCs on host countries include:

- **Job creation** - MNCs create job opportunities in the host country. For example, Volkswagen's manufacturing plant in Kaluga, Russia created over 3,500 jobs with an initial investment of $400 million. Although some MNCs have been criticised for paying 'low' wages to workers in poorer countries, MNCs typically offer higher pay than local firms in these countries.

- **Higher national income** - MNCs help to increase the host country's gross domestic product (GDP). This is the value of a country's annual output or national income by creating consumption expenditure (as more workers are in paid employment) and by boosting export earnings for the host country, which also improves the nation's average standard of living. For example, one of Hungary's largest exporters is German car manufacturer Audi, which has its Audi TT sports car produced in western Hungary.

- **Knowledge and technology transfer** - MNCs have introduced new skills and technologies in production processes to host countries. For example, Japanese firms have introduced lean production and quality management models such as kaizen, just-in-time, quality circles and total quality management (see Chapter 37) to other economies. With new ideas in strategic management thinking and technology transfer, the efficiency of production in the host country is raised. This also helps to improve the international competitiveness of businesses in the host country.

- **Increased competition** - MNCs intensify the degree of competition in the host country. This should lead to greater efficiency gains to the benefit of domestic customers. Also, it can be argued that without the threat or presence of MNCs, domestic firms do not necessarily have the incentive to be as creative or innovative in responding to changes in the economy.

The interrelated negative impacts of MNCs on host countries include:

- **Job losses** - Just as they are able to create jobs, MNCs are capable of causing unemployment in the host country too. This is because MNCs are likely to pose a threat to domestic businesses. Competition can be beneficial if it causes domestic firms to improve their efficiency and productivity, but it can also be a setback if it means that local firms are

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