Essentials of Business Administration

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PREFACE

Business Administration composed of four main fields: finance, accountancy, marketing, and management.

The BBA requires up to 30 courses which lasts for 4 years. The full course causes problems in terms of accurate perception of the business administration as unified field of science.

The purpose of current books is to introduce to the students the essence of each field of business administration by the question-answer form with references on the existing textbooks. The book can be used to review and refresh student’s knowledge in Business Administration.

FINANCE

MAIN ISSUES OF FINANCE

1. What is Finance? What do financial managers try to maximize, and what is their second objective?

Finance is the application of a series of economic principles to maximize the wealth or overall value of a business. More specifically, maximizing the wealth of a firm means making the highest possible profits at the least risk. No one really knows when maximum wealth is achieved, though it is assumed to be the ultimate goal of every firm. One way of finding out the wealth of a firm is through the price of its common stock. When the price of a firm's shares increases, it is said that the wealth of the firm's shareholders has increased.

The primary objective of financial managers is to maximize the wealth of the firm or the price of the firm's stock. A secondary objective is to maximize earnings per share. Profit maximization is a short-term objective and is less important than maximizing the wealth of the firm. A firm can achieve high profits in the short run simply by cutting corners. In other words, managers can delay charging off some expenses, they can defer buying expensive albeit cost effective equipment, and they can lay off some of their most productive high-salaried workers. These short-sighted decisions can lower costs and raise profits temporarily. Furthermore, high profits may be obtained by investing in highly uncertain and risky projects. In the long run, these chancy projects can weaken the competitive position of a firm and lower the value of its stock. Therefore, attempts to maximize profits may prove inconsistent with the goal to maximize the wealth of the firm, which calls for attaining the highest expected return possible at any risk level.

Finance is part science, part art. Financial analysis provides a means of making flexible and correct investment decisions at the appropriate and most advantageous time. When financial managers succeed, they help improve the value of the firm's shares.

A good manager knows how to use the factors in arriving at final decisions, factors as: adapting to changes, manager as an agent. Financial managers are charged with the primary responsibility of maximizing the price of the firm's shares while holding risk at the lowest level possible. In order to achieve these goals, a manager must determine which investments will provide the highest profits at least risk. Once this decision is reached, the next step involves the selection of optimal ways to finance these investments. Planning to achieve the best results should be flexible, allowing for alternative strategies to replace existing plans should financial and economic developments diverge from an expected pattern.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 1, p. 1

2. What is financial planning?

Financial planning, a crucial part of financial management, includes the making of daily decisions to help the firm meet its cash requirements. It requires close attention to intermediate changes in business activity. Analysis of the business cycle helps the financial manager keep financing costs low and avoid excesses in inventories and capacity. Proper timing of business activity leads to better production and inventory decisions to meet changes in economic activity.

Planning to achieve the best results should be flexible, allowing for alternative strategies to replace existing plans should financial and economic developments diverge from an expected pattern. Furthermore, financial planning involves proper timing of investments in order to avoid overexpansion and inefficient use of resources. Optimal use of available funds means exploring different options and selecting those that provide the greatest overall value. It also means adopting effective ways of determining how much to borrow in order to reduce financing risks.

Long-range plans must be developed to give proper direction to research and development and to make sound capital expenditure decisions. If properly managed, the lower risk and higher expected returns that result will be recognized by investors, who are likely to raise their assessment of the value of the firm. By adopting these approaches, financial managers have a better-than-even chance of maintaining a healthy firm and maximizing shareholders' wealth.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 1, p. 2

3. List several examples of agency problem and the costs associated with them. What forms of managerial compensation do you know?

At one time or another, most people have had occasion to hire agents to take care of a specific matter. In doing so, responsibility is delegated to another person. For example, when suing for damages, individuals may represent themselves or may hire a lawyer to plead their case in court. As an agent, the lawyer is given the assignment to get the highest possible award. And so it is with stockholders when they delegate the task of running a firm to a financial manager, who, though not strictly correct, legally may be thought of as an agent of the company. Obviously, the goal is to achieve the highest value of a share of stock for the firm's owners. But there are no standard rules that indicate which course of action should be followed by managers to achieve this. The ultimate guideline is how investors perceive the actions of managers.

In general, managers should seek to use sound investment policies that minimize risk. However, some managers interpret their mission differently. As agents, they envision their role as one of avoiding big mistakes. As a result, these agents may overlook good opportunities with acceptable levels of risk. This conflict between agent and stockholders is unlikely to produce the best results.

There are no easy answers to ensure compatibility between agents and their stockholders. It is up to the stockholders-acting through the board of directors to hire the right managers and to make sure they are properly compensated. This means meeting the market price to attract the right talent. Offering stock to these managers also helps ensure that they will seek to maximize the value of the firm's shares.

In any event, capable managers have the right judgment and instincts to know what policies to implement and when to implement them. They know when to raise funds and how to control assets. These correct decisions are translated into favorable signals to investors, usually resulting in a higher valuation of the firm's common stock.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 1, pp. 2-3

4. State the importance of accounting and statistics for financial managers

Financial managers rely on accountants to prepare income and balance sheet statements that provide information on the profitability and the financial status of a firm. The Financial Accounting Standards Board requires firms to report a current Statement of Cash Flows. This statement provides a detailed analysis of the way cash is generated and traces how cash is utilized in the conduct of all phases of a business. As a result, this statement supplies another important financial tool to managers who seek to control and understand the external factors and internal policies that can influence the cash flows of the firm. Financial statements help managers to make business decisions involving the best use of cash, the attainment of efficient operations, the optimal allocation of funds among assets, and the effective financing of investment and operations. The interpretation of financial statements is achieved partly by using financial ratios, pro forma statements, sources and uses of funds and cash budgets.

It should be pointed out that the managers of a firm are supplied with more detailed statistical information than appears in published financial statements. These data are especially important in developing cash flow concepts for evaluating the relative merits of different investment projects. This information permits managers to determine incremental cash flows (an approach that looks at the net returns a given project generates in comparison with alternative investments), thus enabling them to make more accurate assessments of the profit abilities of specific investments. It is the responsibility of managers to direct their accountants to prepare internal statements that include this information so that they can make the best investment decisions possible.

The primary objectives of financial accounting are to provide information that is useful in making investment and credit decisions; in assessing the amount, timing, and uncertainty of future cash flows; and in learning about the enterprise's economic resources, claims to resources, and changes in claims to resources.

The importance of accounting for investors is huge! Accounting is the language of business. That is what management uses to ‘communicate’ performance to the outside world. However management often wants to communicate only favorable news and this communication is often ‘mis’ communication.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron’s Inc 2006, Chapter 1, pp.7-8

5. What are the three types of business organizations? Define them

The three types of business organizations are proprietorships, partnerships, and corporations. A proprietorship is the oldest form of organization for a business owned by only one individual. Anyone with money can buy basic working tools and start a proprietorship to produce goods or offer services thought to be marketable.

A main advantage of a proprietorship is its easy formation process. The formation of a proprietorship doesn’t require the approval of any regulatory agency. Once the working conditions of the business are present the sole proprietorship is in existence. (The only exception is that certain professions require a license in order to practice.) Another advantage is the straightforward taxation method used for proprietorships: The proprietor’s income is simply included on the owner’s individual tax return each year.

A main disadvantage of this form of organization is that the owner is responsible for the entire liability of the proprietorship. Since the owner has unlimited liability, personal properties that are not used in the business may be lost to creditors.

Another disadvantage is that a proprietorship can’t use organized capital markets — such as stock and bond markets — to raise needed capital. A proprietorship therefore has limited opportunities for growth, because its capital can be expanded only so far. Capital, in the form of either debt or equity, is the means to buy assets and expand a company.

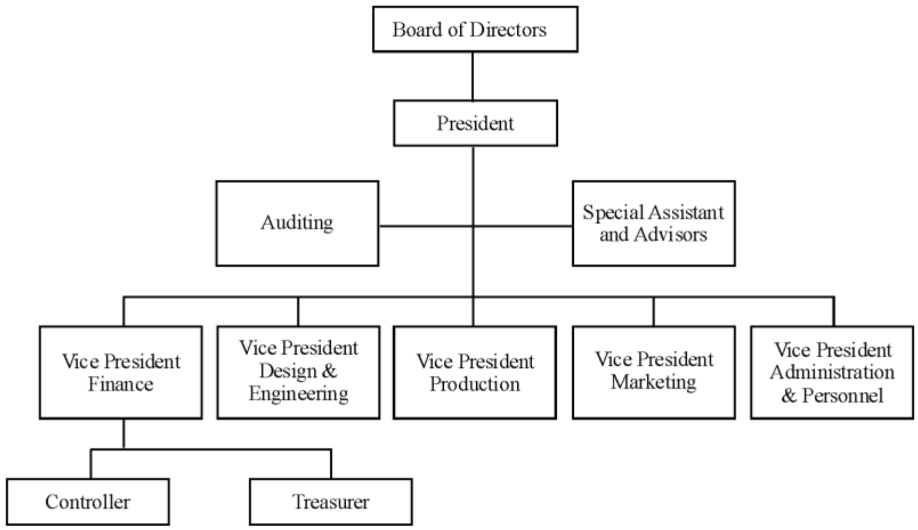
A partnership is a form of business organization in which two or more individuals are the owners. A partnership can be viewed as a proprietorship with more than one owner. There are two kinds of partners: general partners and limited partners. General partners have unlimited liability in running a business, but limited partners are liable only up to the amount of their investments or for a specified amount of money. In a general partnership all partners have unlimited liability. In a limited partnership there is at least one limited partner in the business.

The third form of organization is the corporation, which, in terms of dollars, dominates today’s business world. A corporation can be formed by a person or a group of persons. The “personality” of the corporation, under the law, is totally separate from its owners. Precisely speaking, a corporation is a “legal entity”; therefore, the corporation, rather than the owners, is responsible for paying all debts.

Because of the legal status of a corporation, the owners have limited liability and can’t lose more than their invested money. Unlike a proprietor, the owners of a corporation do not have to withdraw from their personal savings or sell their personal belongings to satisfy creditors if the corporation goes bankrupt. An owner of a corporation is called a stockholder or shareholder.

Advantages of a corporate form include limited liability, unlimited life, separation of ownership and management (ability to own shares in several companies without having to work for all of them), ease of transferring ownership and ease of raising capital.

Disadvantages include separation of ownership and management (agency costs) and double taxation (income tax and dividend tax).



A Typical Corporate Organization

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 2, pp. 1-3

6. What are the advantages and disadvantages of organizing a business as a corporation?

Starting a corporation is more complicated than starting a proprietorship or partnership. The incorporators must prepare articles of incorporation and a set of bylaws. The articles of incorporation must include the following:

- Name of the corporation.
- Intended life of the corporation (it may be forever).
- Business purpose.
- Number of shares of stock that the corporation is authorized to issue, with a statement of limitations and rights of different classes of shares.
- Nature of the rights granted to shareholders.
- Number of members of the initial board of directors.

The bylaws are the rules to be used by the corporation to regulate its own existence, and they concern its shareholders, directors, and officers. Bylaws range from the briefest possible statement of rules for the corporation's management to hundreds of pages of text.

In closely held corporations with few shareholders there may be a large overlap among the shareholders, the directors, and the top management. However, in larger corporations the shareholders, directors, and the top management are likely to be distinct groups.

The potential separation of ownership from management gives the corporation several advantages over proprietorships and partnerships:

- Because ownership in a corporation is represented by shares of stock, ownership can be readily transferred to new owners. Because the corporation exists independently of those who own its shares, there is no limit to the transferability of shares as there is in partnerships.
- The corporation has unlimited life. Because the corporation is separate from its owners, the death or withdrawal of an owner does not affect its legal existence. The corporation can continue on after the original owners have withdrawn.
- The shareholders' liability is limited to the amount invested in the ownership shares. For example, if a shareholder purchased $1,000 in shares of a corporation, the potential loss would be $1,000. In a partnership, a general partner with a $1,000 contribution could lose the $1,000 plus any other indebtedness of the partnership.

Limited liability, ease of ownership transfer, and perpetual succession are the major advantages of the corporation form of business organization. These give the corporation an enhanced ability to raise cash. There is, however, one great disadvantage to incorporation. The federal government taxes corporate income. This tax is in addition to the personal income tax that shareholders pay on dividend income they receive. This is double taxation for shareholders when compared to taxation on proprietorships and partnerships.

Corporate Finance, 6thed, Ross, Westerfield, Jaffe; McGraw-Hill, 2003;Chapter 1, p. 13

7. Describe the triple tax of a corporation

Triple tax a situation where taxes are paid three times: income tax on corporate income, tax on stockholders' dividends, and tax on dividend income of the firm from its outside investment.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 2, pp. 1-3

TIME VALUE OF MONEY

8. What is time value of money? List and explain two main reasons why money changes its value through time

The old saying “A bird in the hand is worth two in the bush” makes a great deal of sense when applied to finance. In monetary terms, it means that cash today is worth more than cash in the future. In other words, the value of money changes over time. Investors have a natural preference for cash now rather than later, so they can increase its value. This, of course, is a major goal of a financial manager. Aside from this basic reason why cash now is worth more than cash later, you should also be aware of factors that decrease the value of money over time. Two important reasons why the value of money decreases progressively over time are as follows:

1. Risk
2. Preference for Liquidity

Risk, or uncertainty about the future, also causes a decline in the value of money. Because the future is uncertain, risk increases with time. Most people wish to avoid risk, so they value cash today more than the promise of cash in the future. Most people are willing to give up cash for promised cash only if properly compensated for the risk they are asked to take.

No one can predict with certainty either the future of domestic economy or economic and financial trends in other parts of the world. It is impossible to predict accurately whether money invested today will be available tomorrow. There is no assurance that a financially sound firm will remain so in the years ahead. Investors cannot be guaranteed dividends or price appreciation in stocks they purchase, nor can they be completely certain that the interest and principal on fixed-income securities will be paid as agreed by the issuer. Financial analysts or sophisticated investors, no matter how competent they are, cannot be assured that the returns they project from a given investment will turn out as originally visualized.

Since uncertainty increases the further one looks into the future, risk also increases — and the value of money promised in the future diminishes accordingly.

Liquidity is important to an investor or a firm. Liquidity refers to how easily assets can be converted into cash without significant loss. Cash, government bonds, and other marketable securities (company assets guaranteed to lenders to ensure repayment of a loan) increase the liquidity of a firm. By the same token, fixed assets such as plant and equipment are not considered very liquid. Investors have a preference for liquidity; that is, they prefer to hold ready cash for unexpected emergencies and financial claims rather than commit funds into future-yielding assets. If they do give up current liquidity by buying assets that promise future returns, they are trading an assured cash asset for a riskier future asset. The trade will take place only if the promised rewards of the future assets are sufficiently high to warrant taking the risk.

When lenders or investors give up cash for very risky future returns, they require high premiums, or returns, on their invested cash to compensate for less liquidity. Conversely, when they invest in low-risk assets, the premiums they expect in return are relatively low.

Example: Liquidity versus Future Returns

If a person deposits cash in a bank that is FDIC (Federal Deposit Insurance Corporation) insured, she will be willing to accept 5% interest, whereas if she buys the long-term bond of an unknown company, a higher rate of interest, say 15%, would be required. In both cases cash, or 100% liquidity, is given up, and the return must compensate for the risk.

It is clearly essential for lenders or investors to know how much their cash investments will grow so they can determine whether their investments are worthwhile. Borrowers also want to know how much, and over what period of time, they will have to repay the lenders, and whether the returns from these borrowed funds will be greater than the costs of borrowing. This all boils down to the concept of future value, as determined by the compound rate of interest and the present value of future returns once they are adjusted for risk.

To sum up, aside from the fact that money invested wisely today will yield a return in the future (a fact that creates a natural investor desire for cash today), money loses value over time because of risk, and preference for cash. The concept that the value of a dollar today is more than the value of a dollar tomorrow is central to financial theory.

Finance, 5thed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 3, pp. 1-2

9. What is Future Value/Present Value of an investment?

Any reasonable investment or commitment of cash must provide for an increase in value over time. Given the amount of cash that you want to commit, you can find out how much that cash value will increase in the future once the expected rate of return is known. This calculation is called finding the future value of an investment.

Example: Future Value after One Year

Suppose an investor saves \$100. This cash is deposited in the bank at a 10% annual interest rate. After one year the investor will have the original \$100 plus \$10 in interest:

$$\text{Original deposit} + \text{Interest on deposit} = \text{FV}$$

$$\$100 + (10\%)(\$100) = \$110$$

At the time of deposit the \$100 was worth 100%, or \$100. Since the bank promised to pay an additional 10%, the future value of the \$100 one year from now is equal to \$110 (\$100 plus 10).

Calculating future value for 1 year is perfectly straightforward, but what happens when someone wants to know how much money will be in an account after 20 years? Luckily, there is an easy formula to calculate future values:

$$FV = PV\ (1 + R)^N$$

Where

FV = future value
PV = initial deposit (principal)
R = annual rate of interest
N = number of years

Example: Future Value after Any Number of Years

The equation just introduced can be used for any number of years. Here are two instances involving a $100 deposit at a 10% interest rate:

1 Year on Deposit	2 Years on Deposit
$FV = P\ (1{+}R)^1$	$FV = P\ (1{+}R)^2$
$FV = \$100\ (1 + .10)$	$FV = \$100\ (1 + .10)^2$
$FV = \$100\ (1.10)$	$FV = \$100\ (1.10)\ (1.10)$
$FV = \$110$	$FV = \$121$

If the preceding example had involved 10 years, you would have had to calculate $(1.10)^{10}$, which is equal to 2.594. So the future value of $100 in 10 years would be $100(2.594), or $259.40. Note that each year the cash value increases, not by 10% of the original $100, but by 10% of each subsequently higher amount. In other words, you earn interest not only on your initial deposit, but also on your interest:

Original $100 x 1.10 = $110 future value (*FV*) after 1 year
$110 x 1.10 = $121 *FV* after 2 years
$121 x 1.10 = $133 *FV* after 3 years

We now know that an annual interest rate of 10 percent enables the investor to transform $1 today into $1.21 two years from now. In addition, we would like to know:

How much would an investor need to lend today so that she could receive $1 two years from today?

Algebraically, we can write this as

$$PV \times (1.09)^2 = \$1$$

In the preceding equation, PV stands for present value, the amount of money we must lend today in order to receive $1 in two years' time. Solving for PV in this equation, we have

$$PV = \frac{\$1}{(1.09)^2} = \$0.84$$

To be certain that $0.84 is in fact the present value of $1 to be received in two years, we must check whether or not, if we loaned out $0.84 and rolled over the loan for two years, we would get exactly $1 back. If this were the case, the capital markets would be saying that $1 received in two years' time is equivalent to having $0.84 today. Checking the exact numbers, we get

$$\$0.84168 \times 1.09 \times 1.09 = \$1$$

In other words, when we have capital markets with a sure interest rate of 9 percent, we are indifferent between receiving $0.84 today or $1 in two years. We have no reason to treat these two choices differently from each other, because if we had $0.84 today and loaned it out for two years, it would return $1 to us at the end of that time. In the multiperiod case, the formula for Present Value of Investment can be written as:

$$\mathrm{PV} = \frac{\mathrm{C_T}}{(1 + \mathrm{r})^{\mathrm{T}}}$$

Where C_T is cash flow at date T and r is the appropriate interest rate.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 4, pp. 67-75

10. How do you compare cash flows at different points in time?

Only cash flows in the same units can be compared or combined. A dollar today and a dollar in one year are not equivalent. Having money now is more valuable than having money in the future; if you have the money today you can earn interest on it. To compare or combine cash flows that occur at different points in time, you first need to convert the cash flows into the same units or *move* them to the same point in time.

Let's define three rules of time travel:

- *First rule is that it is only possible to compare or combine values at the same point in time.*
- *Second rule stipulates that to move a cash flow forward in time, you must compound it.*
- *Third rule stipulates that to move a cash flow back in time, we must discount it.*

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 3

11. What are discount rates? Discount Factors? Write formula for Discount Factor

To calculate present value, a discount rate must be determined that takes into consideration how much risk is associated with each project or investment. Risk levels follow a simple rule: High risk means a high discount (capitalization) rate, and low risk means a low discount rate.

For example, if an investor decides that the discount rate assigned to a stock should be 5%, another stock having double this risk will have a discount rate of 10. Once the risk level is determined, the next step is to adjust returns or future income for the uncertainty of time. Generally speaking, the following principles apply to evaluating discount rates. Evaluating discount rates is accomplished by the following principles:

1. Between two future incomes, the one that will take longer to reach maturity should have a higher discount rate.
2. The lower the perceived risk, the lower the discount rate should be.
3. If general interest rates in the market rise, the discount rate should increase also.

Risk can decline because of a more favorable business outlook, the prospect of declining inflation and interest rates, or less uncertain economic conditions. As risk declines, the present value of future income will increase, as illustrated in the table below.

Inverse Relationship between Present Value and Risk

Future Income (3 years from now) (dollars)	Discount Rate (%)	PV of $1 in 3 Years	PV of Future Income (dollars)
1,000	15 (high risk)	.658	658
1,000	10 (average risk)	.751	751
1,000	5 (low risk)	.684	864

The present value of any future returns declines the further out into the future you look. Obviously, this procedure employs a mathematical adjustment for the time value of money. As it turns out, the principle involved is not a difficult one to grasp — the present value of future returns is merely the reverse of future value compounding.

An arithmetic illustration will provide a better understanding of this principle. Assume you wish to find out the present value of $1,000 3 years from now, and you expect the level of risk associated with the project to be 10% annually. Thus, if

$$FV = PV\ (1 + R)^N$$

Then

$$PV = \frac{FV}{(1 + R)^N}$$

It is evident from the above table that the factors increase as time passes and as the compound interest rate rises. You can observe that, if these factors are plugged into the denominator in the last equation, the present value of $1,000 3 years hence is

$$\frac{\$1{,}000}{(1 + .10)^3} = \$751$$

How was this value found? Simply by multiplying 1.10 three times (1.10 x 1.10 x 1.10 = 1.33), and using this factor to discount:

$$\frac{\$1{,}000}{1.33} = \$751$$

While 10% is the discount rate, it is clear that the discount factor can be defined as the present value of $1 coming in *N* years discounted by the appropriate rate, which in our case is:

$$\frac{\$1}{(1+.10)^3} = 0.751$$

And we can calculate the present value by simply multiplying future cash flow by the discount factor, that is:

$$\$1{,}000 \times 0.751 = \$751$$

To sum up, if the discount rate for one period is *R* and *N* is the number of periods, the discount factor is:

$$\frac{1}{(1+R)^N}$$

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 3, pp. 6-8

12. How does the change in the number of compounding per year affect PV and FV calculations?

From the formula for calculating future value of an investment, it is easily seen that increasing compounding per year will raise FV of investment.

$$\mathrm{FV} = \mathrm{P}\left(1+\frac{\mathrm{R}}{\mathrm{n}}\right)^{\mathrm{N}\times\mathrm{n}}$$

Where

FV = future value
P = initial deposit (principal)
R = annual rate of interest
N = number of years
n = number of compounding periods

Thus interim-year compounding serves as additional source of income.

Vice versa happens when calculating PV of investment. Increase in compounding frequency decreases PV of future cash flows as can also be seen from the formula for calculating present value of an investment:

$$\mathrm{PV} = \frac{\mathrm{C_N}}{\left(1+\frac{\mathrm{R}}{\mathrm{n}}\right)^{\mathrm{N}\times\mathrm{n}}}$$

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 3, pp. 8-9

13. What is perpetuity? Give example and write a formula for present value of perpetuity

Perpetuity is a constant stream of cash flows without end. If you are thinking that perpetuities have no relevance to reality, it will surprise you that there is a well-known case of an unending cash flow stream: the British bonds called consols. An investor purchasing a consol is entitled to receive yearly interest from the British government forever.

How can the price of a consol be determined? Consider a consol that pays a coupon of *C* dollars each year and will do so forever. Simply applying the PV formula gives us:

$$PV = \frac{C}{(1+r)} + \frac{C}{(1+r)^2} + \frac{C}{(1+r)^3} + \cdots$$

Here the dots at the end of the formula stand for the infinite string of terms that continues the formula. Series like the preceding one are called geometric series. It is well known that even though they have an infinite number of terms, the whole series has a finite sum because each term is only a fraction of the preceding term. Before turning to our calculus books, though, it is worth going back to our original principles to see if a bit of financial intuition can help us find the *PV*.

The present value of the consol is the present value of all of its future coupons. In other words, it is an amount of money that, if an investor had it today, would enable him to achieve the same pattern of expenditures that the consol and its coupons would. Suppose that an investor wanted to spend exactly *C* dollars each year. If he had the consol, he could do this. How much money must he have today to spend the same amount? Clearly he would need exactly enough so that the interest on the money would be *C* dollars per year. If he had any more, he could spend more than *C* dollars each year. If he had any less, he would eventually run out of money spending *C* dollars per year.

The amount that will give the investor C dollars each year, and therefore the present value of the consol, is simply

$$PV\ of\ perpetuity = \frac{C}{r}$$

To confirm that this is the right answer, notice that if we lend the amount *C/r*, the interest it earns each year will be:

$$Interest = \frac{C}{r} \times r = C$$

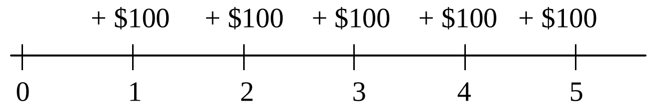
Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 4, pp. 83-84

14. What is Annuity? What is Annuity Due? What is the difference between them?

An annuity is a series of equal payments (or receipts) made at any regular interval of time. An annuity can be a payment or an investment each year, each half-year (semiannually), each quarter, or each month. Not surprisingly, annuities are among the most common kinds of financial instruments. The pensions that people receive when they retire are often in the form of an annuity. Other examples are the monthly mortgage payments on a house, quarterly investments in a trust account for a child's future education, and periodic loan payments.

Below is illustrated the timeline of \$100 annuity for a period of 5 years.

cash flows at the end of period

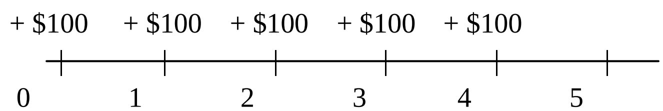


Period (years)

The only difference between annuity and annuity due is the timing of the first cash flow. While ordinary annuity starts at the end of each period, annuity due starts at the beginning of each period. So, the first payment of annuity due is at the time 0, and the first payment of ordinary annuity is at the time 1.

Below is illustrated the timeline of \$100 annuity due for a period of 5 years.

cash flows at the beginning of period



Period (years)

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 4, p. 86

15. What is the future value and present values of ordinary annuity? Annuity Due?

Let us first outline the convention with ordinary annuity that the first payment occurs at the end of each period that is one period from today, at date 1. While for annuity due the first payment occurs at the beginning of every period, thus, the first payment is today, at date 0.

So, from the timeline of ordinary annuity, the present value of an *N*-period annuity with payment *C* and interest rate *r* is:

$$PV = \frac{C}{(1+r)} + \frac{C}{(1+r)^2} + \frac{C}{(1+r)^3} + \cdots + \frac{C}{(1+r)^N} = \sum_{n=1}^{N} \frac{C}{(1+r)^n}$$

To simplify the calculations of the present value of an annuity, let's first remind that the present value of perpetuity is *C*/*r* and annuity is just a perpetuity that ends after some fixed number of payments *N*. Now, the simplest way to derive the formula for present value of an annuity is accomplished in 3 steps:

1. Take the present value of perpetuity starting at time 0
2. Take the present value of perpetuity staring at some time *N*
3. Subtract the results

So, we have:

$$PV\ of\ ordinary\ annuity = \frac{C}{r} - \frac{\frac{C}{r}}{(1+r)^N} = \frac{C}{r}\left(1 - \frac{1}{(1+r)^N}\right)$$

You can easily see this on timeline as follows:

	Now						
Date (or end of year)	0	1	2	…	*N*	(*N* + 1)	(*N* + 2)
Consol 1		*C*	*C*	…	*C*	*C*	*C*…
Consol 2						*C*	*C*…
Annuity		*C*	*C*	…	*C*		

In case of annuity due for *N* payments, we should calculate the present value of an ordinary annuity for *N-1* periods and add one annuity payment of *C* coming at the beginning of the period that is today, at time 0. Note that the present value of *C* coming today is *C* itself.

$$PV\ of\ annuity\ due = C + \frac{C}{r}\left(1 - \frac{1}{(1+r)^{N-1}}\right)$$

Now that we know how to calculate the present value of annuities, we can also provide a formula for the future value of annuities just by taking its future value. So, for an ordinary annuity we have future value of the present value of an ordinary annuity:

$$FV\ of\ ordinary\ annuity = \frac{C}{r}\left(1 - \frac{1}{(1+r)^N}\right) \times (1+r)^N = \frac{C}{r}\left((1+r)^N - 1\right)$$

And, in case of annuity due we calculate the future value of the present value of annuity due. That is:

$$FV\ of\ annuity\ due = \left[C + \frac{C}{r}\left(1 - \frac{1}{(1+r)^{N-1}}\right)\right] \times (1+r)^N$$

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 4, pp. 87-91

RISK AND RETURN

16. Define holding period return (HPR)

A key measure of investors' success is the rate at which their funds have grown during the investment period. The total holding-period return (HPR) of a share of stock depends on the increase (or decrease) in the price of the share over the investment period as well as on any dividend income the share has provided. The rate of return is defined as dollars earned over the investment period (price appreciation as well as dividends) per dollar invested:

$$HPR = \frac{ending\ price - beginning\ price + cash\ dividend}{beginning\ price}$$

This definition of the HPR assumes that the dividend is paid at the end of the holding period.

To the extent that dividends are received earlier, the definition ignores reinvestment income between the receipt of the dividend and the end of the holding period. Recall also that the percentage return from dividends is called the dividend yield, and so the dividend yield plus the capital gains yield equals the HPR.

$$HPR = \underbrace{\frac{ending\ price - beginning\ price}{beginning\ price}}_{capital\ \ gain\,/loss} + \underbrace{\frac{cash\ dividend}{beginning\ price}}_{dividend\ \ yield}$$

Investments, 8thed; Bodie, Kane, Marcus, McGraw-Hill2009, Chapter 5, p. 117

17. What is effective annual rate (EAR)? What is the difference between EAR and APR quote?

Annual Percentage Rate (APR) is interest rate when banks lend money to borrowers and earn interest calculated on many consumer loans, mortgages and credit lines. It is nominal interest rate offered by the bank, and is not the actual interest rate earned because it does not include the effects of intra-year compounding. Effective Annual Rate (EAR) is the effective return assuming that nominal interest paid is reinvested at the same rate and by this way it includes the effects of intra-year compounding. EAR is used when comparing investments with different compounding periods per year and it is always higher than APR.

Example: A bank offers Periodic Rates with 10% APR

1. APR:
   Annual Percentage Rate: APR = 10%
   Semi-Annual Rate (compounds twice a year)
   10%/2 = 5%
   Monthly Rate (compounds twelve times a year)
   10%/12 = 0.833%

2. EAR:
   Effective Annual Rate: EAR = $\left(1+\frac{\text{APR}}{\text{n}}\right)^{\text{n}}-1$
   Semi-Annual Rate (n = 2), EAR = $\left(1+\frac{0.1}{2}\right)^{2}-1$ = 10.25%
   Monthly Rate (n = 12), EAR= $\left(1+\frac{0.1}{12}\right)^{12}-1$ = 10.47%

Investments, 8thed; Bodie, Kane, Marcus, McGraw-Hill2009, Chapter 5

18. Write the formulas for calculating EAR when APR is given and vice versa. How the formulas change in the case of continuous compounding?

$$APR\ =\ Per-period\,rate\ \times\ Periods\,per\ year$$

Therefore, to obtain the *EAR* if there are *n* compounding periods in the year, we first recover the rate per period as *APR*/ *n* and then compound that rate for the number of periods in a year.

$$1+EAR=(1+rate\ per\ period)^{n}=\left(1+\frac{APR}{n}\right)^{n}$$

Rearranging,

$$APR=\left[(1+EAR)^{1/n}-1\right]\times n$$

The formula assumes that you can earn the *APR* each period. Therefore, after one year (when *n* periods have passed), your cumulative return would be (1 + *APR*/*n*)*xn*. Note that one needs to know the holding period when given an APR in order to convert it to an effective rate.

The *EAR* diverges by greater amounts from the *APR* as *n* becomes larger (that is, as we compound cash flows more frequently). In the limit, we can envision continuous compounding when *n* becomes extremely large in equation above. With continuous compounding, the relationship between the APR and EAR becomes

$$1+\text{EAR}=\text{e}^{\text{APR}}$$

Or equivalently

$$APR=\ln(1+EAR)$$

Investments, 8th ed; Bodie, Kane, Marcus, McGraw-Hill2009, Chapter 5, p. 119
Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 3, pp. 12-13

19. What is meant under term “Simple Interest” and how it is calculated for fractional time periods?

On short-term financial instruments, interest is usually “simple” rather than “compound”. Simple interest is called simple because it ignores the effects of compounding. The interest charge is always based on the original principal, so interest on interest is not included. This method may be used to find the interest charge for short-term loans, where ignoring compounding is less of an issue.

Simple interest is calculated on the original principal only. Accumulated interest from prior periods is not used in calculations for the following periods. Simple interest is normally used for a single period of less than a year, such as 30 or 60 days.

$$Simple\ Interest = p \times i \times n$$

Where

p = principal (original amount borrowed or loaned)

i = interest rate for one period

n = number of periods

Therefore,

$$Total\ proceeds\ of\ short-term\ investment = principal \times \left(1 + interest\ rate \times \frac{Days}{Year}\right)$$

By "*Days*/*Year*" we mean "*Number of days in Period* / *Number of days in a Year*"

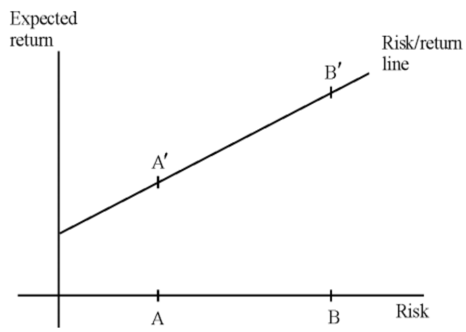
Mastering Financial Calculations, Robert Steiner, Prentiss Hall, Chapter 1, p. 5

20. What is the risk/return trade-off principle?

In finance, higher risks are generally associated with higher possible gains — but there is also a greater chance of loss. The same principle applies to Aunt Jane or John Doe. Both would like to strike it rich, but they know that to do so they must be willing to face the dangers of heavy losses. Aunt Jane and John Doe are aware that it is safer to purchase a U.S. treasury bill than to buy pork belly contracts. The chances of incurring losses from owning a treasury bill are slim indeed, while pork belly contracts could mean high gains or large losses.

Managers are faced with a similar dilemma. Some projects may be more profitable than others, but the risk associated with them could be too high and might jeopardize the solvency of the firm. This situation is analogous to gamblers who insist on betting on long-shot horses. Although the payout is great if the long-shot wins, the chances are that these gamblers will be consistent losers. Bettors who play to “show” or put their money on the favorite horse have a better chance of winning, but their gains will be lower.

The same applies to the policies adopted by managers. There is a constant conflict between engaging in highly profitable ventures and maintaining a sound financial status. These managerial decisions involve a compromise between taking excessive risks to maximize profits and accepting investments that will probably result in lower risk and lower profitability-but will lead to a sound financial posture for the firm.



Relationship Between Risk and Expected Returns

So, risk/return trade-off is the tradeoff between the high returns bearing high risk and the low risk accepting low returns. The goal of maximizing the value of the firm is accomplished by investing in those projects that have the best risk/return trade-off. Relationship between risk and expected return can be graphically illustrated on figure above.

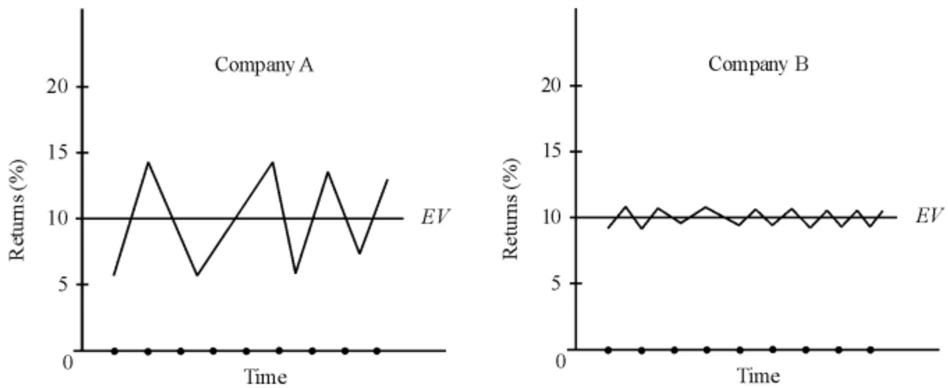
Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 1, pp. 3-4

21. Define risk. How can risk be measured?

Risk can be defined as the statistical possibility of incurring financial losses, above and beyond expected, as changes occur in the environment (market rates, firms in distress, fraud, etc) used in transaction valuation, processing, accounting, etc.Risk and return are the foundations upon which rational and intelligent investment decisions are made. Broadly speaking, risk is a measure of the volatility, or uncertainty of returns, and returns are the expected receipts or cash flows anticipated from any investment.

The following example may help explain the meaning of risk. Everyone knows that deposits at a savings bank are safer than money bet on a horse race. Bank deposits yield a steady but low rate of interest year by year and are insured by the Federal Deposit Insurance Corporation (FDIC). There is a high degree of confidence that these returns and the original deposit will be paid back. The returns from bank deposits don't fluctuate very much, and for this reason they are considered to be safe and to have a low degree of risk. On the other hand, when people gamble they don't know the outcome. They may win big, but they can also lose everything. Returns from horse betting are highly uncertain, very volatile, and subject to a high degree of risk. When two investments yield the same returns, the final choice will be based on the evaluation of the riskiness of each project. The project having the lower risk will be selected.

Risk is the degree of uncertainty associated with an investment. The more volatile the returns from an investment – the greater its risk. When two projects have the same expected returns, choose the one with the least risk.



Volatility of Returns for Company A and Company B
Note: Company A and Company B have same percentage scale of returns and EV = expected value.

Low risk is associated with low returns and high risk with high returns. In finance, risk is measured by the degree of volatility associated with expected returns. Volatility is the amount of fluctuation that occurs in a series of figures as they deviate from a representative average. For example, the average of the series 1, 2, 3 is 2, and the average of the series 1, 3, 5 is 3. The second series is considered more volatile than the first series of figures. The higher the volatility, then, the higher the level of risk.

Risk is defined as the deviation of expected outcomes from a mean or expected value. It can also be regarded as the chance of incurring a loss or gain by investing in an asset or project. The chances of making a profit or incurring a loss can be high or low depending on the degree of risk (variability of expected returns) associated with a given investment.

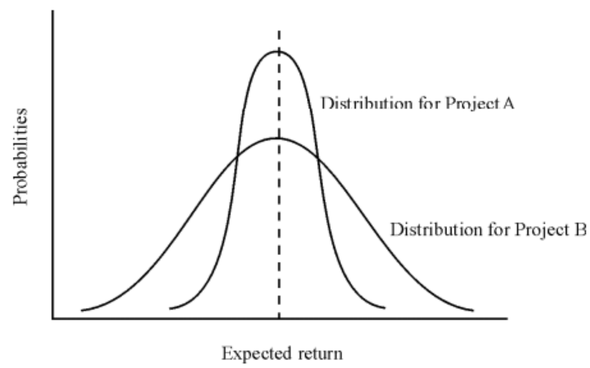
The volatility of the returns of any asset measures the level of risk. The wider dispersion of Company A's returns in above figure indicates that there is a greater chance that an actual return will fall either below or above the straight line, that is expected value.

One common way to measure the risk of an asset is to calculate its deviation from a mean or an expected return. By assuming that all values are distributed normally — that the returns are distributed equally between the higher and lower sides of expected returns — it is possible to measure the volatility of returns for each project and, in turn, to measure their comparative risk. This can be done by subtracting the actual returns R_i from the expected return ER. The values derived from these calculations are then squared to eliminate the problem of minus signs. In a world of uncertainty, probabilities are assigned to each deviation to obtain a single representative value, which is called **variance**. The square root of variance is none other than the **standard deviation**.

$$Standard\ deviation\ (\sigma) = \sqrt{\sum_{t=1}^{N}(R_i - ER)^2 P_i}$$

Where

N = number of observations
i= time period
ER = expected return
P_i = probability of i– th return
R_i = actual return at i – th time period



Normal Probability Distributions of Two Projects, A and B

What does all this mean? First, you must assume that the probability distribution is normal. This implies that half the values in the distribution are likely to fall below the expected value and half to fall above the expected value. The closer a distribution is to the expected value; the more likely it is that the actual outcomes will be closer to the mean or expected value. Chances will be higher that the outcomes will be close to the expected value in a narrow distribution than in a wide distribution.

As the above figure shows, probability distributions for both A and B are normal, but B has a wider dispersion away from the expected value. Consequently, the distribution for B is considered riskier than the distribution for A. Note: Both probability distributions have the same expected value, but A has a narrower distribution, indicating less volatility relative to the expected value and hence less risk.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 4, pp. 1-9

22. What is measured by covariance and correlation? How do they differ?

Covariance is a measure of how much two variables, returns, change together, i.e. co-vary. Therefore, the formula for the covariance of the returns is given in the following equation

$$Cov(r_S r_B) = \sum_{i=1}^{N} p(i) \times [r_S(i) - r_S][r_B(i) - r_B]$$

Covariance as well as correlation shows linear dependence between two variables. Use of correlation is more preferable as covariance doesn't have bounds, while correlation can only take values between [-1; 1].

Formula for correlation is as follows:

$$\rho = \frac{Cov(r_S r_B)}{\sigma_S \sigma_B}$$

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter7; pp. 197-199

23. What is Arbitrage and Speculation?

Essentially, arbitrage is defined as riskless profit with zero investment. In economics and finance, arbitrage is the practice of taking advantage from a price difference: the simultaneous purchase and sale of an asset in order to profit from a difference in the price. It is a trade that profits by exploiting price differences of identical or similar financial instruments, on different markets or in different forms.

Arbitrage exists as a result of market inefficiencies; it provides a mechanism to ensure prices do not deviate substantially from fair value for long periods of time. Arbitrage opportunities may be accomplished by a variety of tactics, including restructuring transactions, financial engineering and geographic relocation.If the market prices do not allow for profitable arbitrage, the prices are said to constitute an arbitrage equilibrium or arbitrage-free market. It is usually assumed that there is no arbitrage opportunity.

Though if arbitrage opportunity is executed it provides riskless profit with zero investment in either of two ways: 1) positive profit today with zero risk in the future or 2) zero investment today with riskless positive profit in the future.

Speculation is purchase (or sale) of goods with a view to resale (repurchase) at a later date. In finance, speculation is a financial action that does not promise safety of the initial investment along with the return on the principal sum.

Speculation typically involves the lending of money or the purchase of assets, equity or debt but in a manner that has not been given thorough analysis or is deemed to have low margin of safety or a significant risk of the loss of the principal investment.In a financial context, the terms "speculation" and "investment" are actually quite specific. For instance, although the word "investment" is typically used, in a general sense, to mean any act of placing money in a financial vehicle with the intent of producing returns over a period of time, most ventured money – including funds placed in the world's stock markets – is actually not investment, but speculation.

Financial speculation can involve the buying, holding, selling, and short – selling of stocks, bonds, commodities, currencies, collectibles, real estate, derivatives, or any valuable financial instrument to profit from fluctuations in its price, irrespective of its underlying value.

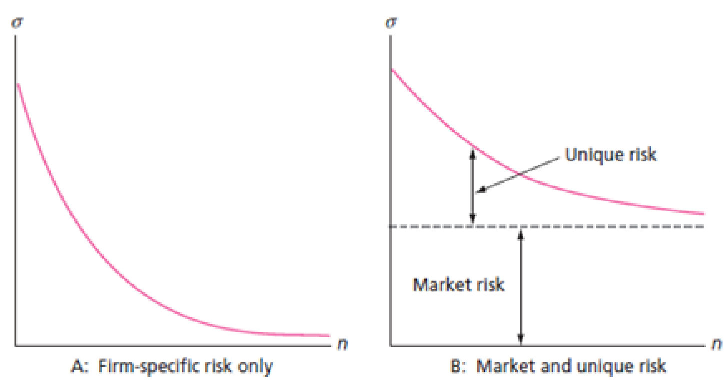
Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter10; p.319
Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter6; p. 157

24. What is diversification? Define market and firm-specific risks

Diversification can be defined as the process of an investment risk allocation by increasing number of assets in the investment portfolio. Thus, diversification implies a portfoliostrategy designed to reduce exposure to risk by combining a variety of investments, such as stocks, bonds, and real estate, which are unlikely to all move in the samedirection.

The goal of diversification is to reduce the risk in a portfolio. It is achieved through volatility being limited by the fact that not all asset classes or industries or individual companies move up and down in value at the same time or at the same rate. Diversification reduces both the upside and downsidepotential and allows for more consistent performance under a wide range of economicconditions.

The figure below demonstrates the diversification effect in panel A: standard deviation is decreasing as the number of assets in the portfolio increases. Though, it is true only for firm – specific or unique risk of the portfolio, that is, risk affecting particular assets included in the portfolio.



However, when common sources of risk affect all firms even extensive diversification cannot eliminate risk. In the panel B of the figure above, portfolio standard deviation falls as the number of securities increases, but it is not reduced to zero. The risk that remains even after diversification is called market risk, risk that is attributable to market wide risk sources. Other names are systematic risk or non-diversifiable risk. The risk that can be eliminated by diversification is called unique risk, firm-specific risk, non-systematic risk, or diversifiable risk.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter7; pp. 195-196

VALUATION AND CAPITAL BUDGETING

25. What is the general definition of the value of an asset? What are three necessary conditions for continuous increase in value of asset?

The value of an asset, such as a share of common stock or a bond, is influenced by three major factors: cash flow of the asset, growth rate of the cash flow, and risk or uncertainty of the cash flow.

An increase in the amount of cash flow tends to raise the price of an asset. Conversely, the price declines if cash flow becomes more uncertain. These relationships are fundamental to the valuation of an asset. Accordingly, the responsibility of a financial officer is to increase cash flows as much as possible while controlling risk.

Since profits raise the price of an asset and risk reduces the price, all of the following three conditions are required for a continuous increase in the value of any asset:

- The asset must continuously produce cash flow.
- Cash flow must have a positive rate of growth (cash flow must increase over time).
- Risk must be controlled.

Of the three factors, estimation of risk is the most difficult task. As a result, the subject of risk in the valuation of an asset should receive more attention when the outlook for the economy becomes more uncertain. The discount rate reflects risk, or uncertainty of the future income. To find the current price of an asset, then, future cash flows must be discounted back to present value at an appropriate rate to reflect each aspect of risk. Therefore, the price of an asset is the same as the present value of its future cash flows.

$$Value\ of\ an\ Asset = The\ Present\ Value\ of\ its\ future\ expected\ cash\ flows$$

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 5, p. 1

26. Why financial analysts are interested in the cash flows and not in the accounting incomes? Why only incremental cash flows are considered in the valuation of investment projects?

Financial analysts are interested in the cash flows because for capital budgeting decision making you need to know the initial investment and future expected cash flows. As a general rule to value any asset we need to find the present value of its future cash flows. Accounting incomes include non-cash expense such as depreciation, credit sales, non-paid expenses, etc. and couldn't be used in assets valuation. The price of an asset is stated in cash, dollars today you should pay to obtain it, and for the price of an asset to be fair it must be equal to the present value of its future cash flows, not non-cash measures like accounting incomes.

In order to decide whether the initial cost will be paid off it is necessary to estimate future cash flows. Management should be concerned only with the incremental cash flow. The incremental cash flow is the additional cash flow that the firm will receive over the existing cash flow after the project is accepted. Suppose that the existing cash flow of a firm is $100. If cash flow increases to $150 after starting a new project, the incremental cash flow is $50. Therefore, only $50 is considered as the relevant cash flow, or the benefit of the project. There is a simple method to determine the incremental cash flow of a new project for each year.

Incremental cash flow is the only relevant cash flow for the capital budgeting decisions; it is all you need to compare projects.

For capital budgeting analysis, investment is in the form of cash outflow. So, naturally the management needs to compare the costs (outflows) and benefits (inflows) arising out of the project. This can be effectively measured only by means of cash flow method. You need cash to buy an asset. It is an outflow. But accounting profit method ignores expenditure of buying asset at the time of purchase. It records the expenditure of an asset over the entire economic life of the project in the form of depreciation, which is a non-cash item. Hence, even in this case, time value is ignored. The accounting profit does not reflect the requirement of cash at outflow and inflow stages of time. Moreover, this does not actually reflect the actual outflows and inflows. So, only the cash flow method is the right choice for evaluating a capital budgeting decision.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 6, pp. 5-8

27. How incremental cash flows are calculated?

You may not have thought about it, but there is a big difference between corporate finance courses and financial accounting courses. Techniques in corporate finance generally use cash flows, whereas financial accounting generally stresses income or earnings numbers. When considering a single project, we discount the cash flows that the firm receives from the project not accounting incomes. When valuing the firm as a whole, we discount dividends – not earnings– because dividends are the cash flows that an investor receives.

There are many differences between earnings and cash flows. In fact, much of a standard financial accounting course delineates these differences. Consider a firm buying a building for $100,000 today. The entire $100,000 is immediate cash outflow. However, assuming straight-line depreciation over 20 years, only $5,000 ($100,000/20) is considered an accounting expense in the current year. Current earnings are thereby reduced only by $5,000. The remaining $95,000 is expensed over the following 19 years.

Because the seller of the property demands immediate payment, the cost at date *0* of the project to the firm is $100,000. Thus, the full $100,000 figure should be viewed as an immediate outflow for capital budgeting purposes. This is not merely our opinion but the unanimous verdict of both academics and practitioners.

In addition, it is not enough to use cash flows. In calculating the NPV of a project, only cash flows that are incremental to the project should be used. These cash flows are the changes in the firm's cash flows that occur as a direct consequence of accepting the project. That is, we are interested in the difference between the cash flows of the firm with the project and the cash flows of the firm without the project.

There are three difficulties in determining incremental cash flows:

- Sunk costs– costs that have already occurred. Because sunk costs are in the past, they cannot be changed by the decision to accept or reject the project. Just as we "let bygones be bygones," we should ignore such costs. Sunk costs are not incremental cash outflows.
- Opportunity costs– your firm may have an asset that it is considering selling, leasing, or employing elsewhere in the business. If the asset is used in a new project, potential revenues from alternative uses are lost. These lost revenues can meaningfully be viewed as costs. They are called opportunity costs because, by taking the project, the firm forgoes other opportunities for using the assets. Incremental cash flows matter this cost.
- Side effects – in determining incremental cash flows come from the side effects of the proposed project on other parts of the firm. The most important side effect is erosion. Erosion is the cash flow transferred to a new project from customers and sales of other products of the firm. Side effect that is opposite of erosion is Synergy. Incremental cash flows matter side effects.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 7, pp.169-171

28. What is the difference between capital expenditures and current expenses?

Current expenses are short-term expenses that are completely written off in the year when the expenses occur. In contrast, capital expenditures refer to spending on long-term assets that are capitalized and amortized over their useful life.

Examples of current expenses include wages, salaries, raw material costs, and administrative expenses. In accounting, current expenses are treated like other short-term expenses. They are fully expensed during the fiscal period in which they are incurred. Unlike capital expenditures, which are first recorded on the balance sheet as assets before hitting the income statement as amortization expenses, current expenses are recorded directly on the income statement as expenses in the current fiscal period. Basically, if the capital outlay is invested in an asset that will last longer than one year, it is considered a capital expenditure and treated accordingly. On the other hand, if the capital outlay is invested in an asset that will last less than one year, it is considered a current expenditure.

Capital Expenditures are long-term expenditures that are amortized over a period of time. A capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset with a useful life extending beyond the taxable year. In accounting a capital expenditure is added to an asset account ("capitalized"), thus increasing the asset's basis (the cost or value of an asset adjusted for tax purposes).

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 6, pp. 1-2

29. List depreciation methods known to you. Write formulae

Depreciation is the allocation, for accounting and tax purposes, of the purchase costs of fixed assets (such as machinery and equipment) over a number of years. Since depreciation is a major expense, it has a significant effect on the net income of the firm. An asset can be depreciated in several ways. Although IRS (Internal Revenue Service) regulations require a certain method for tax purposes, management can use different depreciation methods for internal evaluation and other non– tax purposes. The major methods of depreciation are the accelerated cost recovery system (MACRS) and the straight-line and double– declining balance methods.

In the **straight– line method**, information about the purchase price of the asset, the life of the asset, and its salvage value (or scrap value) is required. Annual depreciation charges are calculated by using the following formula:

$$Annual\ Depreciation = \frac{Purchasing\ Costs - Salvage\ Value}{Number\ of\ years\ the\ asset\ will\ be\ used}$$

In this method, it is assumed that the asset is used at a constant rate over its useful life. The straight-line method is recommended for performance evaluation of various departments in the same company or for comparison of company performance from one year to another.

In the **double-declining balance** method, which was popular before the MACRS became mandatory, the firm uses an annual depreciation ratio equal to double the straight-line ratio. This ratio is multiplied by the book value (undepreciated balance) of the asset to get depreciation charges for that particular year. The rate at which an asset with *N* years of useful life will be depreciated per year is:

$$\frac{1}{N} \times 2$$

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 2, pp. 9-12

30. What is capital budgeting? What methods are used in Capital Budgeting?

Capital budgeting refers to the methods for evaluating, comparing, and selecting projects to achieve maximum return or maximum wealth for stockholders. Maximum return is measured by profit, and maximum wealth is reflected in stock price.

Capital budgeting is answering the question: in what long-term assets the firm should invest. This question concerns the left-hand side of the balance sheet. Of course, the type and proportions of assets the firm needs tend to be set by the nature of the business. We use the terms capital budgeting to describe the process of making and managing expenditures on long-term assets.

Some of the methods used in capital budgeting decision making are: the payback period, the discounted payback period, the net present value (NPV), the internal rate of return (IRR), and the profitability index (PI).

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 6

31. Define NPV and PI

If the present value of a project's future cash flow is greater than the initial cost, the project is worth undertaking. On the other hand, if the present value is less than the initial cost, a project should be rejected because the investor would lose money if the project were accepted. By definition, the net present value of an accepted project is zero or positive, and the net present value of a rejected project is negative. The net present value (*NPV*) of a project can be calculated as follows:

$$NPV = PVCF - I$$

Where

PVCF– present value of future cash flows from the project
I – initial investment

To derive an algebraic formula for net present value of a cash flow, recall that the *PV* of receiving a cash flow, *C* one year from now is:

$$\mathrm{PV} = \frac{\mathrm{C}_1}{(1+\mathrm{r})}$$

And the *PV* of receiving a cash flow *C* two years from now is:

$$\mathrm{PV} = \frac{\mathrm{C}_1}{(1+\mathrm{r})^2}$$

We can write the *NPV* of a *T*-period project as:

$$NPV = -C_0 + \frac{C_1}{(1+r)} + \frac{C_1}{(1+r)^2} + \cdots + \frac{C_T}{(1+r)^T} = -C_0 + \sum_{i=1}^{T} \frac{C_i}{(1+r)^i}$$

The initial flow, $-C_0$, is assumed to be negative because it represents an investment. If the initial investment is not negative, we can use more general formula for *NPV* that considers all cash flow from time *0* to *T*:

$$NPV = \sum_{i=0}^{T} \frac{C_i}{(1+r)^i}$$

The net present value method has three main advantages. First, it uses cash flows rather than net earnings. Cash flows (net earnings + depreciation) include depreciation as a source of funds. This works because depreciation is not cash expenditure in the year the asset is depreciated. In contrast with accounting, the field of finance considers cash flows rather than net earnings.

Second, the *NPV* method recognizes the time value of money. The longer the time, the higher the discount. Simply speaking, if the cash flows of a project with an average risk are discounted at 10%, another project with a higher degree of risk should be discounted at more than 10%. Therefore, the time value of money for a project is reflected in the discount rate, which should be selected carefully by the financial analyst. Generally, the discount rate tends to rise if the money supply is tight and the interest rate is expected to go up.

Third, by accepting only projects with positive *NPV*s, the company will also increase its value. An increase in the value of the company is, in fact, an increase in the stock price or in the wealth of stockholders. The *NPV* method of capital budgeting, therefore, should ultimately lead to more wealth for the owners of the company. Since the objective of modern finance is to continuously increase the wealth of stockholders, the *NPV* method should be viewed as the most modern technique of capital budgeting.

There are also some limitations, however, to the *NPV* approach. The method assumes that management is able to make detailed predictions of cash flows for future years. In reality, however, the more distant the date, the more difficult it is to estimate future cash flows. Future cash flows are influenced by future sales, costs of labor, materials and overhead, interest rates, consumer tastes, government policies, demographic changes, and so on. Overestimation or underestimation of future cash flows may lead to the acceptance of a project that should be rejected, or the rejection of a project that should be accepted.

Additionally, the *NPV* approach usually assumes that the discount rate is the same over the life of the project. The discount rate of a project, like the interest rate, actually changes from one year to another. Opportunities to reinvest future cash flows, future interest rates, and the costs of raising new capital can all affect the discount rate. It may be suggested that the problem can be resolved by predicting future interest rates, and then discounting the cash flow of each future year at the predicted discount rate. While this is an intelligent suggestion, you may agree that the prediction of the interest rate for the next 5 or 10 years is as uncertain as the outcome of flipping a coin 5 or 10 times! Despite its limitations, however, the *NPV* method is still the best method of capital budgeting.

The profitability index, or *PI*, method compares the present value of future cash inflows with the initial investment on a relative basis. Therefore, the *PI* is the ratio of the present value of cash flows (*PVCF*) to the initial investment of a project:

$$PI = \frac{PVCF}{Initial\ Investment}$$

In this method, a project with a *PI* greater than 1 is accepted, but a project is rejected when its *PI* is less than 1. Note that the *PI* method is closely related to the *NPV* approach. In fact, if the net present value of a project is positive, the *PI* will be greater than 1. On the other hand, if the net present value is negative, the project will have a *PI* of less than 1. The same conclusion is reached, therefore, whether the net present value or the *PI* is used. In other words, if the present value of cash flows exceeds the initial investment, there is a positive net present value and a *PI* greater than 1, indicating that the project is acceptable.

An important comment about the *PI* and the *NPV* methods is that, although the two techniques generally lead to the same major decision — whether to accept or reject a project — they often rank alternative projects in different orders.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 7, pp. 4-6

32. Define IRR

The internal rate of return, or IRR, is a popular measure used in capital budgeting. The IRR is a measure of the rate of profitability. By definition, IRR is a discount rate that makes the present value of cash flows equal to the initial investment. In simple terms, the IRR is a discount rate that makes the NPV equal to zero.

The basic rationale behind the IRR is that it tries to find a single number that summarizes the merits of a project. That number does not depend on the interest rate that prevails in the capital market. That is why it is called the internal rate of return; the number is internal or intrinsic to the project and does not depend on anything except the cash flows of the project.

The rate below which projects are rejected is called the cutoff rate, the target rate, the hurdle rate, or the required rate of return. Firms determine their cutoff rates by the cost of financing and the riskiness of the project. Next, they predict future cash flows and calculate the IRR. If the calculated IRR exceeds the cutoff rate, the project is added to the list of recommended investments.

By definition, the IRR of a project is calculated by assigning various discount rates in the net present value formula and choosing the one that makes NPV equal to zero. Thus, we can solve IRR by trial and error or simply by the use of computer from:

$$0 = \sum_{i=0}^{T} \frac{C_i}{(1 + IRR)^i}$$

A number of surveys have shown that, in practice, the IRR method is more popular than the NPV approach. The reason may be that the IRR is straightforward and it uses cash flows and recognizes the time value of money, like the NPV. In other words, while the IRR is easy and understandable, it does not have the drawbacks of the payback period, which ignore the time value of money.

The main problem with the IRR method is that it often gives unrealistic rates of return. Suppose the cutoff rate is 11% and the IRR is calculated as 40%. Does this mean that management should immediately accept the project because its IRR is 40%? The answer is no! An IRR of 40% assumes that a firm has the opportunity to reinvest future cash flows at 40%. If past experience and the economy indicate that 40% is an unrealistic rate for future reinvestments, an IRR of 40% is suspect. Simply speaking, an IRR of 40% is too good to be true! So unless the calculated IRR is a reasonable rate for reinvestment of future cash flows, it should not be used as a yardstick to accept or reject a project.

Finance, 5th ed; Groppelli, EhsanNikbakht; Barron's Inc 2006, Chapter 7, pp. 7-9

33. Define the Payback Period. Why it is and it is NOT recommended? Which method is superior: NPV or payback period? Why?

The number of years needed to recover the initial investment is called the payback period. If the payback period is of an acceptable length of time to the firm, the project will be selected.

Suppose the maximum acceptable payback period for a firm is 4 years. Assume that a project brings annual cash inflow of $20,000 for the next 6 years and that the initial investment is $70,000. A simple calculation shows that, after 4 years, the project will contribute an $80,000 cash inflow (4 years x $20,000 = $80,000). Therefore, it should be accepted, because its initial investment is covered in less than 4 years.

When comparing two or more projects, the projects with shorter payback periods are preferred. However, accepted projects should meet the target payback period, which should be set in advance.

The payback period method has several advantages and disadvantages. The main advantage is that this method is easy to use. It is not necessary to do a great deal of calculation to find out how many years it takes to get the initial outlay back. The payback period is also easy to understand. Therefore, when analysts need a quick measure of risk, they may use the payback period to see if the invested capital will be paid back in a reasonable period of time.

The payback period method, despite its simplicity, can be of value to even the largest multinational corporations. For such firms, political events-such as the nationalization of industry in a foreign country-are major sources of risk. In terms of possible political events, then, the shorter the payback period, the less risky the project. The payback period method, therefore, can help firms measure the risk of losing capital in foreign countries.

The main disadvantage of this method is that it completely ignores the value of money over time. In the payback period method, there is no difference between the value of a $100 cash inflow in the first year and the same amount of cash inflow in a later year. Additionally, the payback period method does not count the cash inflows produced after the initial investment has been recovered. Because of these severe drawbacks, the payback period method should not be considered as a very good approach to capital budgeting.

Thus, we can conclude that NPV is superior method over payback period, because it considers the time value of money.

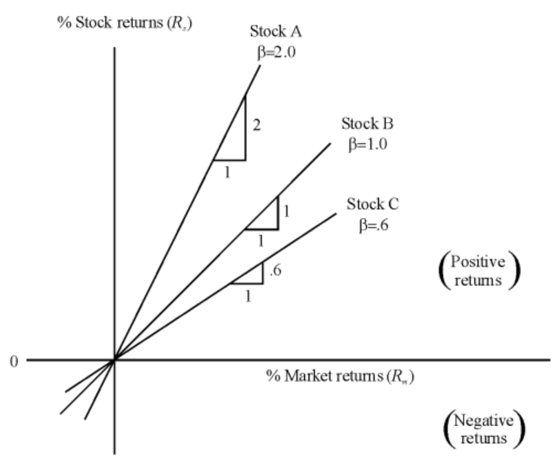
Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 3, pp. 2-4

34. Formulate Capital Asset Pricing Model? How can the Capital Asset Pricing Model be used in valuation methods?

Measuring risk is not an easy task, partly because of the many factors to be considered. The mathematics of risk includes knowledge of probability theory and understanding of how portfolio risks and returns are brought together into a meaningful model. Attempts have been made to simplify the measurement of risk, and one of the more successful efforts has been the development of the Capital Asset Pricing Model (CAPM), a model that relates predicted undiversifiable risks to the expected returns of a project.

The CAPM starts by dividing risk into two major components: diversifiable risk and non-diversifiable risk. The premise is that there is a close relationship between the returns of individual securities and the returns of the market. The volatility of the market provides a common denominator for evaluating the degrees of risk of individual assets and securities. This degree of risk is determined by finding out how sensitive the returns of a stock are to the returns of the market. If a stock's returns move up and down more than the market returns, the stock is said to be more risky than the market. If a stock's returns move up and down less than market returns, the stock is said to be less risky than the market.

The slope, or slant, of each line representing the relationship between stock returns and market returns is called beta (β), and it is precisely this beta that measures the sensitivity or risk of a stock (R_S) compared to the market return (R_M).



Using the CAPM to Compute Betas (β_s) of Individual Stocks

The CAPM is used to estimate a required rate of return for valuation of an asset. The formula for the CAPM is

$$R_S = R_f + \beta_S(R_M - R_f)$$

Where

R_S = required rate of return
R_f = risk-free rate (such as the return on U.S. treasury bills)
β = beta coefficient of the company
R_M = return on a market portfolio

Once R_S (required rate of returns) is computed, the future income is discounted at that rate and, thus, can be used in every valuation method.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 4, pp. 13-16

35. In practice, how do you find the beta of a project?

If a project is similar to other investments in the company, the beta of the company's stock can be used as the beta of the project. In this case, you would calculate the responsiveness of the company's stock returns to the returns of the market by the formula of beta coefficient:

$$\beta = \frac{Cov(company\ returns, market\ returns)}{\sigma^2_{market}}$$

What happens if a project is not a typical investment of the company? In other words, how can you use the CAPM for a project whose risk and other characteristics are different from average or routine projects that the company undertakes? In this case, you can benchmark, i.e. you should look into similar projects outside the firm. For instance, if a firm is considering investing in the aluminum industry, the beta for the new project should be the average beta for a group of firms in the aluminum industry.

Finance, 5th ed; Groppelli, EhsanNikbakht; Barron's Inc 2006, Chapter 8, pp. 4-5

36. State the criterion for accepting or rejecting independent projects under each rule: Payback Period, IRR, PI, NPV

Payback Period:

If the payback period of a project is shorter than the target payback period set by the management of the company, *accept* the project, otherwise, *reject*.

Internal Rate of Return (IRR):

To evaluate projects by IRR method we need to know the required rate of return (RRR) of a project. Criterion for accepting or rejecting projects under IRR differs for different types of projects:

1. For investing projects, projects with negative initial investment and positive cash flow:

   If IRR >RRR, =>*accept* the project
   If IRR <RRR, =>*reject* the project

2. For financing projects, projects with positive initial investment and negative cash flow:

   If IRR >RRR, =>*reject* the project
   If IRR <RRR, =>*accept* the project

3. For projects with multiple sign cash flow, some negative, some positive, no general rule can be defined as such projects have multiple IRRs.

Profitability Index (PI):

If PI > 1, =>*accept* the project
If PI < 1, =>*reject* the project

Net Present Value (NPV):

If NPV > 0, =>*accept* the project
If NPV < 0, =>*reject* the project

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 7

37. What is the practice of capital budgeting?

Not all firms use capital budgeting procedures based on discounted cash flows. Some firms use the payback method, and others use the accounting-rate-of-return method. Most studies find that the most frequently used capital budgeting technique for large corporations is either the internal rate of return (IRR) or the net present value (NPV) or a combination of both.

A survey of large U.S. multinational firms and shows that over 80 percent of the responding firms use either NPV or IRR. Payback is rarely used as a primary method but it is the most frequently used secondary method.

A recent survey of capital budgeting techniques used by a very large sample of U.S. and Canadian firms showed that about 75 percent of all firms use the NPV and IRR in capital budgeting. They report large-dividend-paying firms with high leverage are more likely to use the NPV and IRR than small firms with low debt ratios that pay no dividends.

Many businesses use a combination of methods when making capital budgeting decisions. A company could use the payback period method to narrow down its options, and then apply the NPV method to identify the best of the remaining projects.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 6, pp. 160-162

38. Define the concept of inflation in capital budgeting

Inflation is a general price increase in the economy. When inflation increases, the real value of expected cash flows decreases. If the analyst does not adjust for risk of inflation, the NPV or the IRR may be artificially high. In other words, you might accept a project with an unadjusted IRR or NPV, while the real IRR or NPV, adjusted for inflation, could be unacceptable.

Therefore, capital budgeting techniques that ignore inflation are often misleading. Since inflation has probably become a permanent problem in the economy, you should plan to deal with it anytime you make a major decision. How can you deal with inflation in capital budgeting? The answer is that you should adjust both the cash flows and the discount rate for the annual rate of inflation.

Suppose that the one-year interest rate that the bank pays is 10 percent. This means that an individual who deposits $1,000 at date 0 will get $1,100 ($1,000 x 1.10) in one year. While 10 percent may seem like a handsome return, one can only put it in perspective after examining the rate of inflation.

Suppose that the rate of inflation is 6 percent over the year and it affects all goods equally. For example, a restaurant that charges $1.00 for a hamburger at date 0 charges $1.06 for the same hamburger at the end of the year. You can use your $1,000 to buy 1,000 hamburgers at date 0. Alternatively, if you put all of your money in the bank, you can buy 1,038 ($1,100/$1.06) hamburgers at date 1. Thus, you are only able to increase your hamburger consumption by 3.8 percent by lending to the bank. Since the prices of all goods rise at this 6-percent rate, lending lets you increase your consumption of any single good or any combination of goods by only 3.8 percent. Thus, 3.8 percent is what you are really earning through your savings account, after adjusting for inflation. Economists refer to the 3.8-percent number as the real interest rate. Economists refer to the 10-percent rate as the nominal interest rate or simply the interest rate.

In general, there is Fischer's formula between real and nominal cash flows as:

$$1 + nominal\ interest\ rate = (1 + real\ interest\ rate) \times (1 + inflation\ rate)$$

Rearranging terms, we have:

$$\text{real interest rate} = \frac{1 + \text{nominal interest rate}}{1 + \text{inflation rate}} - 1$$

The formula indicates that the real interest rate in our example is 3.8 percent (1.10/1.06 - 1).

The above formula determines the real interest rate precisely. The following formula is an approximation:

$$\text{real interest rate} \approx \text{nominal interest rate} - \text{inflation rate}$$

The symbol ≈ indicates that the equation is approximately true. This latter formula calculates the real rate in our example as:

$$4\% \approx 10\% - 6\%$$

This approximation is reasonably accurate for low rates of interest and inflation. In our example, the difference between the approximate calculation and the exact one is only .2 percent (4 percent - 3.8 percent). Unfortunately, the approximation becomes poor when rates are higher.

Besides the above techniques, financial practitioners correctly stress the need to maintain consistency between cash flows and discount rates. That is,

Nominal cash flows must be discounted at the *nominal* rate.
Real cash flows must be discounted at the *real* rate.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 7, pp. 177-183

39. What types of dividends do you know? Which type is more preferable? Why?

Any direct payment by the corporation to the shareholders may be considered part of dividend policy. The most common type of dividend is in the form of cash. Public companies usually pay regular cash dividends four times a year. Sometimes firms will pay a regular cash dividend and an extra cash dividend. Paying a cash dividend reduces the corporate cash and retained earnings shown in the balance sheet.

Another type of dividend is paid out in shares of stock. This dividend is referred to as a stock dividend. It is not a true dividend, because no cash leaves the firm. Rather, a stock dividend increases the number of shares outstanding, thereby reducing the value of each share. A stock dividend is commonly expressed as a ratio; for example, with a 2 – percent stock dividend a shareholder receives one new share for every 50 currently owned.

When a firm declares a stock split, it increases the number of shares outstanding. Because each share is now entitled to a smaller percentage of the firm's cash flow, the stock price should fall. For example, if the managers of a firm whose stock is selling at $90 declare a 3:1 stock split, the price of a share of stock should fall to about $30. A stock split strongly resembles a stock dividend except it is usually much larger.

Cash dividends are probably more preferable because no stock dilution follows and the stock price doesn't decline.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 16,pp.495-497

40. Why does the value of a share of stock depend on dividends? Define dividend growth model

To value common stocks like any asset we should find the present value of its future cash flows. A stock provides two kinds of cash flows. First, most stocks pay dividends on a regular basis. Second, the stockholder receives the sale price when they sell the stock. But as the sale price is determined by the dividends after the sale date, then, the value of a firm's common stock to the investor is equal to the present value of all of the expected future dividends.

Over time, the annual dividend per share may remain fixed, may grow at a constant rate, or may rise at a relatively high rate for a few years and then grow at a constant rate. Because of all these possibilities, calculation of the price of common stock calls for careful projection of future dividends. Since a company is considered to operate forever, the price of common stock is not influenced by the number of years an investor wants to maintain ownership.

The price of common stock is largely determined by three factors: the annual dividends, growth of dividends, and discount rate. The rate at which future dividends are to be discounted is called the required rate of return. If a company has a high level of risk, a high required rate of return is expected by investors. To encourage investors to invest their money in a risky venture, a higher payoff must be offered. The following are the procedures to determine the value of common stock in three possible cases:

Case 1 (Zero Growth) The value of a stock with a constant dividend is given by:

$$S_0 = \frac{Div_1}{(1+r)} + \frac{Div_2}{(1+r)^2} + \cdots = \frac{Div}{r}$$

Here it is assumed that $Div_1 = Div_2 = \ldots = Div$. This is just an application of the perpetuity formula.

Case 2 (Constant Growth/Gordon Model) Dividends grow at rate g, as follows:

End of year	1	2	3	4	…
Dividend	Div	$Div(1+g)$	$Div(1+g)^2$	$Div(1+g)^3$	

Note that Div is the dividend at the end of the first period. The value of a common stock with dividends growing at a constant rate is:

$$S_0 = \frac{Div}{(1+r)} + \frac{Div(1+g)}{(1+r)^2} + \frac{Div(1+g)^2}{(1+r)^3} + \frac{Div(1+g)^3}{(1+r)^4} + \cdots = \frac{Div}{r-g}$$

Where *g* is the growth rate and *Div* is the dividend on the stock at the end of the first period. This is just an application of the growing perpetuity formula.

Case 3 (Differential Growth) In this case, an algebraic formula would be too unwieldy. Instead, we present simple rule: in a differential dividend growth model you should discount all dividends separately and calculate the sum, which will result in the current value of common stock. General formula can be written as follows:

$$Stock\ Value = \sum_{i=1}^{\infty} \frac{Div_i}{(1+r)^i}$$

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 27, pp.108-112

ASSET TYPES AND CLASSES

41. What is the difference between real assets and financial assets?

The material wealth of a society is ultimately determined by the productive capacity of its economy, that is, the goods and services its members can create. This capacity is a function of the real assets of the economy: the land, buildings, equipment, and knowledge that can be used to produce goods and services. In contrast to such real assets, there are financial assets such as stocks and bonds. Such securities are no more than sheets of paper or, more likely, computer entries and do not contribute directly to the productive capacity of the economy. Instead, these assets are the means by which individuals in well-developed economies hold their claims on real assets.

Financial assets are claims to the income generated by real assets (or claims on income from the government). While real assets generate net income to the economy, financial assets simply define the allocation of income or wealth among investors. The distinction between real and financial assets is apparent when we compare the balance sheet of households, with the composition of national wealth. Household wealth includes financial assets such as bank accounts, corporate stock, or bonds. However, these securities, which are financial assets of households, are liabilities of the issuers of the securities. Therefore, when we aggregate overall balance sheets, these claims cancel out, leaving only real assets as the net wealth of the economy. National wealth consists of structures, equipment, inventories of goods, and land.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter1; pp.1-2

42. List the categories of financial assets

It is common to distinguish among three broad types of financial assets: debt, equity, and derivatives. Fixed-income or debt securities promise either a fixed stream of income or a stream of income that is determined according to a specified formula. For example, a corporate bond typically would promise that the bondholder will receive a fixed amount of interest each year. Other so-called floating-rate bonds promise payments that depend on current interest rates. For example, a bond may pay an interest rate that is fixed at two percentage points above the rate paid on U.S. Treasury bills. Unless the borrower is declared bankrupt, the payments on these securities are either fixed or determined by formula. For this reason, the investment performance of debt securities typically is least closely tied to the financial condition of the issuer.

Unlike debt securities, common stock, or equity, in a firm represents an ownership share in the corporation. Equity holders are not promised any particular payment. They receive any dividends the firm may pay and have prorated ownership in the real assets of the firm. If the firm is successful, the value of equity will increase; if not, it will decrease. The performance of equity investments, therefore, is tied directly to the success of the firm and its real assets. For this reason, equity investments tend to be riskier than investments in debt securities.

Finally, derivative securities such as options and futures contracts provide payoffs that are determined by the prices of other assets such as bond or stock prices.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter1; pp.3-4

43. Describe money market instruments

The money market is a subsector of the debt market. It consists of very short-term debt securities that are highly marketable. Many of these securities trade in large denominations and so are out of the reach of individual investors. Below are described some of them.

Treasury bills (T-bills, or just bills, for short) are the most marketable of all money market instruments. T-bills represent the simplest form of borrowing. The government raises money by selling bills to the public. Investors buy the bills at a discount from the stated maturity value. At the bill's maturity, the holder receives from the government a payment equal to the face value of the bill. The difference between the purchase price and the ultimate maturity value represents the investor's earnings. T-bills are highly liquid; that is, they are easily converted to cash and sold at low transaction cost and with little price risk.

A certificate of deposit (CD) is a time deposit with a bank. Time deposits may not be withdrawn on demand. The bank pays interest and principal to the depositor only at the end of the fixed term of the CD. CDs issued in denominations larger than $100,000 are usually negotiable, however; that is, they can be sold to another investor if the owner needs to cash in the certificate before its maturity date.

The typical corporation is a net borrower of both long-term funds (for capital investments) and short-term funds (for working capital). Large, well-known companies often issue their own short-term unsecured debt notes directly to the public, rather than borrowing from banks. These notes are called commercial paper (CP).

Dealers in government securities use repurchase agreements, also called repos, or RPs, as a form of short-term, usually overnight borrowing. The dealer sells securities to an investor on an overnight basis, with an agreement to buy back those securities the next day at a slightly higher price. The increase in the price is the overnight interest. The dealer thus takes out a one-day loan from the investor. The securities serve as collateral for the loan.

The London Interbank Offer Rate (LIBOR) is the rate at which large banks in London are willing to lend money among them. This rate has become the premier short-term interest rate quoted in the European money market and serves as a reference rate for a wide range of transactions. A corporation might borrow at a rate equal to LIBOR plus two percentage points, for example.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter2; pp.24-28

44. Describe long term debt securities instruments

The bond market is composed of longer-term borrowing or debt instruments than those that trade in the money market. This market includes Treasury notes and bonds, corporate bonds, municipal bonds, etc.

These instruments are sometimes said to comprise the fixed-income capital market, because most of them promise either a fixed stream of income or stream of income that is determined according to a specified formula. In practice, these formulas can result in a flow of income that is far from fixed. Therefore, the term “fixed income” is probably not fully appropriate. It is simpler and more straightforward to call these securities either debt instruments or bonds.

The U.S. government borrows funds in large part by selling Treasury notes and bonds. T-note maturities range up to 10 years, while T-bonds are issued with maturities ranging from 10 to 30 years.

Municipal bonds (“munis”) are issued by state and local governments. They are similar to Treasury and corporate bonds, except their interest income is exempt from federal income taxation. The interest income also is exempt from state and local taxation in the issuing state.

Corporate bonds are the means by which private firms borrow money directly from the public. These bonds are structured much like Treasury issues in that they typically pay semi-annual coupons over their lives and return the face value to the bondholder at maturity. Where they differ most importantly from Treasury bonds is in risk. Default risk is a real consideration in the purchase of corporate bonds. Corporate bonds sometimes come with options attached. Callable bonds give the firm the option to repurchase the bond from the holder at a stipulated call price. Convertible bonds give the bondholder the option to convert each bond into a stipulated number of shares of stock.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter2; pp.29-35

45. What is equity stock? What types of stock exist and what is the difference between them?

Common stocks, also known as equity securities, or equities, represent ownership shares in a corporation. Each share of common stock entitles its owners to one vote on any matters of corporate governance put to a vote at the corporation’s annual meeting and to a share in the financial benefits of ownership (e.g., the right to any dividends that the corporation may choose to distribute). A corporation is controlled by a board of directors elected by the shareholders. The members of the board are elected at the annual meeting. Shareholders who do not attend the annual meeting can vote by proxy, empowering another party to vote in their name.

The two most important characteristics of common stock as an investment are its residual claim and its limited liability features.

Residual claim means stockholders are the last in line of all those who have a claim on the assets and income of the corporation. In a liquidation of the firm's assets, the shareholders have claim to what is left after paying all other claimants, such as the tax authorities, employees, suppliers, bondholders, and other creditors. In a going concern, shareholders have claim to the part of operating income left after interest and income taxes have been paid. Management either can pay this residual as cash dividends to shareholders or reinvest it in the business to increase the value of the shares.

Limited liability means that the most shareholders can lose in event of the failure of the corporation is their original investment. Shareholders are not like owners of unincorporated businesses, whose creditors can lay claim to the personal assets of the owner—such as houses, cars, and furniture. In the event of the firm's bankruptcy, corporate stockholders at worst have worthless stock. They are not personally liable for the firm's obligations: Their liability is limited.

Preferred stock has features similar to both equity and debt. Like a bond, it promises to pay to its holder a fixed stream of income each year. In this sense, preferred stock is similar to an infinite-maturity bond, that is, perpetuity. It also resembles a bond in that it does not give the holder voting power regarding the firm's management. Preferred stock is an equity investment, however. The firm retains discretion to make the dividend payments to the preferred stockholders: It has no contractual obligation to pay those dividends. Instead, preferred dividends are usually cumulative; that is, unpaid dividends cumulate and must be paid in full before any dividends may be paid to holders of common stock. In contrast, the firm does have a contractual obligation to make timely interest payments on the debt. Failure to make these payments sets off corporate bankruptcy proceedings.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter2; pp.35-38

46. List and describe the stock indexes known to you

Indexes are taken as a measure of the performance of the stock market. The Dow Jones Industrial Average (DJIA) of 30 large, "blue-chip" corporations has been computed since 1896. Its long history probably accounts for its pre-eminence in the public mind. Originally, the DJIA was calculated as the simple average of the stocks included in the index. So, if there were 30 stocks in the index, one would add up the value of the 30 stocks and divide by 30. The percentage change in the DJIA would then be the percentage change in the average price of the 30 shares. The amount of money invested in each company represented in the portfolio is proportional to that company's share price, so the Dow is called a price-weighted average. Because the Dow Jones averages are based on small numbers of firms, care must be taken to ensure that they are representative of the broad market. As a result, the composition of the average is changed every so often to reflect changes in the economy. In the same way that the divisor is updated for stock splits, if one firm is dropped from the average and another firm with a different price is added, the divisor has to be updated to leave the average unchanged by the substitution.

The Standard & Poor's Composite 500 (S&P 500) stock index represents an improvement over the Dow Jones Averages in two ways. First, it is a more broadly based index of 500 firms. Second, it is a market value–weighted index. The S&P 500 is computed by calculating the total market value of the 500 firms in the index and the total market value of those firms on the previous day of trading. 6 The percentage increase in the total market value from one day to the next represents the increase in the index. The rate of return of the index equals the rate of return that would be earned by an investor holding a portfolio of all 500 firms in the index in proportion to their market value, except that the index does not reflect cash dividends paid by those firms.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter2; pp.38-45

47. List the discount instruments that you know? Why are they called "Discounts"?

The pure discount bond is perhaps the simplest kind of bond. It promises a single payment, say \$1, at a fixed future date. If the payment is one year from now, it is called a one-year discount bond; if it is two years from now, it is called a two-year discount bond, and so on. The date when the issuer of the bond makes the last payment is called the maturity date of the bond, or just its maturity for short. The bond is said to mature or expire on the date of its final payment. The payment at maturity (\$1 in this example) is termed the bond's face value. Pure discount bonds are often called zero-coupon bonds or zeros to emphasize the fact that the holder receives no cash payments until maturity.

Consider a pure discount bond that pays a face value of F in T years, where the interest rate is r in each of the T years. (We also refer to this rate as the market interest rate.) Because the face value is the only cash flow that the bond pays, the present value of this face amount is Value of a Pure Discount Bond:

$$PV = \frac{F}{(1+R)^T}$$

An instrument which does not carry a coupon is a "discount" instrument. Because there is no interest paid on the principal, a buyer will only ever buy it for less than its face value – that is "at a discount" (unless yields are negative!). For example, all treasury bills are discount instruments.

Time deposit / loan

A time deposit or "clean" deposit is a deposit placed with a bank. This is not a security which can be bought or sold (that is, it is not "negotiable"), and it must normally be held to maturity.

Certificate of deposit (CD)

A CD is a security issued to a depositor by a bank or building society, to raise money in the same way as a time deposit. A CD can however be bought and sold (that is, it is "negotiable").

Treasury bill (T-bill)

Treasury bills are domestic instruments issued by governments to raise short-term finance.

Repurchase agreement (repo)

A repo is an arrangement whereby one party sells a security to another party and simultaneously agrees to repurchase the same security at a subsequent date at an agreed price. This is equivalent to the first party borrowing from the second party against collateral, and the interest rate reflects this – that is, it is slightly lower than an unsecured loan. The security involved will often be of high credit quality, such as a government bond. A reverse repurchase agreement (reverse repo) is the same arrangement viewed from the other party's perspective. The deal is generally a "repo" if it is initiated by the party borrowing money and lending the security and a "reverse repo" if it is initiated by the party borrowing the security and lending the money.

Mastering Financial Calculations, Chapter 2, pp. 1-3

FINANCIAL SYSTEM AND INVESTMENT ENVIRONMENT

48. What is the definition of investment?

Investment is the current commitment of money or other resources in the expectation of reaping future benefits. For example, an individual might purchase shares of stock anticipating that the future proceeds from the shares will justify both the time that her money is tied up as well as the risk of the investment.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter 1; pp. 1-3

49. List Financial System Clients

There appear to be three major players in the financial markets:

- Firms are net borrowers. They raise capital now to pay for investments in plant and equipment. The income generated by those real assets provides the returns to investors who purchase the securities issued by the firm.
- Households typically are net savers. They purchase the securities issued by firms that need to raise funds.
- Governments can be borrowers or lenders, depending on the relationship between tax revenue and government expenditures. Since World War II, the U.S. government typically has run budget deficits, meaning that its tax receipts have been less than its expenditures. The government, therefore, has had to borrow funds to cover its budget deficit. Issuance of Treasury bills, notes, and bonds is the major way that the government borrows funds from the public. In contrast, in the latter part of the 1990s, the government enjoyed a budget surplus and was able to retire some outstanding debt.

Corporations and governments do not sell all or even most of their securities directly to individuals. For example, about half of all stock is held by large financial institutions such as pension funds, mutual funds, insurance companies, and banks. These financial institutions stand between the security issuer (the firm) and the ultimate owner of the security (the individual investor). For this reason, they are called financial intermediaries. Similarly, corporations do not directly market their securities to the public. Instead, they hire agents, called investment bankers, to represent them to the investing public.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter 1; pp. 11-12

50. What is the difference between a public and private corporation?

A public company or publicly traded company is a limited liability company that offers its securities (stock/shares, bonds/loans, etc.) for sale to the general public, typically through a stock exchange, or through market makers operating in over the counter markets. This is separate and distinct from a Government-owned corporation which might be described as a publicly-owned company.

Usually, the securities of a publicly traded company are owned by many investors while the shares of a privately held company are owned by relatively few shareholders. A company with many shareholders is not necessarily a publicly traded company.

Publicly traded companies are able to raise funds and capital through the sale of its securities. This is the reason publicly traded corporations are important: prior to their existence, it was very difficult to obtain large amounts of capital for private enterprises.

The financial media and city analysts will be able to access additional information about the business. Privately held companies have several advantages over publicly traded companies. A privately held company has no requirement to publicly disclose much, if any financial information; such information could be useful to competitors. For example, publicly traded companies in the United States are required by the SEC to submit an annual Form 10-K containing a comprehensive detail of a company's performance. Privately held companies they leak less information to competitors, and they tend to be under less pressure to meet quarterly projections for sales and profits.

Publicly traded companies are also required to spend more for certified public accountants and other bureaucratic paperwork required of all publicly traded companies under government regulations.

Investments, 8thed; Bodie, Kane, Marcus, McGraw-Hill2009; Chapter 3

51. Define primary and secondary markets

When firms need to raise capital they may choose to sell or float securities. These new issues of stocks, bonds, or other securities typically are marketed to the public by investment bankers in what is called the primary market. Trading of already-issued securities among investors occurs in the secondary market. Trading in secondary markets does not affect the outstanding amount of securities; ownership is simply transferred from one investor to another.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter 3; pp. 54-55

52. What is meant by short position and long position?

In finance, a long position in a security, such as a stock or a bond, or equivalently to be long in a security, means the holder of the position owns the security and will profit if the price of the security goes up. Going long is the more conventional practice of investing and is contrasted with going short.

In contrast, a short position in an asset means that the holder of the position will profit if the price of the futures contract or derivative goes down.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter 3; pp. 60-62;74

53. Describe the concept of short-selling

A short sale allows investors to profit from a decline in a security's price. An investor borrows a share of stock from a broker and sells it. Later, the short-seller must purchase a share of the same stock in order to replace the share that was borrowed. This is called covering the short position.

The short-seller anticipates the stock price will fall, so that the share can be purchased later at a lower price than it initially sold for; if so, the short-seller will reap a profit. Short-sellers must not only replace the shares but also pay the lender of the security any dividends paid during the short sale.

In practice, the shares loaned out for a short sale are typically provided by the short-seller's brokerage firm, which holds a wide variety of securities of its other investors in street name (i.e., the broker holds the shares registered in its own name on behalf of the client). The owner of the shares need not know that the shares have been lent to the short-seller. If the owner wishes to sell the shares, the brokerage firm will simply borrow shares from another investor. Therefore, the short sale may have an indefinite term. However, if the brokerage firm cannot locate new shares to replace the ones sold, the short-seller will need to repay the loan immediately by purchasing shares in the market and turning them over to the brokerage house to close out the loan.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter 3; p. 74

54. Explain why the bid-ask spread is a transaction cost

The cost of trading a stock reduces the total return that an investor receives. That is, if one buys a stock for \$100 and sells it later for \$105, the gain before trading costs is \$5. If one must pay a dollar of commission when buying and another dollar when selling, the gain after trading costs is only \$3. In addition to the explicit part of trading costs—the broker's commission—there is an implicit part—the dealer's bid–ask spread. The bid-ask spread is the difference between the bid price (the amount of money you get when you sell) and the ask price (the amount of money it costs to buy). Since the ask price is higher than the bid price, it costs you more money to buy the asset than you would receive should you be selling the same asset. This spread is the price (along with a commission) for making the trade.

Sometimes the broker is a dealer in the security being traded and charges no commission but instead collects the fee entirely in the form of the bid–ask spread. Both the bid-ask spread and market-impact costs would reduce this gain still further.

Corporate Finance, 6thed, Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, p. 13

FINANCIAL INSTITUTIONS AND THEIR RISKS

55. Why are financial institutions important?

In an economy without FIs, the level of fund flows between household savers and the corporate sectors is likely to be quite low. There are several reasons for this. Once they have lent money to a firm by buying its financial claims, households need to monitor, or check, the actions of that firm. They must be sure that the firm's management neither absconds with nor wastes the funds on any projects with low or negative net present values. Such monitoring actions are extremely costly for any given household because they require considerable time and expense to collect sufficiently high-quality information relative to the size of the average household saver's investments. Given this, it is likely that each household would prefer to leave the monitoring to others; in the end, little or no monitoring would be done. The resulting lack of monitoring would reduce the attractiveness and increase the risk of investing in corporate debt and equity.

The relatively long-term nature of corporate equity and debt, and the lack of a secondary market in which households can sell these securities, creates a second disincentive for household investors to hold the direct financial claims issued by corporations. Specifically, given the choice between holding cash and holding long-term securities, households may well choose to hold cash for liquidity reasons, especially if they plan to use savings to finance consumption expenditures in the near future.

Finally, even if financial markets existed (without FIs to operate them) to provide liquidity services by allowing households to trade corporate debt and equity securities among themselves, investors also face a price risk on sale of securities, and the secondary market trading of securities involves various transaction costs. That is, the price at which household investors can sell securities on secondary markets such as the New York Stock Exchange may well differ from the price they initially paid for the securities.

Because of (1) monitoring costs, (2) liquidity costs, and (3) price risk, the average household saver may view direct investment in corporate securities as an unattractive proposition and prefer either not to save or to save in the form of cash.

FI's Function as Brokers

The first function is the brokerage function. When acting as a pure broker, an FI acts as an agent for the saver by providing information and transaction services. For example, full-service securities firms (e.g., MerrillLynch) carry out investment research and make investment recommendations for their retail (or household) clients as well as conducting the purchase or sale of securities for commission or fees. Discount brokers (e.g., CharlesSchwab) carry out the purchase or sale of securities at better prices and with greater efficiency than household savers could achieve by trading on their own. This efficiency results in reduced costs of trading, or economies of scale. Independent insurance brokers identify the best types of insurance policies household savers can buy to fit their savings and retirement plans. In fulfilling a brokerage function, the FI plays an extremely important role by reducing transaction and information costs or imperfections between households and corporations. Thus, the FI encourages a higher rate of savings than would otherwise exist.

FI's Function as Asset Transformers

The second function is the asset-transformation function. In acting as an asset transformer, the FI issues financial claims that are far more attractive to household savers than the claims directly issued by corporations. That is, for many households, the financial claims issued by FIs dominate those issued directly by corporations as a result of lower monitoring costs, lower liquidity costs, and lower price risk. In acting as asset transformers, FIs purchase the financial claims issued by corporations—equities, bonds, and other debt claims called primary securities—and finance these purchases by selling financial claims to household investors and other sectors in the form of deposits, insurance policies, and so on.

The financial claims of FIs may be considered secondary securities because these assets are backed by the primary securities issued by commercial corporations that in turn invest in real assets. Specifically, FIs are independent market parties that create financial products whose value added to their clients is the transformation of financial risk.

Financial Institutions Management, 6th ed., Anthony Saunders, Marcia Millon Cornett; McGraw-Hill, 2008; Chapter 1, pp 3-8

56. What is the Market Risk? Differentiate between trading and investment portfolios

Market risk is the risk that the value of an investment will decrease due to moves in market factors such as interest rates, market volatility, and market liquidity. It cannot be eliminated through diversification, though it can be hedged against.

Market risk is typically measured using a Value at Risk methodology. Value at risk is well established as a risk management technique. Moreover, market risk can be defined in absolute terms as a dollar exposure amount or as a relative amount against some benchmark.

Conceptually, an FI's trading portfolio can be differentiated from its investment portfolio on the basis of time horizon and liquidity. The trading portfolio contains assets, liabilities, and derivative contracts that can be quickly bought or sold on organized financial markets (such as long and short positions in bonds, commodities, foreign exchange, equity securities, interest rate swaps, and options).

The investment portfolio (or, in the case of banks, the so-called banking book) contains assets and liabilities that are relatively illiquid and held for longer holding periods (such as consumer and commercial loans, retail deposits, and branches). Income from trading activities is increasingly replacing income from traditional FI activities of deposit taking and lending.

The resulting earnings uncertainty, or market risk, can be measured over periods as short as a day or as long as a year.

Financial Institutions Management, 6th ed., Anthony Saunders, Marcia Millon Cornett; McGraw-Hill, 2008; Chapter 10, pp. 266-268

57. What is Credit Risk?

Credit risk is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default. Other terms for credit risk are default risk and counterparty risk.

Credit quality problems, in the worst case, can cause an FI to become insolvent or can result in such a significant drain on capital and net worth that they adversely affect its growth prospects and ability to compete with other domestic and international FIs. However, credit risk does not apply only to traditional areas of lending and bond investing. As banks and other FIs have expanded into credit guarantees and other off-balance-sheet activities, new types of credit risk exposure have arisen, causing concern among managers and regulators. Thus, credit risk analysis is now important for a whole variety of contractual agreements between FIs and counterparties.

To calibrate the default risk exposure of credit and investment decisions as well as to assess the credit risk exposure in off-balance-sheet contractual arrangements such as loan commitments, an FI manager needs to measure the probability of borrower default (PD). The ability to do this depends largely on the amount of information the FI has about the borrower. At the retail level, much of the information needs to be collected internally or purchased from external credit agencies. At the wholesale level, these information sources are bolstered by publicly available information, such as certified accounting statements, stock and bond prices, and analysts' reports. Thus, for a publicly traded company, more information is produced and is available to an FI than is available for a small, single-proprietor corner store. The availability of more information, along with the lower average cost of collecting such information, allows FIs to use more sophisticated and usually more quantitative methods in assessing default probabilities for large borrowers compared with small borrowers. However, advances in technology and information collection are making quantitative assessments of even smaller borrowers increasingly feasible and less costly.

In principle, FIs can use very similar methods and models to assess the probabilities of default on both bonds and loans. Even though loans tend to involve fewer lenders to any single borrower as opposed to multiple bondholders, in essence, both loans and bonds are contracts that promise fixed (or indexed) payments at regular intervals in the future. Loans and bonds stand ahead of the borrowing firm's equity holders in terms of the priority of their claims if things go wrong. Also, bonds, like loans, include covenants restricting or encouraging various actions to enhance the probability of repayment. Covenants can include limits on the type and amount of new debt, investments, and asset sales the borrower may undertake while the loan or bonds are outstanding. Financial covenants are also often imposed restricting changes in the borrower's financial ratios such as its leverage ratio or current ratio.

For example, a common restrictive covenant included in many bond and loan contracts limits the amount of dividends a firm can pay to its equity holders. Clearly, for any given cash flow, a high dividend pay-out to stockholders means that less is available for repayments to bondholders and lenders. Moreover, bond yields, like wholesale loan rates, usually reflect risk premiums that vary with the perceived credit quality of the borrower and the collateral or security backing of the debt. Given this, FIs can use many of the following models that analyse default risk probabilities either in making lending decisions or when considering investing in corporate bonds offered either publicly or privately.

Financial Institutions Management, 6th ed., Anthony Saunders, Marcia Millon Cornett; McGraw-Hill, 2008; Chapter 11, pp. 295-305

58. What is Foreign Exchange Risk?

Currency risk or exchange rate risk is a form of financial risk that arises from the potential change in the exchange rate of one currency in relation to another. Investors or businesses face an exchange rate risk when they have assets or operations across national borders or if they have loans or borrowings in a foreign currency.

The nation’s largest commercial banks are major players in foreign currency trading and dealing. Clearly, an FI could match its foreign currency assets to its liabilities in a given currency and match buys and sells in its trading book in that foreign currency to reduce its foreign exchange net exposure to zero and thus avoid FX risk. It could also offset an imbalance in its foreign asset–liability portfolio by an opposing imbalance in its trading book so that its net exposure position in that currency would be zero.

A positive net exposure position implies a U.S. FI is overall net long in a currency (i.e., the FI has bought more foreign currency than it has sold) and faces the risk that the foreign currency will fall in value against the U.S. dollar, the domestic currency. A negative net exposure position implies that a U.S. FI is net short in a foreign currency (i.e., the FI has sold more foreign currency than it has purchased) and faces the risk that the foreign currency could rise in value against the dollar. Thus, failure to maintain a fully balanced position in any given currency exposes a U.S. FI to fluctuations in the FX rate of that currency against the dollar. Indeed, the greater the volatility of foreign exchange rates given any net exposure position, the greater the fluctuations in value of an FI’s foreign exchange portfolio.

Financial Institutions Management, 6th ed., Anthony Saunders, Marcia Millon Cornett; McGraw-Hill, 2008; Chapter 14, pp. 400-409

BOND TYPES, PRICING AND RETURN

59. What is bond?

A bond is a certificate showing that a borrower owes a specified sum. In order to repay the money, the borrower has agreed to make interest and principal payments on designated dates.

The U.S. government regularly borrows from the public by issuing government bonds to cover its budget deficit. Corporations issue bonds to raise the capital required to expand their operations. In this manner, the U.S. government and borrowing corporations commit themselves to pay a certain amount of money in interest to bondholders on an annual, semiannual, or quarterly basis. The amount of interest to be received is the coupon rate stated on each bond certificate. Other information found on a bond certificate includes the maturity date, the face value, and the number of times interest is paid each year. The maturity date is the date when the issuer must pay the investor the full price of the bond, thus retiring the debt. The face value of a bond is the price of the bond at maturity.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 5, p. 2

60. Write the general formula for bond valuation

To value any asset, we discount its expected cash flows by the appropriate discount rate. The cash flows from a bond consist of coupon payments until the maturity date plus the final payment of par value. Therefore, we have:

$$Bond\ value = Present\ value\ of\ coupons + Present\ value\ of\ par\ value$$

If we call the maturity date *T* and call the discount rate *r*, the bond value can be written as:

$$Bond\ Value = \sum_{t=1}^{T} \frac{Coupon_t}{(1+r)^t} + \frac{Par\ Value}{(1+r)^T}$$

Where $Coupon_t$ is the coupon payment at time *t*. Or, more generally, defining C_i as any cash payments from the bond on date *i* with last payment being C_T at maturity of the bond, we can rewrite:

$$Bond\ Value = \sum_{i=1}^{T} \frac{C_i}{(1+r)^i}$$

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter 14; pp. 452-453

61. What types of bond exist and why are the US Treasury-bills special?

The major types of bonds are:

- U.S treasury securities (T-bills)
- Corporate bonds
- Municipal bonds

U.S Treasury securities are backed by the full faith and credit of the U.S. government and are therefore viewed as default-free securities. There are two types of Treasury securities: discount and coupon securities.

The current practice of the Treasury is to issue all securities with a maturity of 1 year or less as discount securities called *Treasury bills***.** They are issued at a discount to par value, have no coupon rate and mature at par value (i.e. they are zero-coupon instruments). Currently they are issued on a regular basis with initial maturities of 4 weeks, 3monthsand 6 months.

Treasury securities with initial maturities of 2 years or more are issued as coupon securities. Treasury coupon securities issued with original maturities of more than 1 year and no more than 10 years are called *treasury notes,* and those with a maturity greater than 10 years are called *Treasury bonds.* Treasury coupon securities are currently auctioned on a regular basis with initial maturities of 2 years, 5 years, and 10 years. The most recently auctioned issue is referred *to as the on-the-run issue* or the current issue. Securities that are replaced by the on-the-run issue are *called off-the-run issue.*

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter2; pp.24-28

62. What main characteristics have municipal bonds?

Bonds are issued by state and local governments and by entities that they establish. Local government units include municipalities, countries, towns and townships, school district and special service system districts. Included in the category of municipalities and cities, villages, boroughs and incorporate towns that received a special state charter.

These securities are popularly referred to as municipal securities despite the fact that they are also issued by state and public agencies and their instruments. There are both tax-exempt and taxable municipal securities. "Tax-exempt" means that interest on a municipal security is exempt from federal income taxation. The tax exemption may or may not extent to taxation at the state and local levels. Each state has its own rules as to how interest on municipal securities is taxed. Most municipal securities that have been issued are tax-exempt. Municipal securities are taxable municipal securities that have been issued and are traded in the market.

There are basic types of municipal securities structures: Tax-backed debt and revenue bonds. Tax-backed bonds are instruments issued by states, countries, special district, cities, towns, and school districts that are secured by some form of tax revenue. Revenue bonds are issued for enterprise financings that are secured by the revenues generated by the completed projects themselves or for general public-purpose financings in which the issuers pledge to the bondholders. Revenue bonds can be classified by the type of financing. These include utility revenue bonds, transportation revenue bonds, housing revenue bonds, sports revenue bonds and industrial revenue bonds.

Investments, 8th ed., Bodie, Kane, Marcus; McGraw-Hill, 2009;Chapter2; pp.24-28

63. How can the yield on investment be calculated for single cash flow investment? Multiple cash flow investment?

A financial instrument that can be purchased for $6,805.82 promises to pay $10,000 in 5 years. The yield is the interest rate that will make $6,805.82 grow to $10,000 in 5 years. That is, we are looking for the value of *y* that will satisfy the following relationship:

$$\$10\,000 \ = \ \$6\,805{,}82(1 \ + \ y)^5$$

Solving it, we have$y = 0.08$ or 8% and hence the yield on this investment is 8%.

The following formula is consistent with the above:

$$y = \left(\frac{FV}{PV}\right)^{\frac{1}{n}} - 1$$

Where

n – number of periods until the cash flow will be received
FV – future value of an investment
PV – initial investment

For multiple cash flow case, yield calculation becomes identical to the calculation of internal rate of return (*IRR*) of an investment as you might be aware of the fact that *IRR* of a bond is its yield. To see that it is true, let’s compare the *Bond Price* and *IRR* formulas:

$$0 = -C_0 + \sum_{i=1}^{T} \frac{C_i}{(1+IRR)^i}$$

$$Bond\ Price = \sum_{i=1}^{T} \frac{C_i}{(1+y)^i}, or\ 0 = -Bond\ Price + \sum_{i=1}^{T} \frac{C_i}{(1+y)^i}$$

As you can see from the above, IRR of an investment in a bond is its yield.

Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 5, pp. 58-59.*

64. How are the Coupon rate and Yield Related to each other? What influence does their relationship have on price of bond?

For a bond issue, the coupon rate and the term to maturity are fixed. Consequently, as yields in the marketplace change, the only variable that can change to compensate for new yield required in the market is the price of the bond. If the required yield increases (decreases), the price of the bond decreases (increases).

Generally, a bond's coupon rate at the time of issuance is set at approximately the prevailing yield in the market. The price of the bond will then be approximately equal to its par value.

Selling at *par*

When the coupon rate equals the required yield, then the price equals the par value.
When the price equals the par value, then the coupon rate equals the required yield.

When yields in the marketplace rise above the coupon rate at a particular time, the price of the bond has to adjust so that the investor can realize additional interest income. This adjustment happens when the bond's price falls below the par value. The difference between the par value and the price is a capital gain and represents a form of interest income to the investor to compensate for the coupon rate being lower than the required yield.

Selling at *Discount*

When the coupon rate is less than the required yield, then the price is less than the par value.
When the price is less than the par value, then the coupon rate is less than the required yield.

Finally, when the required yield in the market is below the coupon rate, the bond must sell above its par value. This occurs because investors who would have the opportunity to purchase the bond at par would be getting a coupon rate in excess of what the market requires. Because its yield is attractive, investors would bid up the price of the bond to a price that offers the required yield in the market.

Selling *premium:*

When the coupon rate is higher than the required yield, then the price is higher than the par value.
When the price is higher than the par value, then the coupon rate is higher than the required yield

Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 6, pp. 72-73*

65. What is the required yield for bond? How can it be calculated?

The interest rate or discount rate that an investor wants from investing in a bond is called the required yield. The required yield is determined by investigating the yields offered on comparable bonds in the market. By comparable, we mean bonds of the same credit quality and the same maturity.

The required yield is typically specified as an annual interest rate. When the cash flows are semi-annual, the convention is to use one-half the annual interest rate as the periodic interest rate with which to discount the cash flows.

Given the cash flows of a bond and the required yield, we have all the necessary data to price the bond. The price of a bond is the present value of the cash flows, which can be determined by adding:

1. The present value of the semi-annual coupon payments.
2. The present value of the par or maturity value.

In general, the price of a bond can be computed using the formula:

$$P=\frac{c}{(1+y)^1}+\frac{c}{(1+y)^2}+\frac{c}{(1+y)^3}+\cdots+\frac{c}{(1+y)^n}+\frac{M}{(1+y)^n}$$

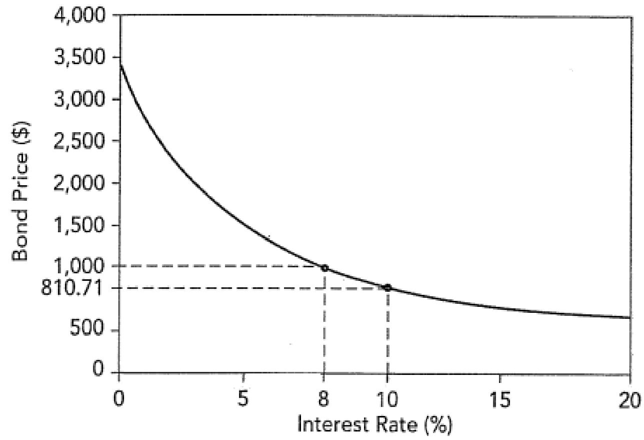
Where

P = Price;
c = Semi-annual coupon payment;
y = Periodic interest rate (required yield/2);
n = Number of periods (number of years×2);
M = Maturity value.

Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 6, pp. 66-67*

66. Graph and explain the relationship between Bond Price and Required Yield

In general, as a bond's price increases, yield decreases. This relationship is measured using the price value of a basis point (PVBP). By taking into account factors such as the bond's coupon rate and credit rating, the PVBP measures the degree to which a bond's price will change when there is a 0.01% change in interest rates. The charted relationship between bond price and required yield appears as a negative curve:



This is due to the fact that a bond's price will be higher when it pays a coupon that is higher than prevailing interest rates. As market interest rates increase, bond prices decrease.

Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 6, pp. 71-72*

67. What happens to Bond price when time reaches its maturity?

If the required yield is unchanged between the time a bond is purchased and the maturity date, what will happen to the price of the bond? For a bond selling at par value, the coupon rate is equal to the required yield. As the bond moves closer to maturity, the bond will continue to sell at par value. Thus, the price of a bond selling at par will remain at par as the bond moves toward the maturity date.

The price of a bond will not remain constant for a bond selling at a premium or adiscount. This can be seen for a discount bond by comparing the price found in Illustration1-1 to that found in Illustration1-2. In both illustrations the bond has a 9% coupon rate and the required yield is l2% or 7%.

Illustration 1

Time Path of the Price of a Discount Bond: 20-Year, 9% Coupon, 12% Required Yield:

Years Remaining To Maturity	Present Value of Coupon Payments of $45 at 6% ($)	Present Value of Par Value at 6% ($)	Price of Bond ($)
20	677.08	97.22	774.30
18	657.94	122.74	780.68
16	633.78	154.96	788.74
14	603.28	195.63	798.91
12	564.77	256.98	811.75

10	516.15	311.80	827.95
8	454.77	393.65	848.42
6	377.27	496.97	874.24
4	279.44	627.41	906.85
2	155.93	792.09	948.02
1	82.50	890	972.50
0	0	1000	1000

Time Path of a Discount Bond Assuming No Change in Required Yield:

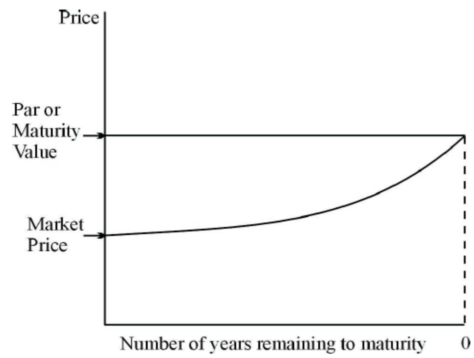
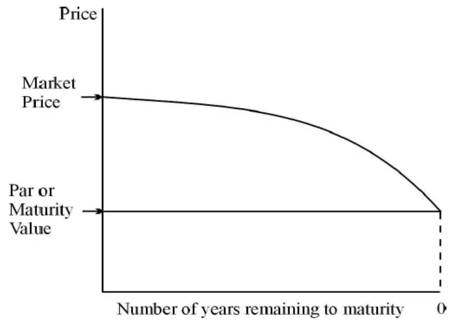


Illustration 2

Time Path of the Price of a Premium Bond: 20-Year, 9% Coupon, 7% Required Yield:

Years Remaining To Maturity	Present Value of Coupon Payments of $45 at 3.5% ($)	Present Value of Par Value at 3.5% ($)	Price of Bond ($)
20	960.98	252.57	1213.55
18	913.07	289.83	1202.90
16	858.10	332.59	1190.69
14	795.02	381.65	1176.67
12	722.63	437.96	1160.59
10	639.56	502.57	1142.13
8	544.24	576.71	1120.95
6	434.85	661.78	1096.63
4	309.33	759.41	1068.74
2	165.29	871.44	1036.73
1	85.49	933.51	1019.00
0	0.00	1000.00	1000.00

Time Path of a Premium Bond Assuming No Change in Required Yield:



Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 6, pp. 73-76*

68. What is the Yield to Maturity of a Bond?

The yield to maturity is the interest rate that will make the present value of the cash flows equal to the price (or initial investment). The yield to maturity is computed in the same way as IRR; the cash flows are those that the investor would realize by holding the bond to maturity and reinvesting coupons at the same rate. Yield to maturity of the bond is computed by solving the following relationship for *y*:

$$P = \frac{c}{(1+y)^1} + \frac{c}{(1+y)^2} + \frac{c}{(1+y)^3} + \cdots + \frac{c}{(1+y)^n} + \frac{M}{(1+y)^n}$$

Where

P = Price ($);
c = coupon interest ($);
y = yield to maturity;
n = Number of periods;
M = Maturity value ($).

The yield to maturity considers not only the current coupon income but any capital gain or loss that the investor will realize by *holding the bond to maturity*. The yield to maturity also considers the timing of the cash flows.

Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 7, p. 94*

69. What are Zero-Coupon bonds? What is its Yield to Maturity?

Bonds that do not make any periodic coupon payments are called zero coupon bonds. Instead, the investor realizes interest by the amount of the difference between the maturity value and the purchase price.

The pricing of a zero-coupon bond is no different from the pricing of a coupon bond: its price is the present value of the expected cash flows. In the case of a zero-coupon bond, the only cash flow is the maturity value. Therefore, the formula for the price of a zero-coupon bond that matures *N* years from now is:

$$P = \frac{M}{(1+y)^N}$$

Where

P = Price;
M = Maturity value;
y = Periodic interest rate;
N= Number of periods;

A zero-coupon bond is characterized by a single cash flow resulting from the investment. Consequently, the following formula can be applied to compute the yield to maturity for a zero coupon bond:

$$y = (Future\ value\ per\ dollar\ invested)^{\frac{1}{n}} - 1$$

Where

y = yield to maturity;

And future value per dollar invested is given by:

$$Future\ value\ per\ dollar\ invested = \frac{Maturity\ value}{Price}$$

Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 7, pp. 96-97*

70. What is Current Yield? How is it calculated? What interdependence it has with Yield to Maturity and Coupon Rate?

The current yield relates the *annual coupon* interest to the market price. The formula for the current yield is:

$$Current\ yield = \frac{Annual\ dollar\ coupon\ interest}{Price}$$

These relationships pertain among coupon rate, current yield, and yield to maturity:

Bond Selling at	**Relationship**
Par	Coupon rate = Current Yield = Yield to Maturity
Discount	Coupon rate < Current Yield < Yield to Maturity
Premium	Coupon rate > Current Yield > Yield to Maturity

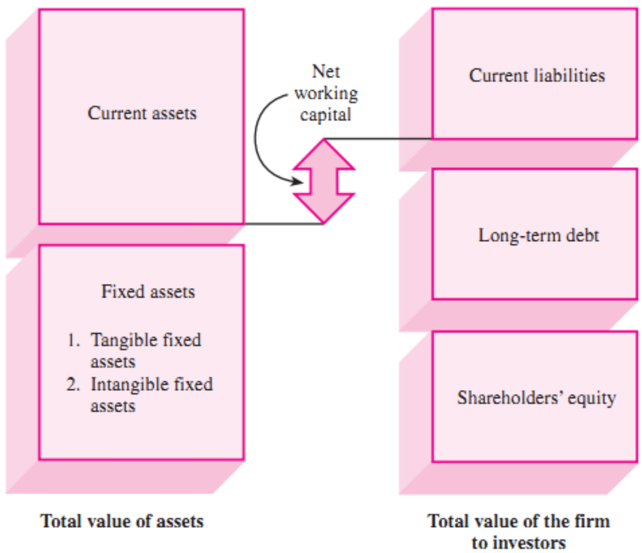
Fixed Income Mathematics,4^{th} *ed., FrankJ.Fabozz, McGraw-Hill; Chapter 7, pp. 93, 99*

CAPITAL STRUCTURE AND MANAGEMENT

71. Graph the balance sheet model of the firm. What questions does corporate finance study? Define each of them.

Balance sheet model of the firm can be graphed as follows:

The Balance-Sheet Model of the Firm



Left side, total value of assets. Right side, total value of the firm to investors, which determines how the value is distributed.

From the balance-sheet model of the firm it is easy to see why corporate finance can be thought of as the study of the following three questions:

1. *Capital Budgeting*. In what long-lived assets should the firm invest? This question concerns the left-hand side of the balance sheet. Of course, the type and proportions of assets the firm needs tend to be set by the nature of the business. We use the terms capital budgeting and capital expenditures to describe the process of making and managing expenditures on long-lived assets.
2. *Capital Structure*. How can the firm raise cash for required capital expenditures? This question concerns the right-hand side of the balance sheet. The answer to this involves the firm's capital structure, which represents the proportions of the firm's financing from current and long-term debt and equity.
3. *Net Working Capital*. How should short-term operating cash flows be managed? This question concerns the upper portion of the balance sheet. There is often a mismatch between the timing of cash inflows and cash outflows during operating activities. Furthermore, the amount and timing of operating cash flows are not known with

certainty. The financial managers must attempt to manage the gaps in cash flow. From a balance-sheet perspective, short-term management of cash flow is associated with a firm's net working capital. Net working capital is defined as current assets minus current liabilities. From a financial perspective, the short-term cash flow problem comes from the mismatching of cash inflows and outflows. It is the subject of short-term finance.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp. 2-9

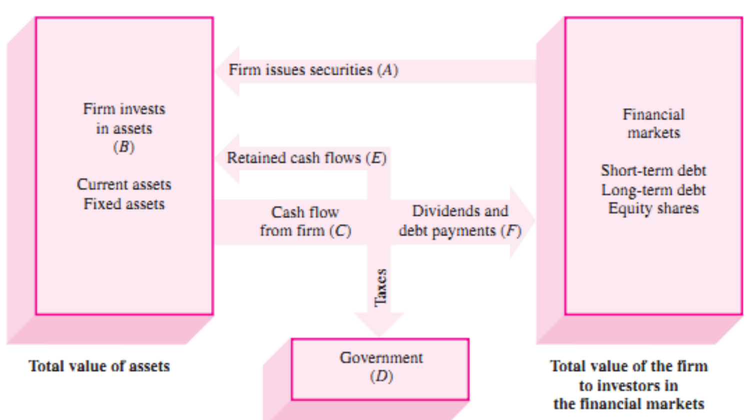
72. How do firms interact with financial markets? Show on the graph how the cash is generated

The most important job of a financial manager is to create value from the firm's capital budgeting, financing, and liquidity activities. How do financial managers create value?

1. The firm should try to buy assets that generate more cash than they cost.
2. The firm should sell bonds and stocks and other financial instruments that raise more cash than they cost.

Thus the firm must create more cash flow than it uses. The cash flows paid to bondholders and stockholders of the firm should be higher than the cash flows put into the firm by the bondholders and stockholders. To see how this is done, we can trace the cash flows from the firm to the financial markets and back again.

Cash Flows between the Firm and the Financial Markets



(A) Firm issues securities to raise cash (the financing decision).
(B) Firm invests in assets (capital budgeting).
(C) Firm's operations generate cash flow.
(D) Cash is paid to government as taxes.
(E) Retained cash flows are reinvested in firm.
(F) Cash is paid out to investors in the form of interest and dividends.

The interplay of the firm's finance with the financial markets is illustrated in the graph below. The arrows in the graph trace cash flow from the firm to the financial markets and back again. Suppose we begin with the firm's financing activities. To raise money the firm sells debt and equity shares to investors in the financial markets. This results in cash flows from the financial markets to the firm (A). This cash is invested in the investment activities of the firm (B) by the firm's management. The cash generated by the firm (C) is paid to shareholders and bondholders (F). The shareholders receive cash in the form of dividends; the bondholders who lent funds to the firm receive interest and, when the initial loan is repaid, principal. Not all of the firm's cash is paid out. Some is retained (E), and some is paid to the government as taxes (D).

Over time, if the cash paid to shareholders and bondholders (F) is greater than the cash raised in the financial markets (A), value will be created.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp. 5-9

73. What advantage does a stock market provide to corporate investors? What stock markets do you know?

The main advantage provided by stock markets is trading in corporate securities, the ability to raise capital. The equity shares of most of the large firms in the United States trade in organized auction markets. The largest such market is the New York Stock Exchange (NYSE), which accounts for more than 85 percent of all the shares traded in auction markets. Other auction exchanges include the American Stock Exchange (AMEX) and regional exchanges such as the Pacific Stock Exchange. In addition to the stock exchanges, there is a large OTC market for stocks. In 1971, the National Association of Securities Dealers (NASD) made available to dealers and brokers an electronic quotation system called NASDAQ (NASD Automated Quotation system, pronounced "naz-dak" and now spelled "Nasdaq"). There are roughly two times as many companies on NASDAQ as there are on NYSE, but they tend to be much smaller in size and trade less actively. There are exceptions, of course. Both Microsoft and Intel trade OTC, for example. Nonetheless, the total value of NASDAQ stocks is much less than the total value of NYSE stocks.

There are many large and important financial markets outside the United States, of course, and U.S. corporations are increasingly looking to these markets to raise cash. The Tokyo Stock Exchange and the London Stock Exchange (TSE and LSE, respectively) are two well-known examples. The fact that OTC markets have no physical location means that national borders do not present a great barrier, and there is now a huge international OTC debt market. Because of globalization, financial markets have reached the point where trading in many investments never stops; it just travels around the world.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp. 19-20

74. What is a firm worth with outstanding stock issued and without it?

Like the general rule for valuing any asset, one way of thinking about the question of how much a firm is worth is to calculate the present value of its future expected cash flows. The value of the firm is found by multiplying its cash flows by the appropriate present value factor. The value of the firm, then, is simply the sum of the present values of the individual cash flows.

Though the above method is correct, it is difficult to implement, costly, time-consuming and even might be unnecessary if the firm under consideration has outstanding stocks issued that are publicly traded. When a stock is traded on a public exchange, in case of efficient markets the stock price reflects all information about the company's future expected cash flows and its value today is measured by the stock's current market price. So, to value a firm with publicly traded stocks outstanding we can simply multiply the current market price of the stock by the number of stocks currently outstanding.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 4, pp.94-95

75. How the changes in capital structure affect the overall value of a firm? Show on the pie diagram

Sometimes it is useful to think of the firm as a pie. Initially, the size of the pie will depend on how well the firm has made its investment decisions. After a firm has made its investment decisions, it determines the value of its assets (e.g., its buildings, land, and inventories).

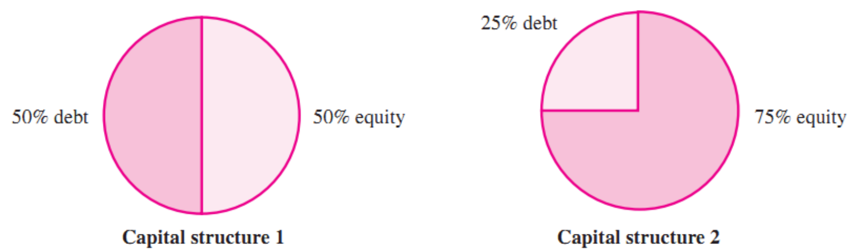
The firm can then determine its capital structure. The firm might initially have raised the cash to invest in its assets by issuing more debt than equity; now it can consider changing that mix by issuing more equity and using the proceeds to buy back some of its debt. Financing decisions like this can be made independently of the original investment decisions. The decisions to issue debt and equity affect how the pie is sliced.

The pie we are thinking of is depicted in figure below. The size of the pie is the value of the firm in the financial markets. We can write the value of the firm, V, as:

$$V = B + S$$

Where B is the value of the debt and S is the value of the equity. The pie diagrams consider two ways of slicing the pie: 50 percent debt and 50 percent equity, and 25 percent debt and 75 percent equity. The way the pie is sliced could affect its value. If so, the goal of the financial manager will be to choose the ratio of debt to equity that makes the value of the pie – that is, the value of the firm, V – as large as it can be.

Two Pie Models of the Firm



Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp.4-5

76. Define the optimal capital structure for a firm

Changing the capital structure of the firm changes the way the firm pays out its cash flows. Firms that borrow pay lower taxes than firms that do not. Because of corporate taxes, the value of a firm that borrows may be higher than the value of one that does not. However, with costly bankruptcy, a firm that borrows may have lower value. The combined effects of taxes and bankruptcy costs can produce an optimal capital structure.

Changes in capital structure benefit the stockholders if and only if the value of the firm increases.

Thus, Managers should choose the capital structure that they believe will have the highest firm value, because this capital structure will be most beneficial to the firm's stockholders.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 29, pp. 390-393

77. What is the opportunity cost of capital?

Recall that the required rate of return is sometimes referred to as the cost of capital, or the opportunity cost of capital. Individuals have to decide where to invest the income they have saved. The goal, obviously, is to gain the highest return possible. To determine which assets are profitable and which are not, investors need a point of reference. This point of reference is known as the required rate of return. A manager of a firm, with the responsibility for making investment decisions, uses a similar point of reference. This point of reference, the firm's required rate of return, is called the cost of capital. The firm must earn a minimum rate of return to cover the cost of generating funds to finance investments; otherwise, no one will be willing to buy its bonds, preferred stock, and common stock. The goal of a financial officer is to achieve the highest efficiency and profitability from asset and, at the same time, keep the cost of the funds that the firm generates from various financing sources as low as possible. In other words, the cost of capital is the rate of return (cost) that a firm must pay investors to induce them to risk their funds and purchase the bonds, preferred stock, and common stock issued by the firm.

Clearly, the cost of capital is one of the major factors used in the determination of the value of the firm. In finance, the cost of capital is the same as the discount rate. High risk means a high cost of capital, while low risk means a low cost of capital. Moreover, a high cost of capital (high discount rate) usually means a low valuation for securities, and a low discount rate means a high value for the securities of a firm. Since the sale of these securities provides firms with funds for investments, the cost of financing increases when the value of securities is low and it decreases when their value is high. The benchmark for determining whether the returns of a firm's securities are high or low is the cost of capital.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 9

78. What is Beta of a security?

The **beta**(*M*,*i*) denotes the responsiveness of security *i* to macroeconomic events; this sensitivity will be different for different securities.

We can calculate responsiveness of the company's stock returns to the returns of the market by the formula of beta coefficient:

$$\beta = \frac{Cov(company\ returns, market\ returns)}{\sigma^2{}_{market}}$$

Or, we can rewrite CAPM formula to obtain beta:

$$\beta_s = \frac{R_s - R_f}{R_m - R_f}$$

If we can plot the relationship on a graph, which shows a possible scatter diagram for stocks excess return against the excess return of the market index, beta will be the slope of solid line (see below):

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 4, pp. 14-16

79. Define MM Propositions I & II with and without Taxes. Show the results graphically

Modigliani and Miller (or simply MM) showed that leverage would not affect the total value of the firm and this result holds more generally under a set of conditions referred to as perfect capital markets:

- No taxes. Investors and firms can trade the same set of securities at competitive market prices equal to the present value of their future cash flows
- No transaction costs. There are no taxes, transaction costs, or issuance costs associated with security trading.
- Individuals and corporations borrow at same rate. A firm's financing decisions do not change the cash flows generated by its investments, nor do they reveal new information about them.

Under these conditions, MM demonstrated the following result regarding the role of capi- tal structure in determining firm value:

MM Proposition I: In a perfect capital market, the total value of a firm is equal to the market value of the total cash flows generated by its assets and is not affected by its choice of capital structure.

MM Proposition II: The cost of capital of levered equity increases with the firm's market value debt – equity ratio.

MM Proposition I (no taxes): $V_L = V_U$ (Value of levered firm equals value of unlevered firm)
MM Proposition II (no taxes): $r_S = r_0 + \frac{B}{S}(r_0 - r_B)$, where r_0 is the cost of unlevered equity

Intuition:

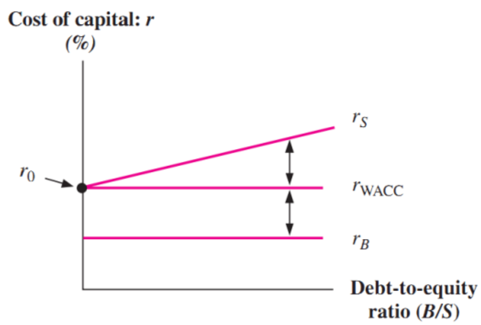
Proposition I: Through **homemade leverage**, individuals can either duplicate or undo the effects of corporate leverage. If investors would like more leverage than the firm has chosen they can borrow and add leverage to their own portfolio.
Proposition II: The cost of equity rises with leverage, because the risk to equity rises with leverage.
After incorporating t_C, corporate tax rate on earnings after interest Modigliani-Miller propositions showed that the total value of the levered firm exceeds the value of the firm without leverage due to the present value of the tax savings from debt:

MM Proposition I (with taxes): $V_L = V_U + T_C B$ (for a firm with perpetual debt)
MM Proposition I (with taxes): $r_S = r_0 + \frac{B}{S}(1 - t_C)(r_0 - r_B)$

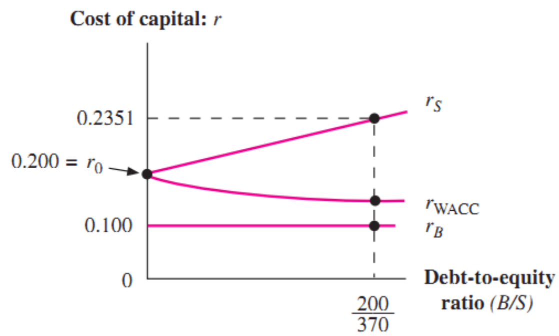
Intuition:

Proposition I: Since corporations can deduct interest payments but not dividend payments, corporate leverage lowers tax payments.
Proposition II: The cost of equity rises with leverage, because the risk to equity rises with leverage.

Graphically the above propositions can be illustrated as follows:



$r_S = r_0 + (r_0 - r_B)B/S$



$$r_s = r_0 + (1 - T_C)(r_0 - r_b)B/S$$
$$= 0.20 + \left(0.65 \times 0.10 \times \frac{200}{370}\right)$$
$$= 0.2351$$

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 15, pp.393-407
Corporate finance, 3rd ed., Jonathan Berk, Peter De Marzo; Pearson 2014; Chapter 14-15, pp. 483-511

80. Explain the limits to the use of debt. What costs are associated with the financial distress?

A frequently asked question is, “Does the MM theory with taxes predict the capital structure of typical firms?” The typical answer is “yes”, but unfortunately, “no.” The theory states that $V_L = V_U + T_C B$. According to this equation, one can always increase firm value by increasing leverage, implying that firms should issue maximum debt. This is inconsistent with the real world, where firms generally employ only moderate amounts of debt.

However, the MM theory tells us where to look when searching for the determinants of capital structure. For example, the theory ignores bankruptcy and its attendant costs. Because these costs are likely to get out of hand for a highly levered firm, the moderate leverage of most firms can now easily be explained. Our discussion leads quite naturally to the idea that a firm’s capital structure can be thought of as a trade-off between the tax benefits of debt and the *costs of financial distress and bankruptcy*. This trade-off of benefits and costs leads to an optimum amount of debt.

In addition, the MM theory ignores personal taxes. In the real world, the personal tax rate on interest is higher than the effective personal tax rate on equity distributions. Thus, the personal tax penalties to bondholders tend to offset the tax benefits to debt at the corporate level. Even when bankruptcy costs are ignored, this idea can be shown to imply that there is an optimal amount of debt for the economy as a whole.

If these obligations are not met, the firm may risk some sort of financial distress. The ultimate distress is bankruptcy, where ownership of the firm's assets is legally transferred from the stockholders to the bondholders. These debt obligations are fundamentally different from stock obligations. While stockholders like and expect dividends, they are not legally entitled to dividends in the way bondholders are legally entitled to interest and principal payments.

The possibility of bankruptcy has a negative effect on the value of the firm. However, it is not the risk of bankruptcy itself that lowers value. Rather it is the costs associated with bankruptcy that lower value.

Direct Costs of Financial Distress

Those are legal and administrative costs of liquidation or reorganization. In the process, lawyers are involved throughout all the stages before and during bankruptcy. With fees often in the hundreds of dollars an hour, these costs can add up quickly. A wag once remarked that bankruptcies are to lawyers what blood is to sharks. In addition, administrative and accounting fees can substantially add to the total bill. And if a trial takes place, we must not forget expert witnesses. Each side may hire a number of these witnesses to testify about the fairness of a proposed settlement. Their fees can easily rival those of lawyers or accountants.

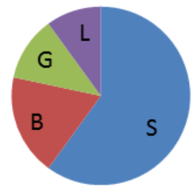
Indirect Costs of Financial Distress

Indirect costs of financial distress, in other words, can be stated as impaired ability to conduct business. Bankruptcy hampers conduct with customers and suppliers. Sales are frequently lost because of both fear of impaired service and loss of trust. For example, many loyal Chrysler customers switched to other manufacturers when Chrysler skirted insolvency in the 1970s. These buyers questioned whether parts and servicing would be available were Chrysler to fail. Sometimes the taint of impending bankruptcy is enough to drive customers away. Though these costs clearly exist, it is quite difficult to measure them.

Taxes and bankruptcy costs can be viewed as just another claim on the cash flows of the firm. Let G and L stand for payments to the government and bankruptcy lawyers, respectively. Then value of a firm, V, is:

$$V = S + B + G + L$$

The more are G and L, the less is left to S and B. Graphically this looks as follows on a pie diagram:



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When a firm has debt, conflicts of interest arise between stockholders and bondholders. Because of this, stockholders are tempted to pursue selfish strategies. These conflicts of interest, which are magnified when financial distress is incurred, impose agency costs on the firm. Three kinds of selfish strategies that stockholders use to hurt the bondholders and help themselves are:

1. Selfish Investment Strategy 1 – Incentive to Take Large Risks: Firms near bankruptcy often take great chances, because they believe that they are playing with someone else's money.
2. Selfish Investment Strategy 2 – Incentive toward Underinvestment: Stockholders of a firm with a significant probability of bankruptcy often find that new investment helps the bondholders at the stockholders' expense.
3. Selfish Investment Strategy 3 – Milking the Property: Another strategy is to pay out extra dividends or other distributions in times of financial distress, leaving less in the firm for the bondholders. This is known as milking the property, a phrase taken from real estate.

It's worth mentioning that strategies 2 and 3 are very similar. In strategy 2, the firm chooses not to raise new equity. Strategy 3 goes one step further, because equity is actually withdrawn through the dividend.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 16, pp.423-430

81. What are the key components of a cash budget?

The cash budget is a primary tool of short-run financial planning. It allows the financial manager to identify short-term financial needs (and opportunities). It will tell the manager the required borrowing for the short term. It is the way of identifying the cash – flow gap on the cash – flow time line. The idea of the cash budget is simple: It records estimates of cash receipts and disbursements.

The financial manager can use the cash budget to identify short-term financial needs. The cash budget tells the manager what borrowing is required or what lending will be possible in the short run. The firm has available to it a number of possible ways of acquiring funds to meet short-term shortfalls, including unsecured and secured loans.

Key components of cash budget are:

1. Cash receipts – arise from sales, but we need to estimate when we actually collect
2. Cash outflow – payments of accounts payable, wages, taxes, and other expenses, capital expenditures, long-term financial planning

Cash receipts can be calculated as:

$$Ending\ Accounts\ Receivable = Starting\ Accounts\ Receivable + Sales - Collections$$

Cash outflow will be the sum of its components:

1. Payments of accounts payable – these are payments for goods or services, such as raw materials. These payments will generally be made after purchases. Purchases will depend on the sales forecast
2. Wages, Taxes, and Other Expenses – this category includes all other normal costs of doing business that require actual expenditures. Depreciation, for example, is often thought of as a normal cost of business, but it requires no cash outflow
3. Capital Expenditures – these are payments of cash for long-lived assets
4. Long-Term Financing – this category includes interest and principal payments on long-term outstanding debt and dividend payments to shareholders

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 27, pp.759-761

82. The book value of a company's assets usually does not equal the market value of those assets. What are some reasons for this difference?

The accounting value of a firm's assets is frequently referred to as the carrying value or the book value of the assets. Under generally accepted accounting principles (GAAP), audited financial statements of firms in the United States carry the assets at cost. Thus the terms carrying value and book value are unfortunate. They specifically say "value," when in fact the accounting numbers are based on cost. This misleads many readers of financial statements to think that the firm's assets are recorded at true market values. Market value is the price at which willing buyers and sellers trade the assets. It would be only a coincidence if accounting value and market value were the same. In fact, management's job is to create a value for the firm that is higher than its cost.

Many people use the balance sheet although the information each may wish to extract is not the same. A banker may look at a balance sheet for evidence of accounting liquidity and working capital. A supplier may also note the size of accounts payable and therefore the general promptness of payments. Many users of financial statements, including managers and investors, want to know the value of the firm, not its cost. This is not found on the balance sheet. In fact, many of the true resources of the firm do not appear on the balance sheet: good management, proprietary assets, favorable economic conditions, and so on.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 2, p. 24

83. Explain the market and book value of a firm

Market value is a concept distinct from market price, which is "the price at which one can transact", while market value is "the true underlying value" according to theoretical standards. The concept is most commonly invoked in inefficient markets or disequilibrium situations where prevailing market prices are not reflective of true underlying market value. For market price to equal market value, the market must be informational efficient and rational expectations must prevail. Market value is also distinct from fair value in that fair value depends on the parties involved, while market value does not. Fair value is frequently used when undertaking due diligence in corporate transactions, where particular synergies between the two parties may mean that the price that is fair between them is higher than the price that might be obtainable in the wider market.

$$\textit{Market Value} = \textit{price of the stock} \times \textit{number of shares outstanding}$$

Book Value or carrying value is the sum of par value, capital surplus, and accumulated retained earnings are the common equity of the firm, usually referred to as the book value of the firm.

$$The\ book\ value\ per\ share = \frac{Total\ common\ shareholders'\ equity}{Shares\ outstanding}$$

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 14, pp. 373-374

84. Why P/E ratio is important? What does it measure?

The P/E ratio is defined as:

$$P/E\ ratio = \frac{Market\ price\ per\ share}{Earnings\ per\ share}$$

For example, if stock A is trading at $24 and the earnings per share for the most recent 12 month period is $3, and then stock *A* has a P/E ratio of 24/3 or 8. Put another way, the purchaser of the stock is paying $8 for every dollar of earnings. Companies with losses (negative earnings) or no profit have an undefined P/E ratio sometimes; however, a negative P/E ratio may be shown.

By comparing price and earnings per share for a company, one can analyze the market's stock valuation of a company and its shares relative to the income the company is actually generating. Stocks with higher (and/or more certain) forecast earnings growth will usually have a higher P/E, and those expected to have lower (and/or riskier) earnings growth will usually have a lower P/E. Investors can use the P/E ratio to compare the value of stocks: if one stock has a P/E twice that of another stock, all things being equal (especially the earnings growth rate), it is a less attractive investment. Companies are rarely equal, however, and comparisons between industries, companies, and time periods may be misleading. P/E ratio in general is useful for comparing valuation of peer companies in similar sector or group.

Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, chapter 18, p.18

85. Explain the costs associated with holding too much cash.

Once a firm has more cash than it needs for operations and planned expenditures, the excess cash has an opportunity cost. It could be invested (by shareholders) in potentially more profitable ways.

Large amount of cash is the concern for shareholders because excess cash on hand can lead to poorly thought-out investments. The thought is that keeping cash levels relatively low forces management to pay careful attention to cash flow and capital spending.

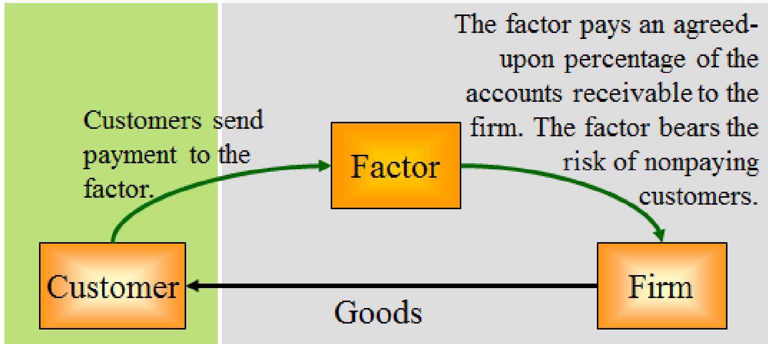
If a firm has too much cash it can simply pay a dividend, or, more likely based on the financial environment, buy back stock. It can also reduce debt. If the firm has insufficient cash, then it must borrow, sell stock, or improve profitability.

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 27

86. What is factoring in credit management?

Factoring refers to the sale of a firm's accounts receivable to a financial institution known as a *factor*. The firm and the factor agree on the basic credit terms for each customer. The customer sends payment directly to the factor, and the factor bears the risk of nonpaying customers. The factor buys the receivables at a discount, which usually ranges from 0.35 to 4 percent of the value of the invoice amount. The average discount throughout the economy is probably about 1 percent.

Graphically, this could be illustrated as follows:



Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 29, p. 810

BASICS OF DERIVATIVES

87. What are Derivative Instruments? Why are they called "Derivatives"?

Options, futures and swaps are examples of derivatives. A derivative is financial instrument (or more precisely, an agreement between two people) that has value determined by the price of something else. For example, a bushel of corn is not a derivative; it is a commodity with a value determined by the price of corn. However, you could enter into an agreement with a friend that says: if the price of a bushel of corn is less than $3, the friend will pay you $1. This is a derivative in the sense that you have an agreement with a value derived by the price of something else (corn, in this case), that's why it is called derivative – its value is derived from the price of something else.

You might think: "that's not a derivative; that's just a bet on the price of corn." So it is: derivatives can be thought of as bets on the price of something. But don't automatically think the term "bet" is pejorative. Suppose your family grows corn and you friend's family buys corn to mill into cornmeal. The bet provides insurance: you earn $1 if your family's corn sells for a low price; this supplements your income. Your family's friend earns $1 if the corn his family buys is expensive; this offsets the high cost of corn. Viewed in this light, the bet hedges you both against unfavorable outcomes. The contract has reduced risk for both of you.

Investors could also use this kind of contract simply to speculate on the price of corn. In this case the contract is not insurance. And that is a key point: *it is not the contract itself, but how it is used, and who uses it, that determines whether or not it is risk-reducing.* **Context is everything.**

Derivatives Markets, 2nd ed., Robert L. McDonald; Pearson, 2006; Chapter 1, pp. 1-2

88. Explain the concept of Forward Contract

Suppose you wish to buy a share of stock. Doing so entails at least three separate steps: (1) setting the price to be paid, (2) transferring cash from the buyer to the seller, and (3) transferring the share from the seller to the buyer. With an outright purchase of stock, all three occur simultaneously. However, as a logical matter, a price could be set today and the transfer of shares and cash would occur at a specified date in the future.

This is in fact a definition of a forward contract: it sets today the terms at which you buy or sell an asset or commodity at a specific time in the future. A forward contract does the following:

- Specifies the quantity and exact type of the asset or commodity the seller must deliver
- Specifies delivery logistics, such as time, date, and place

- Specifies the price the buyer will pay at the time of delivery
- Obligates the seller to sell and the buyer to buy, subject to the above specifications

The time at which the contract settles is called the *expiration date*. The asset or commodity on which the forward contract is based is called the *underlying asset*. Apart from commissions and bid-ask spreads, a forward contract requires no initial payment or premium. The contractual forward price simply represents the price at which consenting adults agree today to transact in the future at which time the buyer pays the seller the forward price and the seller delivers the asset.

Derivatives Markets, 2nd ed., Robert L. McDonald; Pearson, 2006; Chapter 2, p. 21

89. What are Future Contracts? What is the difference between Forwards and Futures Contracts?

Futures contracts are similar to forward contract in that they create an obligation to buy or sell at a predetermined price at a future date. Futures contracts are essentially exchange-traded forward contracts. Because futures are exchange-traded, they are standardized and have specified delivery dates, locations, and procedures. Each exchange has an associated *clearinghouse*. The role of the clearinghouse is to match the buys and sells that take place during the day, and to keep track of the obligations and payments required of the members of the clearinghouse, who are *clearing members*. After matching trades, the clearinghouse typically becomes the counterparty for each clearing member.

Although forwards and futures are similar in many respects, there are differences:

- Whereas forward contracts are settled at expiration, futures contracts are settled daily. The determination of who owes what to whom is called marking-to-market
- As a result of daily settlement, futures are liquid – it is possible to offset an obligation on a given date by entering into the opposite position
- Over-the-counter forward contract can be customized to suit the buyer or seller, whereas futures contracts are standardized
- Because of daily settlement, the nature of credit risk is different with the futures contract, in fact, futures contract are structures so as to minimize the effects of credit risk
- There are typically daily price limits in the futures markets (and on some stock exchanges as well). A *price limit* is a move in the futures price that triggers a temporarily halt in trading

Derivatives Markets, 2nd ed., Robert L. McDonald; Pearson, 2006; Chapter 5, p. 142

90. Explain the concept of Call / Put Option. List their characteristics and draw graph for long and short positions. What is the difference between American and European Options?

Whereas a forward contract obligates the buyer (the holder of the long position) to pay the forward price at expiration, even if the value of the underlying asset at expiration is less than the forward price, a **call option** is a contract where the buyer has the right to buy, but not the obligation to buy. Here are some key terms used to describe options:

Strike price: the **strike price**, or **exercise price**, of a call option is what the buyer pays for the asset

Exercise: the **exercise** of a call option is the act of paying the strike price to receive the asset

Expiration: the **expiration** of the option is the date by which the option must either be exercise or it becomes worthless

Exercise style: the **exercise style** of the option governs the time at which exercise can occur. If exercise can occur only at expiration, option is said to be **European-style option**. If the buyer has the right to exercise at any time during the life of the option, it is an **American-style option**. If the buyer can only exercise during specified periods, but not for the entire life of the option, the option is a **Bermudan-style option.**

To summarize, a European call option gives the owner of the call the right, but not the obligation, to buy the underlying asset on the expiration date by paying the strike price. The buyer is not obligated to buy the underlying, and hence will only exercise the option if the payoff is greater than zero. The algebraic expression for the *payoff* to a purchased (long) call is therefore:

$$Long\ call\ payoff = max[0, S_T - K]$$

Where S_T is spot price of the underlying asset at expiration and K is the exercise price. The expression max $[a, b]$ means take the greater of the two values a and b. In computing profit at expiration, suppose we defer the premium payment (the price of an option); then by the time of expiration we accrue interest on the premium. So, the option *profit* is computed as:

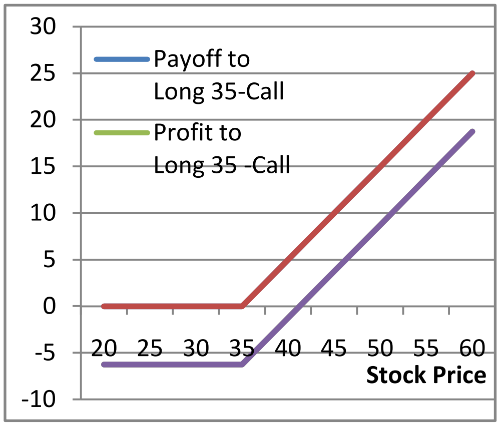
$$Long\ call\ profit = max[0, S_T - K] - future\ value\ of\ option\ premium$$

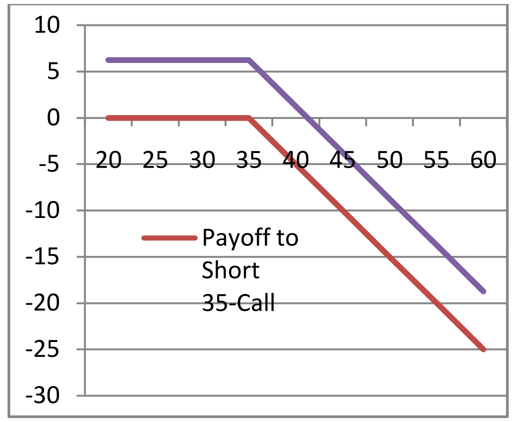
The seller is said to be the **option writer**, or to have a short position in a call option. The payoff and profit to a written call are just the opposite of those for a purchased call:

$$Short\ call\ payoff = -max[0, S_T - K]$$

$$Short\ call\ profit = -max[0, S_T - K] + future\ value\ of\ option\ premium$$

Graphically, the payoff and profit calculations for long and short call option are:





Perhaps you wondered if there could also be a contract in which the *seller* could walk away if it is not in his or her interest to sell. The answer is yes. A **put option** is a contract where the seller has the right to sell, but not the obligation. The put option gives the put buyer the right to sell the underlying asset for the strike price. Thus, the *payoff* on the put option is:

$$Long\ put\ payoff\ = max[0, K - S_T]$$

At the time the option is acquired, the put buyer pays the option premium to the put seller; we need to account for this in computing profit. If we borrow the premium amount, we must pay interest. The option *profit* is computed as:

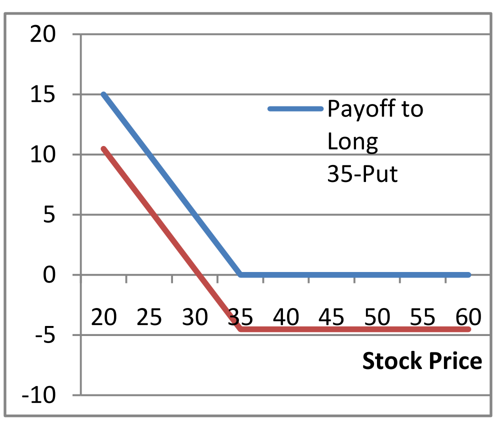
$$\text{Long put profit} = \max[0, \text{K} - \ \text{S}_\text{T}] - \text{future value of option premium}$$

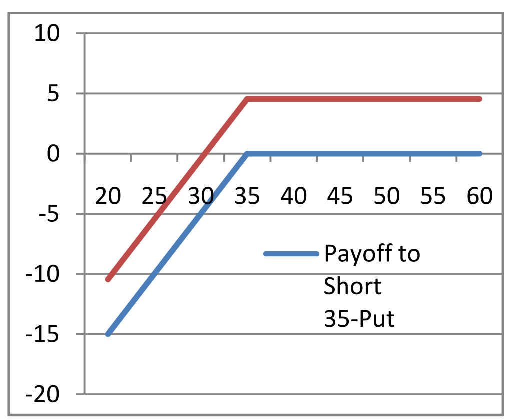
The payoff and profit for a written put are the opposite:

$$Short\ put\ payoff\ = -max[0, K - S_T]$$

$$Short\ put\ profit = -max[0, K - \ S_T] + future\ value\ of\ option\ premium$$

Graphically, the payoff and profit calculations for long and short put option are:





Derivatives Markets, 2nd ed., Robert L. McDonald; Pearson, 2006; Chapter 2, pp. 31-43

FINANCIAL ACCOUNTING

THE FINANCIAL STATEMENTS

1. Who are the main users of accounting?

Accounting provides much of the information that managers and investors use to make decisions. Managers require information to determine how they will *operate* the business, what kinds of investments to make, and how to finance those operations. Accounting information can provide information to help investors make wise decisions about which investments to make. Accounting is an information system that measures business activities, processes that information into reports, and communicates the results to decision makers. **Financial statements** report this information to users.

Accounting information is used by

1. **Individuals** to make investment decisions or manage a checking account.
2. **Business managers** to set goals, evaluate those goals, and take corrective action.
3. **Investors** to decide whether to invest in a business or evaluate an investment.
4. **Creditors** to evaluate a borrower's ability to make required payments.
5. **Government regulatory agencies** to determine if government regulations have been followed.
6. **Taxing authorities,** such as the IRS, to determine the amount of tax due.
7. **Nonprofit organizations** which use accounting information in virtually the same way as for-profit organizations.
8. **Various other users,** such as employees and labor unions.

Accounting information can be classified in two general categories:

1. **Financial accounting** which provides information to **external users** who are not a part of the day-to-day operations and
2. **Managerial accounting** which provides information for **internal use** by management. Types of business organizations

Company types can be divided into following 3 types:

1. **Proprietorship –** a business with a single owner. The owner has unlimited liability which means that the owner assumes personal responsibility for the debts of the business.
2. **Partnership –** a business with two or more owners. Each partner has unlimited liability.
3. **Corporation –** a business owned by shareholders whose ownership is evidenced by the number or shares of stock held. A corporation is run by the **board of directors** who are elected by the shareholders. A shareholder has limited liability. A corporation has many of the rights that a person is entitled to:
   a. The right to enter into contracts.
   b. The right to sue and be sued.
   c. The right to own, buy, and sell property.

Generally Accepted Accounting Principles (or GAAP) are guidelines that govern how accountants measure, process, and communicate financial information.

1. The **primary objective** of financial reporting is to provide information useful for making investment and lending decisions. Useful information is relevant, reliable, and comparable.
2. The Financial Accounting Standards Board (private sector), the Securities and Exchange Commission (public sector), and the American Institute of Certified Public Accountants (private sector) are all involved in determining how accounting is practiced.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 34

2. What is the basic financial accounting equation?

The financial statements, the basic tool of accounting, are based on the **accounting equation.** The accounting equation shows the equality between the assets and the claims to those assets. The accounting equation is:

Economic Resources		***Claims to Economic Resources***
Assets	**=**	**Liabilities + Owners' Equity**

1. **Assets** are economic resources owned by a business that are expected to be of benefit in the future.
2. **Liabilities** are debts payable to outsiders, called **creditors.**
3. **Owners' equity** is the owners' claim to the assets and can be measured by subtracting the liabilities from the assets.

Assets – Liabilities = Owners' Equity

The owners' equity of a corporation—called **stockholders' equity**—is divided into two main categories:

1. **Paid-in** or **contributed capital**, which represents the amount invested in the corporation by its owners, and
2. **Retained earnings**, which represents the amount of profit that has been reinvested in the business. Profit, or **net income**, is determined by deducting **expenses** from **revenues**. **Revenues** are amounts earned by delivering goods or services. Revenues increase net income and therefore also increase retained earnings. **Expenses** are the costs of operating a business. Expenses decrease net income and therefore also decrease retained earnings. If expenses exceed revenues, the result is a **net loss**. **Dividends** are distributions of assets (usually cash) to the stockholders. The amount of dividends declared is determined after net income is computed. Dividends decrease retained earnings because they represent the amount of the net income that is not reinvested in the business.

The financial statements provide answers to **four basic questions**. These questions and answers are summarized:

1. How well did the company perform or operate during the period? (The answer is found on the income statement.)
2. Why did the company's retained earnings change during the period? (The answer is found on the statement of retained earnings.)
3. What is the company's financial position at the end of the period? (The answer is found on the balance sheet.)
4. How much cash did the company generate and spend during the period? (The answer is found on the statement of cash flows.)

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 40

3. What are the 4 financial Statements?

The **Income Statement (Statement of Operations)** reports the revenues, expenses, and net income or net loss of a company for the period. Companies have chosen a fiscal year ending at the same time as the calendar year. A company typically chooses a time of year where business is slightly slower because of all of the administrative issues associated with the year-end reporting process. Many retailers will choose a fiscal year end one month after Christmas because there is little business activity at this time. A Company reports operating results for two fiscal years to enable users to detect any trends.

The **Statement of Retained Earnings** reports the portion of net income that the company has retained, or kept for use in the business. The *Net earnings (or income)* reported on the income statement is added to the beginning balance of retained earnings. After a company earns net income, the board of directors must decide whether to retain the income for use in the business or to pay dividends. A Company paid dividends in 2003 and 2002. The amount of dividends is deducted from beginning retained earnings.

The Balance Sheet reports a company's financial position at a moment in time. The balance sheet is dated as of the last day of the period. The amount of assets reported is the amount of assets A Company owned as of the last day of the accounting period. The other financial statements cover a period of time. The balance sheet reports three main categories: Assets, Liabilities, and Stockholders' Equity.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 43

4. What is balance Sheet?

Assets are divided into two categories: current assets and long-term assets. **Current assets** are those assets that the company expects to convert to cash, sell, or consume during the next 12 months or within the business's normal operating cycle if longer than a year. Examples of current assets are: *Cash, Receivables*–the amount that a company expects to collect from its customers who bought merchandise on credit. *Inventory*–the merchandise A Company sells to its customers. *Prepaid expenses*–the amount of advertising, rent, insurance, and/or supplies that *A* Company has already paid for but has not yet used. **Long-term assets** consists mainly of property, plant, and equipment. These assets are partially used, or depreciated. A Company also reports *Intangible and Other Assets. Intangible Assets* are assets with no physical form such as patents and trademarks. *Other Assets* is a category for assets not reported elsewhere on the balance sheet.

Liabilities are also divided into current and long-term categories. **Current liabilities** are debts that are payable within one year or within the entity's normal operating cycle if longer than a year. Some examples are notes payable, accounts payable, accrued expenses payable, and income taxes payable. *Notes payable*–amounts A Company has borrowed and has promised to pay back within the year. *Accounts payable* represents amounts owed for goods and services that have been purchased but not yet paid for. The word *payable* indicates a liability. *Short-term expenses payable* represents amounts owed to employees, to the government, and interest. *Income taxes payable* is the amount owed to the government for income taxes.

Owners' Equity, or *stockholders' equity,* for A Company consists of common stock and retained earnings. Common stock refers to the amount that owners have paid into the company. The owners have a claim equal to the amount they paid in plus the earnings that have been retained in the company. The retained earnings amount comes from the statement of retained earnings. The *other equity* referred to in this section with parentheses (indicating it should be subtracted) can be ignored.

The **Statement of Cash Flows** reports the sources and uses of cash from the three major activities of a business--operating, investing, and financing. **Operating Activities** relate to the profits of a business, the excess of its revenue over its expenses. Sales of goods bring in cash receipts. A Company also pays cash for its expenses such as salaries and utilities. **Investing**

Activities relate to the purchase and sale of long-term assets that a company uses to conduct is operations. A Company pays cash to purchase assets and receives cash when assets are sold. **Financing Activities** relate to the way a company acquires the funds used for investing and operating activities. A business can finance its activities by borrowing from a bank or other lender, issuing stock to its owners, and paying dividends. A net cash flow is reported for each activity. The ending cash balance is reported. This amount should also be reported on balance sheet.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 46

PROCESSING ACCOUNTING INFORMATION

5. What is the double entry? And what are examples of transactions?

A business **transaction** is an event that affects the financial position of a business *and* may be reliably recorded.

Business transactions are analyzed according to their effect on the **accounting equation**. The accounting equation must balance after each transaction is recorded.

Single-entry records one side of the transaction.
Double-entry records both the giving and receiving side of each transaction.

1. **Owners' investment of cash** increases both assets and stockholders' equity.
2. **Purchase of an asset for cash** increases assets and decreases assets (no effect on *total* assets).
3. **Purchase of an asset on credit***(on account)* increases both assets and liabilities.
4. **Receipt of cash for service revenue** increases both assets and stockholders' equity.
5. **Performance of services *on account*** increases both assets and stockholders' equity.
6. **Cash payment of expenses** decreases both assets and stockholders' equity.
7. **Payment *on account*** decreases both assets and liabilities.
8. Personal transactions of the owner do not affect the business, per the entity concept.
9. **Collection of cash *on account*** increases assets and decreases assets.
10. **Sale of an asset** at a price equal to its cost increases assets and decreases assets.
11. **Declaration and payment of cash dividends** decreases both assets and stockholders' equity.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 79

6. What is trial balance?

Accounting is a **double-entry system** that reports the dual effects, giving and receiving, of all business transactions. Each transaction affects at least two accounts. The **T-account** is an abbreviated form of an account, used to help illustrate the effect of transactions.

Account Name

Debit	**Credit**
entries	entries
(left side)	(right side)

The type of account determines the side on which increases and decreases are recorded; the **rules of debit and credit** keep the accounting equation in balance.

1. **Increases in assets** are recorded on the **left (debit)** side of the account. **Decreases in assets** are recorded on the **right (credit)** side.
2. Rules for liabilities and stockholders' equity accounts are the opposite of the rules for assets. **Increases in liabilities and stockholders' equity** accounts are recorded on the **right (credit)** side of an account, and **decreases** are recorded on the **left (debit)** side.

Double-entry bookkeeping and the rules of debit and credit are based on the **accounting equation, A = L + SHE**. After each transaction is recorded, the equation must remain in balance.

Analysis of each transaction involves these steps:

1. Identify the transaction from the source document, such as a sales invoice or check stub. Specify each account affected Classify each account by type such as asset or expense
2. For the accounts involved. Determine which accounts increase and which decrease. (Some transactions may require only increases or only decreases.) Apply the rules of debit and credit
3. Enter the transaction in the journal, listing first the debit and then the credit. Verify that total debits equal total credits.

The **trial balance** is a listing, in general ledger order (assets, liabilities, then stockholders' equity), of the debit or credit balance in each account.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 103

ACCRUAL ACCOUNTING AND THE FINANCIAL STATEMENTS

7. What is accrual based accounting?

In **accrual-basis** accounting, an accountant recognizes the impact of a business transaction as it occurs. Both cash transactions (collections from customers and paying salaries) and noncash transactions (purchase of supplies on account or providing a service on account) are recorded under the accrual basis. Accrual accounting is more complex and more complete than cash basis accounting. All but the smallest businesses use the accrual basis of accounting. In **cash-basis** accounting, the accountant does not record a transaction until cash is received or paid.

Accrual accounting is based on a conceptual framework that includes these three concepts/principles:

The **time-period concept** ensures that accounting information is reported at regular intervals. Because these intervals are often different from the intervals for transactions, accounts must be updated (or adjusted) to make sure that all revenues and expenses for the accounting period have been recorded.

The basic accounting period is one year. Around 60% of companies use the calendar year from January 1 to December 31.

The **revenue principle** governs (1) *when* to record revenue and (2) the *amount* of the revenue that should be recorded. In most cases, revenue should be recorded when the business has delivered a completed good or service to the customer. The amount of revenue recorded should be equal to the cash value of the goods or services transferred to the customer.

The **matching principle** tells accountants *how* to measure expenses and *when* expenses should be recorded. When possible, expenses should be matched with the revenue that created the expense (for example, Cost of Goods Sold should be matched with Sales). If there is no cause-and-effect relationship, the expenses should be associated with a time period, such as a year.

Why are **adjusting entries** needed? Adjusting entries are needed to bring the books up to date for transactions that have taken place but that may not be associated with a single, economic event. They are recorded on the last day of the period. There are three categories of adjusting entries:

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 137

8. What are the examples adjusting entries?

A **deferral** is an adjustment of an asset or a liability for which the business paid or received cash in advance.

Depreciation records the obsolescence and/or wear-and-tear on a long-term asset. The adjustment is similar to a deferral.

An **accrual,** the opposite of a deferral, is an adjustment of an asset or a liability for which the business records an expense or revenue before paying or receiving cash.

Prepaid expenses require adjustment because the cash is paid in one period, but the resource is not completely used until a later period. Examples include prepaid rent, prepaid insurance, and supplies. Exhibit 3-7 diagrams the timing of prepaid-type and accrual-type adjusting entries.

Depreciation is the allocation of the cost of a plant asset to expense over its life. 1. When a plant asset is acquired, an asset is recorded. This asset will eventually wear out, or depreciate. Therefore, the asset is expensed as it is used. 2. As the asset depreciates, the asset value declines. Instead of reducing the asset account, another account, **Accumulated Depreciation**, is used. Accumulated Depreciation is a **contra asset** account; that is, an asset account with a credit balance. The **book value**, or carrying value, of the asset is determined by deducting the accumulated depreciation from the original cost.

Accrued expenses are expenses that are incurred by the end of the period but will not be paid until the next period. The adjusting entry records the expense and a liability. The text illustrates accrued salary expense.

Accrued revenues are revenues that have been earned (because the good or service has been delivered) but not yet received. The adjusting entry records increases to both a revenue and a receivable. The text illustrates accrued service revenue.

Unearned revenues arise when a business receives cash in one period but does not earn all of it until a later period.

1. An unearned revenue is a **liability** because the business owes the customer a good or service.
2. The adjusting entry records the part of the unearned revenue that has been earned.

The **adjusted trial balance** is prepared after the adjusting entries have been journalized and posted. The financial statements are prepared using the account balances found on the adjusted trial balance. The **income statement** must be prepared first. The **statement of retained earnings** is prepared next, using the net income calculated from the income statement. The **balance sheet** is prepared last and uses the ending balance of retained earnings from the statement of retained earnings. **Closing the books or accounts** refers to the end-of-period process of preparing the accounts for the next accounting period. There are three closing entries:

1. Each revenue account is debited and Retained Earnings is credited.
2. Each expense account is credited and Retained Earnings is debited.
3. Dividends is credited and Retained Earnings is debited.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 142

9. What are temporary accounts and permanent accounts?

Closing entries set the balances of **temporary accounts** to zero.

a. Temporary accounts are revenue, expense, and the dividend accounts.
b. These account balances need to have a zero balance to begin the next accounting period. The balances of the temporary accounts are transferred into retained earnings.

Permanent accounts are the accounts that will not be closed—assets, liabilities, and stockholders' equity accounts.

The **current ratio** measures a company's ability to pay current liabilities with current assets.

1. The formula is: $$\textbf{Current ratio} = \frac{\textbf{Total current assets}}{\textbf{Total current liabilities}}$$
2. A company prefers to have a high current ratio which indicates that it should have little difficulty paying current debts as they come due.
3. A current ratio that is too high may mean that a company has too many current assets that are low-earning assets.

The **debt ratio** indicates the proportion of a company's assets that is financed with debt.

1. The formula is: $$\textbf{Debt ratio} = \frac{\textbf{Total liabilities}}{\textbf{Total assets}}$$

A low debt ratio indicates that the company has a relatively small amount of debt which results in small interest and principal payments.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 169

SHORT-TERM INVESTMENTS AND RECEIVABLES

10. What does short term investment mean?

Key terms for short term investments are:

1. **Creditor –** The party to whom money is owed. Records a *receivable.*
2. **Debt instrument –** The terms of borrowing the money are contained in the *debt instrument.*
3. **Debtor –** The party who owes the money to the creditor. Records a *payable.*
4. **Equity securities –** Shares of stock in a corporation.
5. **Maturity –** The date on which a debt instrument matures or must be paid by debtor.

6. **Term –** The length of time until a debt instrument matures.

Short-term investments (marketable securities) are investments that the company plans to hold for one year or less.

The purpose of a **trading investment** is to sell it for more than its cost. Trading investments are reported after cash and before receivables are they as the next-most-liquid asset after cash.

Trading investments can be either debt or stock of another company purchased as a long-term investment.

The **market-value method** is used to account for all trading securities. Trading securities are reported on the balance sheet at their market value. Accounting for trading securities is as follows:

	Short-Term Investment		**Unrealized Gain on Investment**	
a. Purchase of investment	XX			
b. Year-end adjustment to market value (gain)	XX			XX

When a company receives dividends as a stockholder in another company, Dividend (or other) Revenue is reported on the income statement. When a company sells a trading investment, the gain or loss on the sale is the difference between the sale proceeds and the last carrying amount of the investment.

A realized gain or loss usually occurs when the investor sells an investment.

1. A realized gain = sale price *greater than* the investment carrying amount.
2. A realized loss = sale price *less than* the investment carrying amount.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 257

11. What is allowance? And what are the methods to calculate the allowance?

Accountants measure uncollectible-account expense by use of the **allowance method** or the **direct write-off method**. With the **allowance method,** an estimate of the total bad-debt expense for the period is made based on past collection experience. The estimate of the uncollectible accounts is recorded in the account, **Allowance for Uncollectible Accounts.** The balance of this account represents the amount the business does *not* expect to collect. The Allowance for Uncollectible Accounts is a **contra-asset** account and is deducted from Accounts Receivable on the balance sheet as follows:

Accounts receivable:	XX
Less: Allowance for uncollectible accounts	XX
Accounts receivable, net	**XX**

Two methods of estimating uncollectible accounts are the **percent-of-sales method** and the **aging-of-accounts receivable method.** In the **percent-of-sales** (the income statement approach), uncollectible-account expense is determined by multiplying the net sales by a percentage that is based on past collection experience. This entry reduces assets and net income.

a. The journal entry to record the uncollectible-account expense is:

Uncollectible-Account Expense	XX	
Allowance for Uncollectible Accounts		XX

The **aging-of-accounts receivable method** (the balance sheet approach) illustrated in Exhibit 5-2 uses an analysis of the age of the receivables to help estimate Uncollectible-Account Expense.

The accounts receivable are classified by their age. A percentage is applied to the total in each category. This percentage is determined from past collection experience. This amount is the desired balance in Allowance for Uncollectible Accounts. The Uncollectible-Account Expense is the difference between the balance before adjustment and the desired ending balance.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 264

12. What the difference is between write off and direct write off?

When the credit department determines that a specific account cannot be collected, the account is **written off**, meaning that the account's balance will be reduced to zero.

The entry to write off the account is:

Allowance for Uncollectible Accounts	XX
Accounts Receivable	XX

The write-off of an account does not affect net income or net accounts receivable. Under the **direct write-off** method, the uncollectible account is expensed when it is written off.

1. Accounts receivable are reported at their full amount and not the expected realizable value.
2. The expense is not matched against the revenue in the same period.
3. The entry to record the uncollectible-account expense is:

Uncollectible-Account Expense	XX
Accounts Receivable	XX

The direct write-off method is only acceptable when the amount of bad debts is immaterial. It is usually unacceptable because it violates the matching principle and accounts receivable reported on the balance sheet would be overstated because there is no allowance account to reduce the balance to what is expected to be collected.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 267

13. What is notes receivable?

Notes receivable are more formal than accounts receivable. The **principal** is the amount borrowed by the debtor. The **interest** is the borrower's cost of using the creditor's money. It is always stated on an annual basis unless specified. The text uses a 360-day year. Interest is revenue to the lender and an expense to the borrower. Accounting for notes receivable is illustrated below.

1. A note receivable can be received for cash, for a sale, or in settlement of an account receivable. The entry is:

Note Receivable	XX	
Cash, Sales Revenue, or Accounts Receivable		XX

2. The entry to accrue interest revenue at the end of the accounting period is:

Interest Receivable	XX	
Interest Revenue		XX

3. The entry to record collection of the note and interest on the maturity date is:

Cash	XX	
Note Receivable		XX ←Principal amount
Interest Receivable		XX ←Amount accrued at year end
Interest Revenue		XX ←Amount earned this period

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 274

MERCHANDISE INVENTORY AND COST OF GOODS SOLD

14. What is cost of goods sold?

The transition from service entities to **merchandisers** can be summarized as follows: "Service revenue" is replaced by "**Sales revenue**" on the merchandising company's income statement. Rather than just list "Expenses," the merchandising income statement lists "**Cost of goods sold**" and "**Operating expenses.**" The merchandising company's balance sheet includes a new current asset, "**Inventory**" or "**Merchandise inventory**."

Number of units in inventory is determined from the accounting records and backed up by a physical count of goods at year end. **Inventory cost** includes "all costs incurred to bring the asset to its intended use."

Gross profit or gross margin is the excess of the sales revenue over the cost of goods sold. Two inventory accounting systems are used to maintain inventory records—the **perpetual** inventory system and the **periodic** inventory system.

The **periodic inventory system,** often used by a business that sells a large number of goods at a low unit price, **does not keep a continuous record of the inventory on hand.** A **physical count** of the quantity of inventory is made at the end of the period. The unit cost is applied to this quantity and the result is the inventory figure that appears on the balance sheet.

The **perpetual inventory system,** often used by a business that sells relatively fewer numbers of goods at a higher price per unit, maintains a **continuous record for each inventory item.**

1. Both purchases and sales of inventory items are recorded directly to the **Inventory** account.
2. The quantity and cost of the inventory on hand can be determined from inventory records, although an actual physical count must still be made at least once a year.
3. **Cost of Goods Sold** is an actual account in the ledger. It is reported as an expense on the income statement. Perpetual records provide information for the following decisions: Perpetual records give up-to-the-minute data about inventory, enabling managers to make decisions about when and how much to buy. Financial statements can be prepared using information from the perpetual inventory records.
4. Two entries are required to record the **sale of inventory** in a perpetual system:

Accounts Receivable (or Cash)	XX	
Sales Revenue		XX
Cost of Goods Sold	XX	
Inventory		XX

Purchase discounts and **purchase returns and allowances** both affect the amount of inventory purchases.

1. **Purchase discounts** decrease the cost of purchases; these result from making prompt payment on purchased goods and receiving a cash discount from the vendor for the prompt payment.
2. **Purchase returns and allowances** both also decrease the cost of purchases. **Purchase returns** result from the buyer returning goods to the seller. **Purchase allowances** result from the seller granting the buyer a subtraction (allowance) from the amount owed. The buyer does not return the goods to the seller.
3. The net purchases of the business may be calculated as follows:

Net purchases = Purchases
+ Freight-in
– Purchase returns and allowances
– Purchase discounts
= Net purchases

The specific-unit-cost (or specific identification) method assigns to a specific item its exact, specific price. This method is applicable to high-value, low-quantity items such as real estate, cars, appliances, or jewels.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 305

15. What are the methods to calculate cost of goods sold?

The average cost method assigns an average cost to both the units on hand and the units sold during the period. The weighted-average cost per unit is computed by dividing the cost of goods available for sale by the number of units available for sale. Ending inventory and cost of goods sold are computed by multiplying the number of units by the weighted-average cost per unit.

FIFO (first-in, first-out) cost assumes that the first goods purchased are the first goods sold and, therefore, the most recent (the latest) prices should be assigned to the units on hand; this leaves the earliest prices to be assigned to cost of goods sold.

LIFO (last-in, first-out) cost assumes that the latest goods purchased are the first sold and, therefore, the earliest prices should be assigned to the units on hand; this leaves the latest prices to be assigned to cost of goods sold.

Use of the different inventory methods affects the amount of net income reported and the income taxes paid. **LIFO** results in the **lowest net income, lowest taxable income** and, therefore, the **lowest income taxes paid** when prices are rising.

1. When inventory costs are rising, LIFO ending inventory is the lowest.
2. Some companies prefer FIFO because **FIFO results in higher income** during a period of rising prices.

A comparison of the three inventory costing methods produces the following conclusions

1. LIFO matches the most current costs with current revenues (cost of goods sold, which is reported on the income statement, has the current costs).
2. FIFO reports the most current ending inventory costs on the balance sheet.
3. LIFO results in lowest income taxes (in periods of rising prices).
4. Use of FIFO overstates income because of **FIFO inventory profit** created by the increase in replacement cost of the inventory (in periods of rising prices).
5. LIFO allows **manipulation** of net income.
6. When inventory levels fall, **LIFO liquidation** occurs; LIFO liquidation results in increased income and, therefore, increased income taxes.
7. Some foreign countries do not allow the use of LIFO.

The **inventory turnover** indicates how rapidly inventory is sold. A business desires to sell its inventory as quickly as possible. The formula for calculating inventory turnover is:

$$\textbf{Inventory turnover} = \frac{\textbf{Cost of goods sold}}{\textbf{Average inventory}}$$

The cost-of-goods-sold model brings together all the inventory data for the entire accounting period. The model is:

Beginning inventory
+ Purchases
= Cost of goods available for sale
– Ending inventory
= Cost of goods sold

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 313

PLANT ASSETS, NATURAL RESOURCES, AND INTANGIBLES

16. What are the different methods to calculate depreciation? What is depreciation expense and accumulated depreciation?

Plant assets (or **fixed assets**) are those long-lived assets that are tangible in nature and are used in the operation of the business.

1. The usefulness of **tangible assets** is derived from their physical form.
2. The **cost principle** directs a business to carry an asset on the balance sheet at its original cost.

Expenditures relating to long-lived assets can be classified as either **capital** or **revenue expenditures.**

A **capital expenditure** is an expenditure made to increase the capacity or efficiency of an asset or to extend its useful life. An **extraordinary repair** is a capital expenditure that extends the life of an asset. These extraordinary repairs and other capital expenditures are recorded with a **debit** to the **asset** account.

A **revenue expenditure** is one made to keep the asset in its existing condition or restore it to good working order. Revenue expenditures are recorded with a debit to an **expense** account.

A Depreciation is the process of allocating a plant asset's cost to expense over the asset's useful life.

1. Depreciation is based on the **matching principle**, because the depreciation expense is recorded in the period(s) that an asset is used.
2. Depreciation is based on the historical cost of an asset, and therefore is not a process of valuation.
3. Depreciation does not represent a fund of cash set aside to replace worn or obsolete assets. **Accumulated depreciation,** a contra-asset account, is the portion of the asset's cost that has already been depreciated (or expensed).

Causes of depreciation include physical deterioration and obsolescence. To calculate depreciation, cost, the estimated useful life, and the estimated residual value must be known.

1. The **useful life** is an estimate of the years the asset will be useful to the business, not an estimate of its physical life.
2. The **residual value** (also called scrap or salvage value) is the estimated cash value at the end of the asset's useful life. This amount will not be depreciated.

Four basic methods are used for computing depreciation--straight-line (SL), units-of-production (UOP), double-declining-balance (DDB), and the sum-of-years'-digits method.

The text does not illustrate the sum-of-years'-digits method since it is infrequently used. (Exhibit 7-4 provides the data that will be used in the text illustrations.)

1. The **SL** formula is:

$$\frac{\textbf{Cost - residual value}}{\textbf{Useful life in years}} = \textbf{Annual depreciation expense}$$

SL allocates equal amounts of expense to each year of the asset's life. **Book value (or carrying amount)** is the cost of the asset less accumulated depreciation.

The **UOP** formula is:

$$\frac{\textbf{Cost - residual value}}{\textbf{Useful life in units}} = \textbf{Depreciation per unit} \times \textbf{Units produced} = \textbf{Annual depreciation expense}$$

The UOP method assigns a fixed amount of depreciation to each unit of output or production. Depreciation each period will vary based on the units of output.

DDB is an accelerated depreciation method. **Accelerated depreciation methods** depreciate higher amounts of the asset's cost in the early years of the asset's life, and lower amounts of the asset's cost are depreciated in the later years of the asset's life. **DDB** depreciation is calculated using the following steps

Step 1: compute the SL rate.

$$\textbf{SL rate} = \frac{\textbf{1}}{\textbf{useful life}}$$

Step 2: multiply the SL rate by 2. This is the DDB rate.

DDB rate = SL rate x 2

Step 3: multiply the book value (cost - accumulated depreciation) by the DDB rate. This is depreciation expense.

Depreciation expense = Book value x DDB rate

Regardless of the method used, the **total amount of depreciation recorded will be the same** under all three methods. Any of the three methods may be used. A company may select one method for certain assets while using a different method for other assets. All three methods are considered GAAP. The type of method chosen may depend upon the type of asset being depreciated.

a. UOP best fits assets that wear out due to physical use.
b. DDB best fits assets that generate greater revenue earlier in their useful lives.

The **SL method** is most often used for financial reporting. Accelerated depreciation methods are most often used for tax purposes.

1. The higher depreciation in earlier years leads to lower taxable income and, therefore, lower taxes.
2. Lower taxes mean greater cash flow. Exhibit 7-10 illustrates the **cash-flow advantage** of DDB over SL.

Partial-year depreciation calculations are required for assets that are purchased and/or disposed of on a date other than the beginning or end of the fiscal year. Depreciation expense should only be recorded for the period of time the asset was actually used during the period. Depreciation must be revisedany time a change in the useful life or residual value occurs. To revise depreciation:

1. Determine the remaining depreciable book value.

Remaining depreciable book value = Remaining book value – Residual value

2. Then, revise the SL depreciation as follows:

$$\textbf{New annual depreciation expense} = \frac{\textbf{Remaining depreciable book value}}{\textbf{Remaining useful life}}$$

A business **disposes of plant assets** when they wear out, become obsolete, or are no longer useful to the business. Record the depreciation from the beginning of the period to the date of disposal. Then, calculate the asset's remaining book value. If an asset is **junked** before it is fully depreciated, record a **loss** (other expense) equal to the remaining book value.

The rules for the **sale of a plant asset** are:

1. Record a **gain** on the sale if the cash received is **greater than** the remaining book value.

Cash	XX			
Accumulated Depreciation			XX	
Plant Asset (cost)				XX
Gain on Sale of Asset				XX

2. Record a **loss** on the sale if the cash received is **less than** the remaining book value.

Cash	XX			
Accumulated Depreciation			XX	
Loss on Sale of Asset		XX		
Plant Asset (cost)				XX

Businesses often **exchange (trade in)** their old plant assets for similar assets.

1. The new asset's cost is often the book value of the old asset plus any cash received.
2. The entry to record a trade-in is:

Equipment (new)		XX		

Accumulated Depreciation		XX	
Equipment (old)			XX
Cash	XX		

Natural resources are assets such as timber, petroleum, natural gas, coal, and other mineral deposits. The process of allocating the cost of a natural resource to expense over its useful life is called **depletion. Depletion expense** represents the portion of the cost of the natural resource that has been extracted during the period. Depletion is calculated in the same way as UOP depreciation:

$$\frac{\textbf{Cost – residual value}}{\textbf{Estimated units of resource}} = \textbf{Depletion per unit} \times \textbf{Units extracted} = \textbf{Annual depletion expense}$$

The depletion entry is as follows:

Depletion Expense	XX	
Accumulated Depletion		XX

Accumulated Depletion is a contra account similar to Accumulated Depreciation.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 363

17. What are intangible assets?

Intangible assets, such as patents, copyrights, and franchises, are long-lived assets that generally are valued for the special rights that they carry. The process of allocating the cost of an intangible asset to expense over its useful life is called **amortization.** Amortization is calculated using the **straight-line method** over the asset's estimated useful life (not to exceed its legal life).

Examples of intangible assets include:

1. **Patent**— an exclusive right to manufacture and/or sell a product or process for a period of 20 years.
2. **Copyright**— an exclusive right to publish and/or sell an artistic or literary work, a musical composition, or a film. It extends for 70 years after the author's death.
3. **Trademark** and **trade name**— an exclusive right to use a name, symbol, or other product identification.
4. **Franchise** and **license**— an agreement in which one party grants another party the right to sell a product or service.
5. **Goodwill**— the excess of the cost of an acquired company over the market value of its net assets (assets minus liabilities). Goodwill is recorded by the acquiring

company. It is recorded *only* as the result of the purchase of another company. Goodwill is not amortized because the goodwill of many entities increases in value.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 385

CURRENT AND LONG-TERM LIABILITIES

18. What are current liabilities?

A **current liability** is a liability due within the longer of one year or the operating cycle if longer than a year. The amount of some current liabilities is known.

1. **Accounts payable** are amounts owed for goods or services purchased "on account."
2. **Short-term notes payable** are notes due within one year and have the interest paid at maturity. The **credit to Note Payable** for the maturity value equals the cash received. If the maturity date of the note occurs in the next accounting period, the following **adjusting entry** must be recorded to accrue the interest expense.

Interest Expense	XX	
Interest Payable		XX

If an **adjusting entry was not necessary** (because the maturity date did not occur in the next accounting period), the following entry is required when the note is paid.

Note Payable	XX	
Interest Expense	XX	
Cash		XX

If an **adjusting entry was necessary**, the following entry is required when the note is paid.

Note Payable	XX	
Interest Expense	XX	
Interest Payable		XX
Cash		XX

Sales tax payable reports the sales taxes that are collected by retailers and that must be periodically remitted to the taxing authority.

Accounts Receivable (or Cash)	XX
Sales Revenue	XX
Sales Tax Payable	XX

The **current portion (or current installment) of long-term debt** is the principal portion of a long-term installment debt that is payable within one year.

Accrued expenses (accrued liabilities) are expenses incurred but not yet paid; this category of liabilities includes accrued interest and taxes, and accrued wages and related expenses.

Payroll liabilities include salary payable, along with various employee taxes withheld from paychecks

Unearned revenues, also called **deferred revenues**, customer prepayments, and revenues collected in advance, result from collecting cash before the revenue is earned.

Some current liabilities must be **estimated** if the amount is not known.

Warranty agreements are guarantees that companies make concerning defects in their products. Because some warranty agreements last many years, the exact amount of repairs required under the warranty may not be known for many years. The **matching principle** requires that the warranty expense relating to sales in a period be **estimated** and deducted from the sales revenue. A **liability for the estimated repairs** must be reported on the balance sheet. The journal entry is:

Warranty Expense	XX	
Estimated Warranty Payable		XX

The entry to record the **actual repair or replacement of defective merchandise** is:

Estimated Warranty Payable	XX	
Cash or Inventory		XX

Estimated Warranty Payable appears among the current liabilities on the balance sheet, as a part of Accrued Liabilities.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 413

19. What are long term liabilities?

Issuing bonds payable or long-term notes payable is a popular method of financing operations for a corporation. **Bonds payable** are groups of notes payable issued to many lenders (**bondholders**); they are usually sold through an **underwriter**. (Exhibit 8-2 illustrates an actual bond certificate.)

Bonds spread risk over many lenders, as compared with a note payable that has only one lender. **Principal or par value** is the amount printed on the face of the debt instrument and will be repaid at maturity; it is also called the **maturity or face value**.

All of the bonds may mature at a specific time (**term bonds**), or in installments over a period of time (**serial bonds**). The **contract (stated) interest rate** is always stated on the face of the bond certificate. Interest is normally paid semi-annually. Bonds may be **secured** (such as a **mortgage bond**) or may be **unsecured (debenture)**.

Prices of bonds are quoted on the bond market in **eighths of a percentage point**.

If the market price is less than the maturity (par) value, record a **discount** on the sale of bonds payable; if the market price is greater than the maturity (par) value, record a **premium.** If the market price equals the maturity (par) value then the bonds sell at par and no premium or discount is recorded.

The selling price (the amount an investor is willing to pay for the bond) equals the **present value of future receipts.** The present value will always be less than the future value because of interest.

1. Present value calculations are based on the **time value of money**.
2. The future receipts consist of **principal plus interest payments**.
3. Refer to Appendix B for a more detailed discussion of the time value of money, including both present and future value. Additionally, the appendix includes illustrations of how the present value concept applies to bonds payable.

Two interest rates work to set the price of a bond—the contract rate and the market rate.

1. The **contract (stated) interest rate** determines the amount of cash interest the borrower pays; it is a set amount over the life of the bonds.
2. The **market (effective) interest rate** is the return investors demand for lending their money; the market rate changes daily, depending on various market factors.
3. If the **contract rate exceeds the market rate** when a bond is issued, the bond sells for a **premium**.
4. If the contract rate is less than the market rate when a bond is issued, the bond sells at a discount.
5. If the contract rate equals the market rate when a bond is issued, the bond sells at at par.

Bonds sold at par on an interest date are recorded with this entry:

Cash	XX	
Bonds Payable		XX

At each semiannual interest payment date, **interest expense** is recorded with this entry:

Interest Expense	XX	
Cash		XX

Year-end **interest accrual entries** are necessary if interest is not paid on that date as shown below:

Interest Expense	XX	
Interest Payable		XX

Discount on Bonds Payable (when the market price is less than par value) is a contra liability account. It is amortized over the life of the bonds.

he entry to record the issuance of bonds at a discount is:

Cash	XX	
Discount on Bonds Payable	XX	
Bonds Payable		XX

The bonds are issued for less than par value; the contract rate of interest is less than the market rate. The carrying amount of the bonds on the balance sheet equals Bonds Payable minus the Discount.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 422

20. What are the different methods to calculate the amortization of bonds?

The effective-interest method of debt amortization is used to calculate the amount of interest expense each period. The effective-interest method of amortizing a discount or premium is preferable to the straight-line method; it follows the matching principle, according to GAAP.

Straight-line amortization means that an equal amount of the discount (or premium) is amortized (written off) each semiannual interest period; this method is useful for quick analysis or estimates, or when the amount of the discount or premium is relatively insignificant.

Early retirement of bonds payable occurs before the scheduled maturity date or earlier; **callable bonds** (callable at the issuer's option) allow the issuer to retire the bonds prior to maturity, at some specified price (usually higher than par). If the bonds are not callable, the corporation may buy the bonds on the market and retire them prior to maturity. Remove bonds payable and the related unamortized premium or discount from the accounts; record **extraordinary gain** or **extraordinary loss on the retirement** (the difference in the carrying value of the bonds and the cash paid).

Convertible bonds and notes allow the bondholder to exchange bonds for common stock.

1. The bonds are convertible at the bondholder's option.
2. The carrying amount of the bonds on the date of conversion becomes the amount of paid-in (contributed) capital. Remove bonds payable and the related unamortized premium or discount from the accounts and increase common stock and paid-in capital in excess of par; no gain or loss is recorded.

The **disadvantages** of financing with **debt** include:

1. Interest payments must be made even in years when the business sustains a loss.
2. The principal amount must be repaid at maturity of the bonds.

Advantages of financing with **stock** include:

1. The business raises capital but incurs no additional liabilities or interest expense.

2. There is no obligation to pay dividends to shareholders. (Dividends are optional and can be paid only if there have been profitable operations.)

The **disa**d**vantages** of financing with **stock** include:

1. Ownership is spread among more shareholders.
2. Control and income (dividends) are spread over more shares.

There are **advantages** for a business that finances operations with **debt** rather than with stock.

1. There is no dilution of ownership when bonds are sold, resulting in higher EPS.
2. Interest expense is tax-deductible; therefore, there is a tax savings associated with bonds.

Trading on the equity means that the business earns more by investing borrowed funds than it pays in interest expense on the bonds. This results in increased EPS.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 432

STOCKHOLDERS' EQUITY

21. What is company's equity?

The corporation is the dominant form of business organization in the United States. The **advantages of the corporation** include the following:

Corporations are **separate legal entities.** Corporations are granted **charters** by the state that authorizes the organization of the corporation. The corporation is separate from its owners, who are called **stockholders** or **shareholders.** The corporation has many rights that a person has, such as the right to buy, own, and sell property; the right to sue and be sued; and the right to enter into contracts. The owners' equity of a corporation is divided into **shares of stock.** The charter indicates how many shares the corporation can sell. Most corporations have **continuous lives**; that is, the corporation does not terminate, as a proprietorship or partnership does, when ownership changes. Ownership may be transferred easily. It is simply a matter of selling stock. Stockholders have **limited liability** for debts of the corporation. (A shareholder can lose no more than his investment in the business.)

Disadvantages of the corporation include the following: There is a separation of ownership and management. Corporations pay taxes on their earnings. They pay both federal and state taxes not borne by other business forms. **Corporate earnings** are subject to **double taxation.** After corporate earnings are taxed to the corporation, the net income distributed to stockholders as dividends is subject to personal income tax. Corporations are subject to **government regulations** that do not apply to proprietorships and partnerships. The cost of compliance is often expensive.

Stockholders have **four basic rights**. Those are the rights to

1. **Vote –** to participate in management by voting. Each share receives one vote.

2. **Receive dividends –** Each share of stock of a particular class receives an equal dividend.
3. Receive a proportionate share of assets remaining upon **liquidation** of the corporation.
4. Maintain one's proportionate ownership in the corporation. This right is called the **preemptive right** and is often withheld from stockholders.

Stockholders' equity is divided into two main parts--**paid-in (or contributed) capital** , and **retained earnings**.

1. **Paid-in capital** is the amount that stockholders had contributed to the corporation.
2. **Retained earnings** is the amount of net income not paid to stockholders as dividends.

Stock certificates are issued to stockholders in exchange for their investment.

a. These shares are often referred to as **capital stock.**
b. The number of shares that the corporation is **authorized** to issue is listed in the corporation's charter.
c. **Issued stock** is that stock that has been sold.
d. **Outstanding stock** is that stock held by shareholders.

The two **classes of stock** are common stock and preferred stock.

All corporations issue **common stock**. Common stockholders assume risks when they buy common stock and therefore demand increases in stock prices, dividends, or both, or they will sell the stock.

Preferred stock is considered less risky than common because preferred stockholders receive their dividends before the common stockholders and receive assets before the common stockholders in the event of corporate liquidation.

(1) Preferred stock pays a fixed dividend similar to interest on debt.
(2) Preferred dividends are not tax deductible. Corporations often prefer to borrow money rather than issue preferred stock because interest is tax deductible.

Stock may be **par value** stock or **no-par** stock. **Par value** is an arbitrary amount assigned by a company to a share of its stock. Most companies set a very low par value to avoid legal difficulties of selling the stock below par. The total par value of the shares issued represents **legal capital,** the minimum amount of stockholders' equity required by most states. This minimum amount of capital is set for the protection of creditors. **No-par** stock may also be issued. Some no-par stock may have a **stated value** that is treated in the same manner as par value.

Corporations **issue stock** to raise capital to finance operations. A corporation **issues (sells)** all or part of the stock that is **authorized** in the corporate charter. Stock may be sold either to an **underwriter** or directly to shareholders. The price that the stockholder pays is called the **issue price.** Stock is usually issued at the market price. The issuance of stock increases assets (usually cash) and stockholders' equity. Issuance of stock for assets other than cash can pose an ethical challenge. The company issuing the stock may be tempted to record a value that is greater than the asset's fair market value. It may have the opportunity to do so because it may be difficult to determine the market value of other assets such as land, buildings, equipment, or stock in nonpublic traded companies.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 473

22. What is treasury stock?

Treasury stock is issued stock that has been later reacquired by the issuing corporation. **Reasons for acquiring** treasury stock include:

1. Using treasury stock to give to employees as part of their compensation package.
2. Increasing net assets by purchasing treasury stock at a low price and selling it at a higher price.
3. Trying to avoid a takeover.

The **purchase of treasury stock** reduces assets (usually cash) and stockholders' equity. The Treasury Stock account is a **contra stockholders' equity account,** that is, a stockholders' equity account with a debit balance. The Common Stock account is **not** used because the number of shares **issued** has **not changed--**just the number of shares **outstanding.**

Corporations may purchase stock to **retire** it by canceling the stock certificates, thus reducing the number of shares issued and outstanding.

1. Retired stock may not be reissued.
2. The balance of all paid-in capital accounts (common or preferred as well as paid in capital in excess of par) related to the retired shares are removed from the books.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 488

23. What is retained earnings?

Retained Earnings is the account that accumulates all net income minus all net losses and dividends. It is not a fund of cash. A negative balance in Retained Earnings is called a **deficit** A **dividend** is a corporation's distribution of its earnings to shareholders. Three relevant dates for dividends are the **declaration date, date of record**, and the **payment date**.

Dividends on preferred stock may be **cumulative**, that is, the preferred stockholders must receive all dividends, even the dividends not paid in prior years (**dividends in arrears)**, before the corporation can pay dividends to common stockholders. Dividends in arrears are not a liability until declared by the corporation.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 490

24. What is dividend?

A **stock dividend** is a proportional distribution by a corporation of its own stock to its own stockholders.

1. Stock dividends **do not** transfer assets to stockholders and therefore only affect stockholders' equity and stockholders' equity accounts.
2. The **reasons** that a corporation might choose to distribute a stock dividend are: To conserve cash. To reduce the market price per share
3. **Small stock dividends** are dividends that are less than 20-25% of the outstanding stock. Small stock dividends are recorded at their **market value** when distributed, with the following entry:
4. **Large stock dividends** are stock dividends that are greater than 25% of the outstanding stock. Large stock dividends are recorded at **par value** when distributed, with the following entry:

A **stock split** is an increase in the number of shares coupled with a proportionate reduction in the par value of the stock. Stock splits are recorded with a **memorandum entry** because no account balances are affected. Stock splits **reduce the par value** of the stock. Stock splits **reduce the market price** of the stock.

The **market value** of a stock is its current selling price. Market value is more important to stockholders than any of the other values mentioned here. The **redemption value** of a stock is the price the corporation pays to buy back its preferred stock. Redeemable preferred stock is a liability, because the corporation has the obligation to redeem preferred stock at the option of the stockholder. The **book value** of a stock measures the amount of net assets or stockholders' equity per share. Book value is based on historical cost of the net assets and is not market value. **Common book value** = (Total stockholders' equity – Preferred equity) ÷ Number of common shares *outstanding.* **Preferred equity** = Redemption value + Dividends in arrears.

The **return on assets** (rate of return on total assets) measures a company's ability to use its assets to earn income. The formula is:

$$\textbf{Return on assets} = \frac{\textbf{Net income + Interest expense}}{\textbf{Average total assets}}$$

The **return on equity** (rate of return on common stockholders' equity) measures a company's ability to use its invested capital to earn income. The formula is:

Return = **Net income – Preferred dividends**

on equity **Average common stockholders' equity**

If a company's return on assets is greater than the interest on its debt, the return on equity will be greater than the return on assets. Borrowing money to finance assets is called **leverage**. Leverage used during good economic times produces high returns for stockholders. A higher return on equity than return on assets also indicates favorable leverage. The higher the rate of return on common stockholders' equity, the more successful the company.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 500

ACCOUNTING FOR LONG-TERM INVESTMENTS

25. What are the long term investments? What are the different types of long-term investments?

Stock investments are shares of stock of a corporation (the **investee**) that have been purchased by an **investor**.

Short-term stock investments or marketable securities are current assets. These investments must be liquid and management must intend to sell them within one year.

Long-term investments are all other investments, including available-for-sale securities, equity-method investments, and consolidated investments; these will all be held for more than one year.

Available-for-sale investments are stock investments comprising up to a 20% ownership level. These are accounted for by the **market value method,** because the company expects to resell the stock at its market value. They are classified as current assets if the business expects to sell them within the next year. Otherwise, they are classified as long-term assets. The original purchase of an available-for-sale investment is recorded at **cost**, with a debit to Long-Term Investment and a credit to cash. **Cash dividends** received are credited to dividend revenue when received; **stock dividends** are reported with a memo entry only. An **unrealized gain or loss** is recorded to reflect the change in market value of the asset from period to period. This entry adjusts the security to its current market value for balance-sheet reporting, if there has been a change in the market value. On the balance sheet, the allowance account either adds to (if a debit balance) or deducts from (if a credit balance) the investment account balance. The unrealized gain or loss is reported in two places:

- as part of comprehensive income on the income statement, separate from net income;
- as part of accumulated other comprehensive income, a separate section of stockholders' equity.

When an available-for-sale investment is sold, a **realized gain or loss** may be recorded; this is the difference between the amount received and the cost of the investment. Realized gain or loss is reported as **"other" income or loss** on the income statement, and no adjustment is made to the Allowance account at this time. It is *updated* at the end of the fiscal year to reflect the current difference between the historical cost and market value of investments still held by the company. Long-term investments of **between 20% and 50%** of the investee's outstanding stock require the use of the **equity method**.

Gain or loss on the sale of the investment is the difference between the sales proceeds and the carrying amount of the investment.

Consolidation accounting is required when the investor or **parent** has a controlling (greater than 50%) interest in the outstanding stock of the investee or **subsidiary** company. **Consolidation accounting** combines financial statements of two or more companies that are controlled by the same owners into one set of consolidated statements. **Consolidated financial statements** help provide better insight into the total operations of the parent and its subsidiaries. Exhibit 10-7 illustrates how a parent with consolidated subsidiaries and an equity-method investment would account for various transactions. Both parent and subsidiaries keep their own separate set of books. On the **consolidated balance sheet**, **elimination entries** are necessary to correctly report the financial statements of the consolidated entity and avoid double-counting. They are prepared on the consolidation work sheet but are not recorded on the books of either the parent or the subsidiary. **Elimination entries** must: Eliminate the stockholders' equity of the subsidiary. Since the parent and subsidiary are considered one entity for financial reporting, the parent company's stockholders' equity represents ownership of the consolidated entity. The stockholders' equity of the subsidiary must be eliminated.

Goodwill and minority interest are reported on a consolidated balance sheet:

Goodwill arises if the parent company's purchase price of the subsidiary is greater than the market value of its net assets, calculated as assets minus liabilities.

Minority interest arises if the parent company purchases less than 100% of the subsidiary's stock. Minority interest is reported as a long-term liability on the *parent* company's balance sheet.

The **consolidated income statement** will show the net income of the parent plus the parent's proportionate share of each subsidiary's net income. The dollar amounts of bond transactions are the same for both issuer and investor; only the accounts differ. Short-term investments in bonds are rare.

Held-to-maturity investments are usually (**long-term**) noncurrent assets. This type of bond investment is accounted for by the **amortized cost method**.

1. Record the investment at **cost** and report the carrying amount of the investment on the balance sheet at **amortized cost**, that is, its cost less unamortized discount or cost plus unamortized premium.
2. The **discount or premium is amortized** directly to the Investment account; amortizing the discount increases the Investment account, while amortizing the premium reduces the Investment account.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 533

THE STATEMENT OF CASH FLOWS

26. What are the different methods to calculate Cash flows from operating activities?

The **statement of cash flows**, one of the four required financial statements, **shows cash receipts and cash payments** during the year. It also explains the changes in cash during the year. The statement covers the same period of time as the income statement.

The **purposes** of the statement are:

1. To predict future cash flows;
2. To evaluate management decisions;
3. To determine the ability to pay dividends and interest; and
4. To show the relationship of net income to cash flows.

Cash includes cash on hand, cash in the bank, and cash equivalents. **Cash equivalents** are highly liquid investments such as money market investments and Treasury bills. Cash flows on the statement are classified as operating, investing, or financing. Exhibit 12-2 links the sections of the cash flow statement to the balance sheet.

Operating activities create revenues, expenses, gains, and losses.

a. Operating activities relate to transactions that make up net income.
b. Over the life of the business, cash flow from operating activities is the most important activity for a business.

Investing activities are increases and decreases in assets other than those involved in operating activities.

a. Investing activities relate to long-term asset accounts (investments and fixed assets).
b. Investments in fixed assets suggest a strong company.

Financing activities involve obtaining funds from investors and creditors.

a. Financing activities relate to long-term liabilities and owners' equity accounts.
b. Both stock transactions and debt transactions are financing activities. However, paying dividends on stock is considered a financing activity, while paying interest on debt is considered an operating activity. (The reason is that interest expense is on the income statement and, thus, part of net income, while dividends paid are not part of net income.)

The **indirect method** is one method of reporting net cash flow from operating activities. The indirect method **begins with accrual-basis net income** and makes adjustments to that number to **derive net cash flow from operating activities**. The following items are included as **adjustments to net income**:

1. **Add depreciation, depletion, and amortization expenses** because they reduce net Income without reducing cash.
2. **Add losses and subtract gains on the sale of long-term assets or early extinguishment of debt** because they also affect income without affecting cash. The cash flows related to selling long-term assets is a part of investing activities; gains and losses will be included as part of those cash flows.
3. **Add decreases in most current assets other than cash** because decreases in current assets indicate that cash has increased.
4. **Subtract increases in most current assets other than cash** because increases in current assets, such as inventory, indicate that cash has been paid.
5. **Add increases in most current liabilities** because increases in current liabilities indicate that cash has not been paid.
6. **Subtract decreases in most current liabilities** because decreases in current liabilities indicate that cash has been paid.
7. Most current assets and liabilities result from operating activities. Exceptions include short-term investments and dividends payable.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p.620

27. What is cash flow?

To prepare the cash-flow statement:

1. Identify the activities that increase or decrease cash.
2. Classify each increase or decrease as operating, investing, or financing.
3. Identify the cash effect of each transaction.

Investing and financing activities are the same under both methods. Cash flows from **investing activities** include

a. Cash **receipts (inflows)**
   (1) Proceeds from the sale of plant assets
   (2) Proceeds from the sale of investments that are not cash equivalents
   (3) Cash receipts (collections) on notes receivable

b. Cash **disbursements (outflows)**
   (1) Payments for the acquisition of plant assets
   (2) Payments for the acquisition of investments that are not cash equivalents

(3) Making new loans

Cash flows from **financing activities** include:

a. Cash **receipts (inflows**)

(1) Proceeds from the issuance of long-term debt
(2) Proceeds from the issuance of stock
(3) Proceeds from the sale of treasury stock

b. Cash **disbursements (outflows)**

(1) Disbursements for the repayment of debt
(2) Payments for the purchase of treasury stock
(3) Payment of dividends
(4) Payments to retire the company's own stock

Cash may decrease when net income increases because of asset purchases, investments, or repayment of debt. Cash may increase when net income decreases if the company has borrowed money or sold assets or investments. **Only transactions with cash effects belong on the statement of cash flows**.

Cash flow from investing activities can be identified by analyzing noncurrent asset accounts. An increase in an asset account (for example, Land) indicates that an asset has been acquired. This is reported as a cash outflow (use of cash).

A decrease in an asset account indicates that an asset has been sold. The amount of the decrease may not equal the amount of cash received (the cash inflow or source of cash), because the asset might have been sold at a price greater than or less than its book value. (Gains and losses on the sale of investments and plant assets come from the income statement.)

Cash flows from operating activities include:

1. Cash **receipts (inflows)**
   a. Cash collections from customers
   b. Cash receipts of interest and dividends

2. Cash **disbursements (outflows)**
   a. Cash payments to suppliers for both inventory and operating expenses
   b. Cash payments to employees
   c. Cash payments for interest and income taxes

3. **Depreciation, depletion, and amortization** do not affect cash and are not listed on the statement of cash flows (direct method).

Investing and financing activities are the same under both methods. Amounts for the statement of cash flows may be calculated based on the income statement amounts and changes in the related balance sheet accounts. Cash flow from operating activities is computed by converting accrual-basis net income to the cash basis.

Noncash investing and financing activities, such as acquisition of plant assets by issuing long-term debt, are reported in a separate schedule that accompanies the statement of cash flows.

Financial Accounting, 7/8th edition, Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p.617

MARKETING

PRINCIPLES OF MARKETING

1. What is Marketing?

Marketing boasts a rich array of concepts and tools. Marketing is considered as a social and managerial process by which individuals and groups obtain what they need and want through creating offering and freely exchanging products and services. Good marketing aims at proper understanding the needs and wants of customers so that the offered product or services fits and complies with their requirements.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 7-8

2. Explain Needs/Wants/Demands

Marketers must understand customers' needs, wants and demands.

Need – include basic *physical* needs for food, clothing, warmth and safety; *social* needs for belonging and affection; individual needs for knowledge and self-expression. Marketers do not create needs; they are a basic part of the human make-up. Human need is a state of felt deprivation.

Wants - are shaped by the culture and surrounding society, a person needs food but may want mango.

Demands - are wants for the specific products, supported with the ability to pay.

Kotler, P.& Armstrong, G. "Marketing. An Introduction", 2nd edition, Northwestern University,1990, pp. 5-6

3. What is marketing plan and why to write marketing plan?

Planning is the process of anticipating future events and identifying the right strategies aimed at achieving the organizational goals. Marketing planning involves designing plan that facilitates the achievement of marketing goals, it does represent basis for all marketing strategies and decisions. By identifying objectives and adequate actions written marketing plan will be in place that will facilitate the clarification of stated activities directing employees and managers to work towards common goal .

Lamb, Ch., Hair, J.&McDaniel,C."Marketing 8",Thomson South Western, 2006, p. 39

4. What is marketing plan and what are the basic sections to be included in the marketing plan?

Marketing plan is a written document that summarizes what marketers have learned and how the firm plans to reach its objectives. It operates at two levels strategic and tactical levels:

A typical marketing plan comprises of the following major sections:

- Executive summery and table of content
- Situation analysis
- Marketing strategy and programs
- Financial projections
- Implementation controls

All companies handle the marketing plan in a different way. Though observations revealed that the weakest part in terms of effective marketing planning is the lack of realism, insufficient competitive analysis and short run focus.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 33-34

5. Explain the meaning of Exchange and Transaction

Exchange represents the core concept of marketing, it is the process of obtaining a desired product or service from someone by offering something in return. This exchange process will remain relevant and effective as long as human society exists since satisfying human needs is the basic instinct of humans and no one can produce everything that customers' needs. For an exchange process to take place between two or more parties, few conditions have to be met such as:

- There must be at least two parties
- Each party has something that could be of value to another party.
- Each party has a desire, willingness and ability to exchange.
- Each party is capable of communicating and delivery
- Each party has the freedom to accept or reject the offer

Transaction is a trade of values between two or more parties, involving at least two things of value which are the subject of conditions

Transfer - when A party gives something to B party and does not receive anything tangible in return. Transfer also can be understood as the concept of exchange.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 3-4

6. List the key tasks to be undertaken and implemented by marketing managers

Marketing management undergoes significant changes forcing marketers to rethink their concepts and marketing tools. At the background of highly competitive and changing environment those companies capable of adjusting their marketing concepts and marketplaces will survive and remain competitive. There are several key tasks that marketers should consider and implement:

- Develop marketing strategies and plans
- Capture marketing insights. understand inside and outside environment in which the organization has to operate through thorough marketing research
- Connect with customers identify how to create value for the selected target market
- Build strong brands understand brands strength and weakness
- Shape market offering decision about product quality, design, features and packaging
- Delivering value identify the most effective ways of delivering the desired value to a selected target group
- Communicating value inform, persuade and remind customers about the company's brand
- Creating long term growth.

Kotler, P. & Armstrong, G. "Marketing. An Introduction", 2nd edition, Northwestern University, 1990,pp. 15-17

7. Discuss the marketing management tasks

Marketing management is changing due to extremely changing competitive environment. Marketing management tasks include the following actions to be performed by the marketing managers:

- Develop marketing strategies and plans
- Capture marketing insights – understand the external environment
- Understand the target audience needs and wants in order to effectively put them into a product
- Communicate value to customers
- Establish long term relationship with the target group

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 15-17

8. Discuss the term Integrated Marketing

Integrated Marketing: **-** is aimed at devising marketing activities and marketing programs in order to maximize the ability to create, communicate and deliver customer value. Marketing activities come in different forms, one of such implications is marketing mix comprising of four Ps representing price, product, place and promotion. Marketing mix decisions are designed in order to influence trade channels and final consumers. From buyers point of view each marketing tool is designed to deliver a customer benefit. Robert Lauterborn suggested that sellers 4Ps correspond to customers 4 Cs:

- Customer solution
- Customer cost
- Convenience
- Communication

Those companies able to meet customer needs economically and conveniently will manage to survive and remain at the top position. Two things of the integrated marketing encounter the following: 1 many different marketing activities are applied with the aim to communicate and deliver value 2 all applied marketing activities are directed towards maximizing the joint efforts. In general it implies that design and implementation of all marketing activities are executed with all other activities in mind

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 9-10

9. Discuss Products and Services

Product can be characterized as anything that can be offered to a market for attention, utilization or consumption aimed at meeting a want or need of a customer. It can be both tangible and intangible product.

Service **-** can be characterized as anything intangible that one party can offer to another party in order to meet customers' wants or needs.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey , 2000, pp. 3-5

10. Discuss the scope of marketing

Marketing is viewed as the task of creating, promoting and delivering goods and services to customers and businesses. Marketers are involved in marketing 10 different types of entities: goods, services, experiences, events e.g. time based events Olympics persons, places, properties, organizations, information and idea,

Marketers **-** someone seeking response from another party, called prospect.

Market –actual place where buyers and sellers gather to buy and sell goods

Exchange – a core concept of marketing, process of obtaining a desired product from someone by offering something in return

Transaction – a trade of values between two parties

In order to be a marketer, one needs to understand what marketing is, how it works, what is marketed and who does marketing.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 2-3

11. Discuss Core Marketing Concepts – Target Market and Segmentation

No marketer can fit all markets, tastes are different consequently satisfying all tastes is a tough job resulting into complete failure. For that reason marketers start segmentation by identifying certain group of buyers, who might prefer or require various products, market segment can be identified by demographic, psychographic and behavioral differences, followed by identification of which segment is the most appropriate and which represents the greatest opportunity. Target market is a group of customers that the company aims to direct all marketing efforts.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 8-9

12. Discuss Five competitive Forces under which organizations conduct marketing activities

- Production concept – consumers prefer products that are widely available and inexpensive.
- Product Concept – consumers prefer products that offer the best quality, performance and innovation.
- Selling concept – considers aggressive selling approach to sell more in order to make money, to sell what they make rather than to sell what the market wants.
- Marketing Concept - the key to achieving the success is performing better than competitors by understanding the market demand and delivering superior customer value to a chosen target group.
- Societal marketing concept – considers that organization has to determine needs, wants and interests of target market and deliver desired satisfaction in a way that enhances the well-being of a society.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 17-25

13. Explain the difference between Needs/Wants/Demands

Marketers must understand customers' needs, wants and demands.

Need – include basic *physical* needs for food, clothing, warmth and safety; *social* needs for belonging and affection; individual needs for knowledge and self-expression. Marketers do not create needs. Wants are shaped by the surrounding society, a person needs food but may want mango. Demands are wants for the specific products, supported with the ability to pay.

Kotler, P. The Millennium Edition, "Marketing Management " Northwestern University, Prentice Hall, New Jersey, 2000, pp. 8-9

14. What is Holistic Marketing?

Holistic marketing can be considered as the development of design, implementation of different marketing programs and activities that recognizes breadth and interdependencies involved in today's marketing . Holistic marketing has four key dimensions:

- Internal marketing – ensuring everyone in the organization has the same marketing principles
- Integrated marketing – ensuring multiple means of delivering value is employed in an optimal manner
- Relationship marketing - having beneficial relationship with customers
- Socially responsible marketing – understanding ethical environmental and legal issues

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. XV

15. What can be marketed?

Marketing people are involved in marketing the ten types of entities: goods, services, experiences, events, persons, places, properties, organizations, information and ideas.

- Goods - refers to all types of goods
- Services – many market offerings consist of a variable mix of goods and services
- Events – marketers promote onetime events e.g. trade shows, company anniversaries etc
- Experiences – there is a huge market for customized experiences
- Persons – celebrity marketing is a major business
- Places – e,g cities , states , regions etc

- Properties – e,g real estate or financial property
- Organizations - organizations work actively in order to create strong brand in the minds of customers
- Information – production, packaging and distribution of information is one of our society's major industries
- Ideas – every market offering offers a basic idea.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 4-5

16. Explain the concept Total Quality Management (TQM)

Total Quality Management – represents an organization wide approach to continuously improving the quality of the processes, products and services within the organization. Product and service quality, customer satisfaction and company profitability are extremely connected. The higher the level of offered product, the higher the level of customer satisfaction directly connected to company profitability. Companies initially need to correctly identify the customers' needs and wants, communicate customers' expectations to designers, ensure orders are filled correctly and ensure after sales service is in place. when marketers do all this, they are making substantial contributions to total quality management and customer satisfaction.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 68

17. Discuss the external environment of marketing and explain how it affects firm

The external market environment consists of social, demographic, economic, technological, political, legal and competitive variables. Marketers are not in a position to control everything, all the elements of external environment. Instead marketers must understand the way external environment changes and to what degree it impacts the target market. With the consideration of analysis marketers are responsible for devising a marketing mix in order to effectively meet the needs of target market.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 98

18. What is Marketing Mix?

The term marketing mix refers to a unique mix of product, place, promotion and pricing strategies designed to produce mutually satisfying exchange with a target market. usually referred to as four 4Ps. Marketing manager has to control each component of marketing mix. Successful marketing mixes are designed to satisfy target market

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 51-52

19. Explain the meaning of Elastic Demand/Inelastic Demand?

Elasticity of demand refers to consumers responsiveness or sensitivity to changes in price. Elastic demand occurs when consumers buy more or less of a product when the price changes.

Inelastic demand means that an increase or a decrease in price does not significantly affect the product.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006

20. Explain the notion of Knowledge Management and types of knowledge

Knowledge management represents an umbrella term comprising of a range of organizational processes and practices having common concern of generating value from knowledge. The term knowledge management cannot be distinguished with a long history, it encounters R &D, management information system, employee training and managing intellectual property - strategic planning is also considered as knowledge management activity. Knowledge management initially comprised of information technology – the appliance of database, analyzing and disseminating information. The real value of knowledge management can be considered as providing overall view of multiplicity of knowledge development , knowledge transfer, and knowledge utilization. Types of knowledge:

- Know – how – tacit knowledge, involving skills expressed through their performance
- Knowing about – explicit, it comprises facts, theories and set of instructions.

Explicit knowledge - can be communicated
Tacit knowledge – can't be directly articulated

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 163-164

21. Explain Market Penetration Strategy

A market penetration strategy considers product introduction to the market at a low price in order to attract a large pool of buyers as quickly as possible. It tends to create a low price barrier to market entry. The intent is to attain a high or even total, initial market share and maintain this share high during the further stages of the product's life cycle .

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 220

22. Explain Market Skimming Strategy

A market skimming policy considers that a company initially puts the highest price that the market will bear, and promotional effort is aimed at a small percentage of the potential market. These customers are most often innovators, willing to purchase during the introduction stage of the product's life cycle, followed closely by the early adopters who are also more receptive to new concepts and products.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007

23. Describe the company's marketing environment

A company's marketing environment consists of the actors and forces outside marketing that affect marketing management's capability to develop and preserve successful transactions with its target customers. The marketing environment encounters both opportunities and threats. The marketing environment consists of task environment and broad environment.

Task environment encounters immediate actors involved in producing, distributing and promoting the offering such as the company, suppliers, distributors, dealers, and the target customers.

The broad environment encounters six major components: demographic environment, economic environment, physical environment, technological environment, political environment and social- cultural environment. These environments encompass forces that may greatly influence actors in the task environment. Market actors must pay attention to trends and developments in the environment.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 15

24. Explain Production Concept

A: production concept holds that consumers prefer highly affordable and available products, and therefore management should therefore focus on improving production and distribution efficiency. This concept makes sense in developing countries, where consumers are more interested in obtaining the product than in its features.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey , 2000, p. 17

25. Explain Selling Concept

The selling concept focuses on the idea that consumers and businesses will not buy enough of the organization's products. For that reason companies should undertake aggressive selling and promotion efforts Most firms follow the selling concept when they have overcapacity. Their endeavor is to sell what they make rather than make what the market wants. Selling concept indeed focuses on short-term results – generating immediate sales transactions - rather than on building long-term, profitable relationships with customers.

Marketing based on hard selling carries high risks. It assumes that customers who are coaxed into buying the product will like it. Or, if they don't like it, they may forget their disappointment and buy it again later. These are usually poor assumptions to make about buyers. Most studies show that dissatisfied customers do not buy again.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 19

26. Explain Marketing Concept

The marketing concept views that achievement of organizational goals hinges upon the successful determination of needs and wants of target markets and delivering the desired satisfactions more efficiently compared to your competitors. The marketing concept involves the following:

- Focus on customers' needs and wants
- Integrating all activities available within the organization in order to satisfy those needs and wants
- Achieving long term successful existence by satisfying the target market requirements legally and responsibly.

Marketing concept requires constantly obtaining information on your target market requirements, changes in their taste, determining ways of delivering the superior value and implementing actions to provide ultimate value to customers. Understanding the competitive environment and competitors strength and weakness is an important part of market orientation. The marketing concept takes an outside-in perspective. It commences with definite market, focuses on customer needs, coordinates all the marketing activities affecting customers and makes profits by ensuring long-term customer relationships based on customer value and satisfaction.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. xxxi

27. Discuss Marketing Communication and Marketing Communication Mix

Marketing communications are means applied by companies aimed at, informing, persuading and reminding consumers- directly or indirectly about the brand / product they offer to a market. Marketing mix consists of six major models of communication

- Advertising any paid form of presentation and promotion of ideas
- Sales promotion incentives to boost sales
- Events and experiences company sponsored activities designed to create brand related interactions
- Public relations and Publicity
- Direct marketing Mail, telephone, fax
- Personal selling face-to face interaction with purchasers in order to market the offered product

Companies usually apply other means such as product styling and price, shape and color of the package, sales people dresses and manners,

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 279-280

28. Explain the Concept of Societal Marketing

The Societal Marketing Concept – This marketing concept considers that indeed the major directions should be aimed at not only determining the needs and wants of the target markets in order to deliver the desired satisfaction but also at preserving and enhancing the overall well-being of our society.

This concept calls upon marketers to build social, ethical and environmental considerations into their marketing practices. Recent years have witnessed lots of complaints about products and packaging that are harmful to health and ecology. Marketers must come forward to protect the interest of both the customers and the environment and this can be achieved by adopting or following the societal marketing concept

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey, 2000,p. 25

29. What is Marketing Mix?

Marketing Mix – is a set of marketing tools applied in order to pursue the marketing objective in the target market. the four components of the marketing mix are as follows: product, price, promotion, place

Product - refers to goods and services' that the company can offer to the target market

Price refers to what customers pay to acquire the offered product.

Promotion - refers to various activities undertaken by companies in order to effectively communicate the message regarding the merits of the product and influence target customers to buy it.

Place – refers to location selected, covering proper selection of channels transportation etc.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 15

30. What is Strategic Marketing and what are the stages included in the strategic marketing plan?

Strategic marketing, the process of aligning the strengths of a company with the target groups of customers it can serve most effectively.

The strategic marketing plan process typically has three stages:

1. Segment the market
   - Geographic
   - Demographic
   - Psychographic
   - Behavior
2. Profile the market segments
   - Revenue potential
   - Market share potential
   - Profitability potential
3. Develop a market segment marketing strategy
   - Market leader or product line extension

- Mass marketing or targeted marketing
- Direct or indirect sales

After analyzing market segments, customer interests, and the purchase process, it's time to create the strategic marketing plan. The strategic marketing plan document usually includes:

- Situational Analysis - Where is the company now?
  a. Market Characteristics
  b. Key Success Factors
  c. Competition and Product Comparisons
  d. Technology Considerations
  e. Legal Environment
  f. Social Environment
  g. Problems and Opportunities
- Marketing Objectives - Where does management want the company to go?
  a. Product Profile
  b. Target Market
  c. Target Volume in Dollars and/or Units
- Marketing Strategies - What should the company do to achieve its objectives?
  a. Product Strategy
  b. Pricing Strategy
  c. Promotion Strategy
  d. Distribution Strategy
  e. Marketing Strategy Projection

http://www.allen.com/cgi-bin/gt/tpl.h,content=125

31. Explain the marketing planning process and its importance

Planning in general is the process of anticipating the future events and developments and determining the right strategies that will facilitate the achievement of designed goals. Marketing planning is the process of designing effective activities aimed at achieving the marketing objectives of the company. Marketing planning does represent basis for all relevant marketing strategies and decisions. Marketing planning process undergoes several steps including assessment of the environment where the company has to operate, understanding objectives that the company wants to achieve, selecting the right marketing strategies and monitoring the implementation process in order to ensure desired outcome is delivered and taking corrective measures if required.

Lamb, Ch., Hair, J. &McDaniel, C. “Marketing 8”,Thomson South Western, 2006,pp. 38-39

32. Explain the meaning of Positioning

Initial step comprises of defining the target market, once identified a strong competitive position must be ensured. Product positioning represents the place a product holds In a certain market, Market positioning gives product a clear, distinguishing and attractive place in the minds of target consumers compared to competing products. Marketers plan positioning in such a way that distinguishes their products from competing brands and give them the greatest strategic advantage in their target markets.

Hutt, M.D.&Speh, T.W. "Business Marketing Management: B2B", Miami University, Thomson South Western, 2007,p. 227

33. Discuss benefits of Segmentation

Market segmentation represents a process of dividing a market into an important, moderately similar and identifiable segment or groups. The purpose of segmentation is to enable the marketers to tailor marketing mix aimed at meeting their chosen target group needs.

Segmentation helps identify the group of customers having similar needs in order to analyze characteristics and buying behavior of this group. It also gives relevant information to marketers enabling the design of effective marketing mix. And finally segmentation is consistent with the marketing concept of satisfying customer wants and needs while meeting the organization's objectives. Segmentation scheme must meet four basic criteria:

1. Substantiality – market segment needs many potential customers in order to make commercial sense,
2. Identifiability and measurability – segment must be identifiable and measurable ,
3. Accessibility – targeted segment must be reachable with customized marketing mixes,
4. Responsiveness – different segments are having different response to marketing mix, segments need not be treated separately.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,pp. 224-226

34. Discuss the steps involved in segmenting markets

Market segmentation represents a process of dividing a market into an important, moderately similar and identifiable segment or groups. The purpose of segmentation is to enable the marketers to tailor marketing mix aimed at meeting their chosen target group needs. The purpose of segmentation in both customer and business market is to identify the marketing opportunities. There are six steps to be considered when segmenting the market:

- Select a market or product category for study
- Choose a basis or bases for segmenting the market
- Select segmentation descriptors identify specific segmentation variables
- Profile and analyze segments
- Select target market
- Design, implement and maintain appropriate marketing mixes.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,pp. 238-239

35. Discuss how to position a firm effectively

The success of a company is hinged on effective positioning. Positioning refers to perception the company builds in the minds of customers concerning their product. Strong positioning influences customers.

In order to position firms effectively company managers need to understand the competitive forces surrounding the business and position the company where those competitive forces are the weakest. Effective positioning imposes requirement on companies in terms of anticipating the possible changes within the competitive environment that may affect the industry in general and consequently devising the immediate measures to minimize the knock – on effect and maximize the positive implications of opportunities offered by the competitive environment

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 81-81

36. What is Segmentation, Market Segment and benefits of segment marketing?

Segmentation implies dividing a market into separate groups of buyers with different needs, characteristics or behavior, that may need separate products or marketing. Market segmentation can be viewed as the process of breaking down the total market for a product or service into different sub-groups or parts where each part may represent a separate target market requiring different marketing mix.

Market segmentation is an attempt to boost precision marketing of a company. The initial point for any segmentation discussion is mass marketing. Market segment consists of a large group within a market with similar wants, purchasing power, geographic location, buying attitudes or buying habits

Segment marketing offers several benefits over mass marketing. The company can create more tailored product for the target audience. The choice of distribution channels and communications channels become much easier. The company also may face less competition in a particular segment.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 256- 257

37. What is meant by Niche and Niche Marketing ?

Niche represents more narrowly defined group, generally it implies a small market whose needs are not well met and served. Marketers identify niche by dividing segments into sub-segments or by defining a group seeking a distinctive mix of benefits. Segments are normally large and attract several competitors whereas niche is fairly small and usually attracts only one of two competitor. Niche marketing implies identifying the certain segment of the general market in order to serve their needs and wants through offering tailored service or product line.

Niche marketers usually understand their target audience needs and wants so well, that customers are willing and happy to pay premium for the offered product. Customers in niche have distinctive set of needs, they pay premium for firms best satisfying and fitting their needs, the niche is not likely to attract other competitors, niche gains certain economies through specialization. Both small and large companies can apply niche marketing

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 257-258

38. Discuss the contribution of Game Theory

The criticism of Porters five forces is associated with its failure to fully consider the interactions among firms. The essence of strategic competition is the interaction among players. By Relegating competition as a mediating variable linking the industry structure with the profitability, five forces offer little insight into competition. Game theory enables the modeling of competitive interactions. It offers two valuable contributions to strategic management:

1. It permits the framing of strategic decision. Game theory provides a structure, concepts and terminology in order to depict the competitive situation in terms of :

   - identity of players
   - specifications of each players opinion
   - specifications of each payoffs from every combination of options
   - the sequencing of decisions using game trees.

2. It can predict the outcome of competitive situations and identify optimal strategic choice

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 99-100

39. Discuss bases for segmentation

Segmentation implies dividing a market into separate groups of buyers with different needs, characteristics or behavior, that may need separate products or marketing. Market segmentation must be redone periodically since market segment change.

Two broad variables are used in order to segment the consumers market. First focuses on consumer characteristics such as; geographic, demographic, psychographic, followed by examining whether these customer segments exhibit different needs or product responses.

Another viewpoint focuses on consumer responses to benefits or brands. Once the segment is formed, researchers will see whether different characteristics are associated with each consumer response segment.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University,
Prentice Hall, New Jersey,2000,, p. 263

40. What are the stages in segmentation analysis?

1. Identify key segmentation variables (determine the basis of segmentation, which customers to serve and what to offer them)
2. Construct a segmentation matrix, (once the segmentation variables are selected, determine categories)
3. Analyze segmentation attractiveness (evaluate how attractive the segment is, how effectively a company can meet the selected segment requirements)
4. Identify key success factors in each segment
5. Select segment scope (company has to decide whether it wants to be a segment expert or compete across multiple segments).

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 109-113

41. Discuss Industrial Goods Classification

Industrial goods are those applied for conducting business or certain production process, we distinguish three groups of industrial goods: material and parts, capital items and supplies and business services

- Material and parts – they fall into two categories raw material and manufactured materials and parts e.g. cotton, vegetable etc.
- Capital items – it includes two categories installations and equipment e.g. office, computer
- Supplies and business services – short lasting goods or services that facilitate the development and management of finished goods e.g. lubricant paint etc.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 397-398

42. Consumer Goods Classification

Consumer products are those bought by final consumers for personal consumption. Consumer goods include the following:

- Convenience goods- consumer usually buys frequently, immediately and with a minimum of efforts and comparison Examples are soap, sweets
- Shopping goods - purchased frequently and consumers spend time on gathering information on product in order to compare the alternative options. E.g. furniture, clothing,
- Specialty goods– goods with unique characteristics or brand
- Unsought goods - consumer either does not know about or knows about but does not normally think of buying

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 397

43. Explain New Product Development Stages

The new-product development process consists of nine steps

1. Idea generation - The new idea about the product is coming from customers, competitors, scientists, employees, R&D, sales personnel, brainstorming, discussions, distributors, suppliers.
2. Idea Screening - The purpose is to attract good ideas out of multiple choices.
3. Concept development – concept is more comprehensive option of a product
4. Concept testing – presenting the product concept to appropriate target consumers in order to get their reaction
5. Marketing strategies - depicts the target market, the planned product positioning, sales, market share and profit goals for the first few years
6. Business analyses – analyzing the financial viability of a product
7. Product development – this is the stage where the product has already passed through previous stages and prototypes will be developed that will be assessed

8. Test marketing is the second to last stage. The new product is introduced and put to a market test in order to learn how the market will react and how consumers and dealers react to handling, using and repurchasing the product.
9. Commercialization is where the product is about to be launched on the market. All of the various filters have taken place, but even at this stage success is not guaranteed.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 334-351

44. Discuss Product Classification according to durability and tangibility

Products can be classified according to their durability and tangibility.

Non-durable products are goods that are normally consumed rapidly and consumed in one or a few uses, such as beer, soap and food products.

Durable products are products used over an extensive period of time and usually survive for many years. E.g. refrigerators, cars and furniture.

Service - is intangible, inseparable and perishable products, they require higher level of control, supplier credibility and adaptability e.g. haircut, repair

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 396

45. What are the factors influencing the new-product adoption process?

There are several factors influencing the new product adoption process, and among these factors are those beyond the control of marketers such as:

- Consumers and organizations willingness to try new product
- Consumers and organizations readiness to try new product
- Characteristics of the new product or innovation
- Personal influences

Therefore new product marketers have to research all these factors and give the key maximum attention to design and the adequate marketing programs.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 355-357

46. List the types of new products

- *Innovative products* - they represent completely new to the marketplace.
- *Replacement products* - new product with the old traditional theme that might be represented with a new design and functions.
- *Imitative products* – often represent innovative product that has been successfully established. Marketing slang refers to them as ‘me too’ products.
- *Re-launched products* – it takes place when an original product has undertaken a decline stage, but still sufficient potential for sale is available if the image of the product is changed through marketing mix tools.

Geoff Lancaster, London School of Commerce. Lecture notes, 2009

47. Explain Product Life Cycle

The product life cycle has four stages:

1. Introduction - a period of slow sales growth as the product is introduced in the market. Profits are non-existent in this stage because of the heavy expenses of product introduction.
2. Growth - a period of rapid market acceptance and profit improvement.
3. Maturity - a period of slowdown in sales growth because the product has achieved acceptance by most potential buyers. Profits stabilize or decline because of increased marketing outlays to defend the product against competition
4. Decline is the period when sales fall off and profits drop.

Kotler, P. The Millennium Edition, “Marketing Management”, Northwestern University, Prentice Hall, New Jersey,2000, pp. 303-304

48. Explain the concept of Product Life Cycle (PLC)

Every product has a life cycle , which implies that the following four things need to be considered:

- Products have limited life time
- Product sales pass through distinctive stages, each posing different challenge, opportunities and problems to sellers
- Profits rise and fall at different stages of the product life cycle
- Product require different marketing, financial manufacturing, purchasing and human resources strategies in each stage of their life cycle

Kotler, P. The Millennium Edition, “Marketing Management”, Northwestern University, Prentice Hall, New Jersey,2000, p. 303

49. What are the critiques of the Product Life Cycle ?

The product life cycle concept (PLC) is applied to interpret the product and market dynamics. It helps managers to identify at what stage the product is and what actions and measures are to be taken, in other words facilitates the identification of challenges that need to be addressed through different marketing strategies. Critics of the PLC empathize that PLC patterns are too variable in their shape and duration, they lack the fixed sequence of stages and fixed length of each stage. Critics also underline the fact that marketers often fail to indicate at what product life cycle stage is a particular product. They charge that the PLC pattern is more a result of marketing strategy rather than an inevitable course that sales must follow

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 315

50. Explain Push Strategy

A push promotional strategy - involves taking the direct promotion of product by using sales force and trade promotion in order to sell a product to end user. Such approach is appropriate especially when a brand is not characterized with high brand loyalty, when a choice is made right in the store and benefits are well understood.

Examples of push tactics

- Trade show promotions
- Direct selling to customers or face to face
- Negotiation with retailers to stock your product
- Packaging design to encourage purchase

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 567

51. Explain Pull strategy

A pull strategy involves – selling strategy requiring soaring costs on advertising and consumer promotion to generate consumer demand for a product. This approach is especially appropriate in the presence of high brand loyalty and high involvement in the category when people perceive differences between the brands and brand purchase decision is made before coming to store

Examples of pull strategy

- Advertising and mass media promotion
- Word of mouth referrals

- Customer relationship management

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 567

52. What is Customer Value and how to create it?

Customer value is the ration of benefits to the sacrifice necessary to obtain these benefits. Creating customer value is a core business strategy of almost all successful and profitable companies. Customer value is created through increasing the perceived benefits and minimizing perceived sacrifice. Customer satisfaction occurs when perceived performance matches or exceeds expectations. Marketers interested in customer value should perform the following:

- Offer product that perform
- Give more than expected]
- Offer realistic price
- Offer organization-wide commitment in service and after sales support.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. xxxii

53. What is Marketing Research and what are the steps included in the research process?

Marketing research is the regular design, collection, evaluation, and reporting of data and findings. Effective marketing research encounters six relevant steps which are as follows:

- Define the problem, decision alternatives and research objectives
- Develop the research plan gather secondary and primary information, select research approach
- Collect relevant information
- Analyze the information
- Present the findings
- Make the decision

Kotler, P. & Armstrong, G. "Marketing. An Introduction", 2nd edition, Northwestern University, 1990,pp. 44-45

54. Define marketing research and its importance to marketing decision

Marketing research can be classified as a process of collecting, assessing and analyzing data with the aim to solve a specific posed problem. Marketers use marketing research in order to investigate profitability of marketing strategies. It helps to analyze why certain strategies fail and analyze characteristics of specific market segment. Marketing research enables the company to keep proactive position, rather than reactive, to identify fresh emerging patterns in the environment. The task of marketing is to facilitate the creation of exchange.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,pp. 292-293

55. Discuss the development process from knowledge creation to innovation

Basic knowledge — invention – innovation – diffusion = imitation/adoption

Invention is the creation of a new product and processes through the development of new knowledge or through combination of existing knowledge. Innovation is the initial commercialization of invention by producing or marketing a new good service or by using a new method of production. Once introduced innovation diffuses- on the demand side through customers purchasing good/innovation diffuses- on the demand side through customers purchasing good/service and on the supply side though imitation by competitors.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, p. 298

56. What is Patent /Copyright/Trademark/Trade secrets ?

Patents – the exclusive right to a new and useful product, process, substance or design. Patent right differ in all countries.

Copyright – exclusive production, publication, or sales right to the creators of artistic, literary, dramatic or music works. Examples are articles, books, musical compositions

Trademark – words, symbols, or other marks used to distinguish goods or services supplied by a firm. Trademark provides basis for brand identification

Trade secrets – is a modest degree of legal protection for recipes, industrial processes, and other knowledge acquired in the course of business

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, p. 300

57. Discuss the Marker Followers Strategies

Firms applying the market follower strategies seek stable market shares and profit by following competitors' product offers, prices and effective marketing programs. Many companies prefer to follow rather than challenge the leader. One broad strategy for followers is to be a counterfeit, copying the leaders product, package and selling it on the black market. Another strategy is cloner - imitating the leaders product, the third strategy is imitator – copying some things from leader. The fourth strategy is adapter – adapting or improving the leaders product. Normally followers ear less than the leaders

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 172

58. Discuss the Marker Challenger Strategies

Market challengers first define strategic objective. Market challengers first identify whom to attack and then apply aggressive attack on competitors. market challengers also attack firms of their own size that are underperforming, have aging products, charge excessive prices or fail to satisfy customers in any other way. Five general market-challenger attack options are the followings:

- Frontal attack - match the opponents products, advertising, price and distribution
- Flank attack – Identifying shifts in market segments that cause gaps to develop, then filling the gaps and developing them into strong segment
- Encirclement attack – launching a grand offensive on several fronts
- Bypass attack – bypassing the enemy and attacking easier markets
- Guerilla warfare – small intermittent attacks to harass the opponents

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 170-171

59. The tools of IMC Integrated Marketing Communication

Integrated Marketing Communications can be viewed as a careful coordination of all promotional messages – general advertising, direct marketing, interactive, public relations, sales promotion, personal selling, event marketing and other communications- to ensure that message is consistent at any point of interaction between the company and customer. With the consideration of IMC method marketing managers identify the role of each promotional element played in the marketing, mix. Timing of the promotional activities is coordinated and result of each campaign is evaluated against the desired outcome in order to identify the weaknesses of the promotional mix tools that need to be addressed. The basic tools used to accomplish an organization's communication objectives are often referred to as the promotional mix. Generally, the promotional mix included four elements: advertising, sales promotion, publicity/public relations, and personal selling.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western,2006,p. 498

60. Discuss factors affecting the Promotional Mix

The elements of promotional mix encompasses four elements: advertising, sales promotion, public relations and personal selling. There are many factors that may influence the promotional mix elements, therefore promotion managers look at many things when creating promotional mix. Much attention deserve such factors as: nature of the product, product life cycle, target market characteristics, type of buying decision involved, availability of funds, feasibility of push and pull strategy. As the product goes through the different life cycle stage, marketers choose different promotional mix elements. For e.g. advertising is applied at the introductory stage, small firms with limited resources rely heavily on public relations, whereas large firm apply advertising. If pull strategy is selected firm undertakes aggressive mass promotion, such as advertising and sales promotion to stimulate consumer demand.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 501

61. Explain the term - Marketing Channel

Marketing channel represents a business structure of interdependent organizations reaching from one point of product origin to the consumer with the aim of physically moving products to their final consumption destination, representing place or distribution in the marketing mix and involving the processes of getting the right place to the right destination. Members of the marketing channel create supply chain and support marketing channel functioning.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 426

62. Discuss three types of marketing channels applied by marketers

Marketing channel represents a business structure of interdependent organizations reaching from one point of product origin to the consumer with the aim of physically moving products to their final consumption destination, representing place or distribution in the marketing mix and involving the processes of getting the right place to the right destination. To reach the target market marketers use three types of marketing channels, which are as follows:

- Communication channels – deliver and receive messages from target group, e.g. TV, radio, newspaper, etc.
- Distribution channels – distributors, wholesalers, retailers and agents
- Service channels – to carry out transactions with potential buyers

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 14

63. What is Marketing Communication and 6 major models of marketing communication?

Marketing communications – referred to those means applied by the companies in order to inform, to increase awareness, persuade, and remind consumers directly or indirectly about the products they offer.

<u>Marketing communication mix consist of 6 major models of communication</u>

1. Advertising – paid form of non-personal presentation and promotion of ideas, goods or services
2. sales promotion – short term incentive to stimulate and promote purchase of
3. Events and experiences – company sponsored activities and programs aimed at creating the brand related connections
4. PR and publicity – programs protecting and promoting the company or product image.
5. Direct marketing – use of mail, phone, fax, internet to communicate directly to customers
6. Personal selling – face-to-face interaction with prospective purchasers.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 550

64. Discuss the role of marketing communications

Marketing communications – are referred to those means applied by the companies in order to inform, increase awareness, persuade and remind consumers – directly or indirectly about the products they offer.

Marketing communications tell or show consumers how and why a product is used, by what kind of consumer, where it is applied and how, give information to a customer about what a company stands for and how a company offers certain advantage for trying the offered product. Marketing communication greatly contribute to increasing awareness on product, positioning the brand image, triggering brand response from customers and facilitating brand and customer connection.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 278-279

65. Define the meaning of Direct Marketing

Direct marketing implies direct communication to a consumer with the aim to generate a response in the form of request for further information or direct order or visit to a store or purchase of a specific product or service.

Direct marketing – is often called direct response marketing. it refers to the techniques applied to make customers purchase product from home, office or other non-retail settings. It can be considered as a pro-active approach to marketing that takes a product to potential customers rather than waiting for them to come and have access to a product. Direct marketing techniques involve: direct mail, catalogues and mail orders, telemarketing, and electronic retailing.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 447

66. Discuss CRM and is nature

Customer Relationship Management is the term that describes methodologies and technologies applied by firms in order to effectively manage customer relationships. The fundamental principles behind the CRM is that company staff has a common understanding of the importance of customers' point of view.

Companies have to analyze how effectively they are implementing the CRM principles by checking the following: general planning, the proposition made to each segment, how well information and technologies are applied, how well staff is supported by an effective organizational structures.

CRM is a company-wide business strategy designed to optimize profitability, revenue and customer satisfaction by focusing on highly defined and precise customer group.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 660

67. What is meant by Guerilla Marketing

Guerilla marketing – requires any marketer who wants to attack and grab share from the leader without risking the higher costs and provocation of frontal attack. In order to start guerilla marketing marketers must think creatively about how to attract customers attention and how to achieve marketing goals with minimum investment. Guerilla marketing does not mean being socially responsible.

Initially, guerilla marketing tactics were applied by small companies with limited budgets and marketing capabilities who were creative in getting their name out. Partially due to its successful appliance by smaller companies resulting into success stories, larger companies have started employing these methods as well.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 171

68. Explain the Corporate Social Responsibility CSR

The Corporate Social Responsibility – represents a business concern regarding the welfare of the society. CRS can be discharged across five dimensions: physical environment, social, consumer, supply chain and employee relations.

The newest theory in social responsibility is called sustainability. Sustainability – implies that socially responsible companies will outperform their peers by focusing on the worlds social problems and view them as the opportunity to build profits and help the world in the meantime. The pyramid of corporate social responsibility is a model –suggesting that CSR is composed of economic, legal, and philanthropic responsibilities and that the firm's economic performance supports the entire structure.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 70

69. Explain the meaning of Licensing

Another extremely effective way of moving into a global market offered to companies is licensing, which bears relatively low risk. Licensing is a process where a licensor permits another company to use its manufacturing process, trademarks, patents, trade secrets, or other proprietary knowledge. The licensee has to pay licensor a royalty or fee, which is preliminary agreed between the parties.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 124

70. What is Franchising?

Franchising represents a business model uniting different owners in a single brand name. Franchising is type of licensing where certain package of services is offered by the franchisor to franchisee in return of payment. There are two types of franchising : Product & Trade Name Franchising, the best example is coca. A parent company permits entrepreneurs to apply the company's strategies and trademarks and in exchange, the franchisee pays an initial fee and royalties based on revenues. The parent company also provides the franchisee with support, including advertising and training, as part of the franchising agreement.

Franchising represents faster and cheaper form of growth and expansion, since opening of a new store costs much more. Though it should be mentioned that potential for revenue growth is limited since the parent company will only earn a percentage of the earnings from each new store.

Lamb, Ch., Hair, J. &McDaniel, C."Marketing 8",Thomson South Western, 2006,p. 437
http://www.wikinvest.com/concept/Franchising

STRATEGIC MANAGEMENT

71. What is Mission Statement?

The basis of the marketing plan is mission statement, addressing the questions of what business is the company in. Business mission influences the firm's long –run resources allocation, profitability and survival. Mission Statement represents a statement of Firm's business based on cautious analysis of benefits sought by present and potential customers and analysis of current and possible future environment.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 40

72. Discuss the drivers of uniqueness when applying the differentiation strategy

Differentiation is concerned with the provision of uniqueness. Company's opportunity to be unique in offering a product is not located in particular function or activity but can be generated from everything it does. Porter identified several drivers of uniqueness, which are as follows:

- Product features and performance
- Complimentary service
- Effective marketing activities
- The quality of acquired input
- Skilled and experienced staff
- Technology embodied in the design and manufacture
- Location
- Procedures influencing the conduct of each activity (e.g. control, service procedure etc.)
- The degree of vertical integration

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 253-254

73. Discuss Product Differentiation Strategy

Product differentiation is one of the paramount strategies enabling a company to gain competitive advantage by growing the customers' willingness to pay more for the offered differentiated product.

The success of a company is hinged on effective positioning. Positioning refers to perception the company builds in the minds of customers concerning their product. Strong positioning influences customers.

Differentiation offers more secure basis for competitive advantage than low cost, since cost advantage is highly vulnerable to unpredictable external forces.

Sometimes customers' perception creates basis for product differentiation which is neither designed by the company nor desired. Successful differentiation strategy involves matching customers' demand for differentiation with the firm's capacity to supply differentiation.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 247-251

74. Discuss basis for product differentiation

1. Product features –
2. Product complexity – identifies how complex an individual product is
3. Timing of product introduction - introducing the right product at the right time and enjoying the advantage of the first mover can greatly contribute to a company's product differentiation.
4. Location –
5. Product customization – when a product is tailored for a particular customer e.g. enterprise software
6. Product reputation – socially complex relationship between the company and customer.
7. Linkage among functions of the company – connection between the different functions of the company facilitates better understanding of a product, various team members can better understand the new attributes, features of a product.
8. Linkage with other firms –
9. Distribution channel – how correctly channels are selected by the company in order to distribute a product e.g. Contemporary Strategy Analysis, Robert M Grant, 7-th edition, P-245-264

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 253-254

75. How does product differentiation strategy help to minimize the threat coming from 5 force identified by Porter ?

Successful product differentiation helps to reduce the threat coming from five forces identified by Porter.

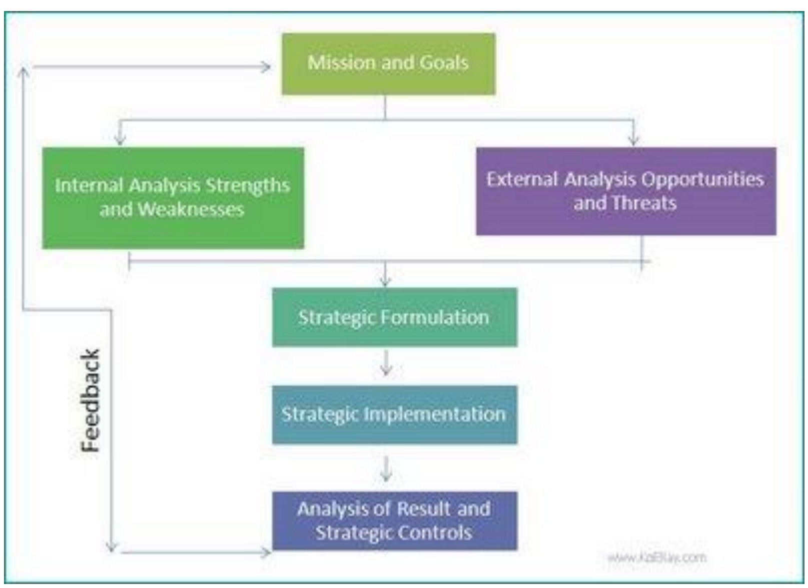
1. Successful differentiation sends a signal to a new entrant that the costs of overcoming the incumbent company's differentiation will be too costly and may easily prevent the new entrant decision to join the market.
2. Successful differentiations reduce threat from rivalry, by curving out unique product niche. Indeed competition is still on for a common set of customers though it is somewhat attenuated.
3. Product differentiation reduces threat from substitute product by making the initial product more attractive than the substitute one.
4. Product differentiation reduces threat from suppliers. When suppliers increase prices of service, this price surge must be offset by increasing the cost of a product. Highly differentiated product is more likely to be accepted by loyal customers with a high price.
5. Product differentiation - can reduce the threat of buyers by enjoying quasi monopoly in that segment of the market. So, buyers wanting this product must buy it from a particular firm.

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002, pp. 279-280

76. Discuss Strategic Management process

Strategic Management process encounters several correlated activities which are as follows:

- Situation analysis – scanning and evaluation the current organizational context, external environment and organizational environment.
- Strategy formulation – choosing the appropriate strategy for the company.



- Strategy implementation – putting various plans into action
- Strategy evaluation – evaluation how strategy has been implemented. A company representatives have to monitor both the implementation process and performance outcomes. If the outcome fails to deliver the desired outcome, a strategy must be modified or amended.

http://www.koellay.com/2009/05/strategic-management-and-planning.html

77. Why external analysis is important?

Marketing managers have to understand the external environment in order to effectively plan for future. The evaluation process commences with scanning in order to identify opportunities and threats. There are many benefits associated with the external environment assessment such as ability to better plan for future, to set up smart strategy capable of delivering the desired outcome, to be more flexible in terms of responding to unexpected developments triggered by changing environment, to identify threats and opportunities and forecast trends, to be proactive rather than reactive. At the background of fluctuating environment marketers have to act as adapters rather than agents of change. The external environment comprises of competitors, technological developments, social changes, political and legal factors, economic condition, and demography. Consideration and assessment of all those factors is of high importance, having immense influence on the successful development of a company.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006, pp.75-7

78. Explain Prisoner's Dilemma

The prisoner's dilemma is a canonical example of a game, analyzed in game theory that shows why two individuals might not cooperate, even if it appears that it is in their best interest to do so. It was originally framed by Merrill Flood and Melvin Dresher working at RAND in 1950. Albert W. Tucker formalized the game with prison sentence payoffs and gave it the "prisoner's dilemma" name Poundstone, 1992. A classic example of the prisoner's dilemma *PD* is presented as follows:

Two men are arrested, but the police do not possess enough information for a conviction. Following the separation of the two men, the police offer both a similar deal- if one testifies against his partner defects / betrays, and the other remains silent cooperates / assists, the betrayer goes free and the cooperator receives the full one-year sentence. If both remain silent, both are sentenced to only one month in jail for a minor charge. If each 'rats out' the other, each receives a three-month sentence. Each prisoner must choose either to betray or remain silent; the decision of each is kept quiet. What should they do?

If it is supposed here that each player is only concerned with lessening his time in jail, the game becomes a non-zero sum game where the two players may either assist or betray the other. In the game, the sole worry of the prisoners seems to be increasing his own reward. The interesting symmetry of this problem is that the logical decision leads both to betray the other, even though their individual ‘prize’ would be greater if they cooperated.

In the regular version of this game, collaboration is dominated by betraying, and as a result, the only possible outcome of the game is for both prisoners to betray the other. Regardless of what the other prisoner chooses, one will always gain a greater payoff by betraying the other. Because betraying is always more beneficial than cooperating, all objective prisoners would seemingly betray the other.

In the extended form game, the game is played over and over, and consequently, both prisoners continuously have an opportunity to penalize the other for the previous decision. If the number of times the game will be played is known, the finite aspect of the game means that by backward induction, the two prisoners will betray each other repeatedly.

In casual usage, the label "prisoner's dilemma" may be applied to situations not strictly matching the formal criteria of the classic or iterative games, for instance, those in which two entities could gain important benefits from cooperating or suffer from the failure to do so, but find it merely difficult or expensive, not necessarily impossible, to coordinate their activities to achieve cooperation.

http://en.wikipedia.org/wiki/Prisoner's_dilemma:
Grant, Robert M. “Contemporary Strategy Analysis”, 7-th edition,
John Willey &Sons Ltd Publication, 2010

79. Explain the meaning of Strategic Fit

Strategy represents a link between the organization and its external environment - which is a notion of strategic fit. For the strategy to be successful it must comply with the external environment, and with the internal environment – with goals, values, resources, capabilities, structure and system. Mostly failure of the company to attain the desired outcome is often attributed to an inconsistency existent within the company. Such viable argument can serve as a justification that the notion of strategic fit goes beyond the simple notion implying the importance of compliance between the company’s external and internal environment. The theory of the strategic fit encounters the focus on organizational design – called contingency theory and the view of the firms interlinked activities.

Grant, Robert M. “Contemporary Strategy Analysis”, 7-th edition,
John Willey &Sons Ltd Publication, 2010, p. 13

80. Explain Resource Based View and its importance

Resource Based View RBV says that a firm's resources and capabilities are the key factors in terms of gaining and maintaining the competitive advantage. Resource based view can be applied to individual firms to understand whether these firms are capable of gaining sustainable competitive advantage .

Resources include; financial, physical, human, tangible and intangible, structural/cultural assets used by an organization to develop, produce and deliver products or services.

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002, p. 178

81. Explain the meaning of Horizontal Integration

"Horizontal integration is a practice in business by which companies that produce a similar product or provide a similar service merge. Generally, a company will engage in horizontal integration to increase its share of the market for a certain kind of product or service. Such horizontal growth is an important part of the study of business and of microeconomics, and is also an important strategic management skill.

Integration is considered horizontal only if all mergers and acquisitions are conducted at the same level of production. The goal of horizontal integration is not to control all aspects of production, from raw materials to the final product. It is, instead, to be able to produce a large number of the same product or similar products and to control a large share of the market."

http://www.wisegeek.com/what-is-horizontal-integration.htm, accessed on Dec. 11. 2011

82. Discuss reasons for Mergers and Acquisitions

Firms can use merger and acquisitions to create corporate strategies. The reason behind the M&A can be summarized as follows:

- To reduce competition
- To increase growth rate and capture a greater market share
- To improve value of organizational stock
- To acquire needed resources quickly
- To take advantage of synergy
- To acquire resources to stabilize operations
- To achieve economies of scale

http://www.slideshare.net/suresh.singh/growth-strategies-presentation-805753, p.9

83. Discuss M&A and categories of mergers and acquisitions

A merger – implies combination of two similar size companies in order to form a new company. An acquisition takes place when one company clearly purchases another and turns into a new owner.

- Vertical merger – a firm acquires former suppliers or customers. When it vertically integrates either forward or backward through its acquisition efforts
- Horizontal merger – a firm acquires a former competitor
- Product extension merger – a firm gains access to complimentary products through an acquisition
- Market extension merger – a firm gains access to complimentary markets though an acquisition
- Conglomerate merger – there is no relationship between a bidding and a target firm

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002, pp. 485-486

84. Discuss the role of analysis in strategy formulation

The intuition, creativity and spontaneity – do represent those vital qualities the absence of which may result into unfavorable outcome. Those are the essential qualities of a successful strategy. Whether the strategy formulation is formal or informal, deliberate or emergent systematic analysis of the strategy is a vital input into the strategy process. Without analysis strategic decision would be susceptible to power battles, individual whims, and wishful thinking. Concepts, different theories and analytical tools are the compliments not substitutes for experience commitment and creativity. They aim at creating frameworks for organizing decisions, processing information and options and facilitating agreement. The purpose of strategy analysis is not to provide answers but to help understanding the issue. Increased understanding of the fundamental issues concerning competitive advantage, customers' needs and general frameworks can greatly facilitate the innovation and flexibility and the formulation of an accurate strategy capable of delivering the desired outcome.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 26-27

85. Discuss Henry Mintzberg's Competitive Strategies

Henry Mintzberg offered an alternative type of competitive strategies that better reflects the increasing complexity of the competitive environment. He proposed six possible competitive strategies. These include differentiation by price, differentiation by marketing image, differentiation by product design, differentiation by product quality, differentiation by product support, and undifferentiated.

- Price – represents a variation of Porter's low cost leadership strategy
- Marketing image – creating image in the minds of customers as a competitive weapon
- Product design – distinctiveness by providing desirable features and design
- Product quality – delivering reliable quality of an offered product
- Product support – providing an all-encompassing desired customer support services.
- Undifferentiated – absence of any basis for differentiation and therefore following a copycat strategy

http://www.openlearningworld.com/books/Competitive%20Strategies/Traditional%20Approaches%20to%20Competitive%20Strategies/Mintzbergs%20Competitive%20Strategy.html

86. Discuss Strategic Planning Cycle

Small companies can operate without an explicit strategy, since it may exist in the minds of management and founders. This can't be applied to large companies where the presence of accurate strategic plan is of high importance. Most large companies have a regular annual strategic planning process. For multibusiness company this process creates business plans for separate divisions that are integrated into a corporate plan

Formal or informal, systemic or ad-hoc, documented or not- documented strategy formulation process is an important vehicle for achieving coordination within the company. The system through which the strategy is formulated varies within companies. As companies mature their strategic planning process becomes more systematized. The typical strategic planning process comprises of the following elements:

- A statement of the goals – the company tries to achieve, it refers to both financial and strategic goals.
- A set of assumptions and forecasts – about the major developments in the external environment
- A qualitative statement - how the shape of the business will be changing in relation to geographic and segment emphasis and the basis of the company's competitive advantage.
- Specific action steps – refers to steps and decisions to be undertaken within the specific dates
- A set of financial projections –

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 198-199

87. What are the major Growth Strategies?

- Market penetration strategy (grow by selling more of an organization's existing products to existing customers)
- Market development strategy (grow by selling more of an organization's existing products to new customers)
- Product development strategy (develop new product)
- Diversification (grow by serving new customers through delivering new products).

Based on Geoff Lancaster, London School of Commerce. Lecture notes, 2009

88. What is Strategic Business Unit?

Strategic Business Unit SBU represents a subgroup of a single business or collection of related businesses within the large organization. A proper SBU must have clear mission and specific target market, control over its resources and competitors as well as detailed plan of action. An SBU can be a company division, a product line -within a division, or sometimes a single product or brand.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 42

89. Discuss challenges facing the implantation of corporate strategy in the multi-business company

Formulation and implementation of corporate strategy in the multibusiness company presents very complex issue. Strategy analysis needs to be wider in order to address challenging issues such as organizational design, management control, and coordination between business. However developing general recommendation as to how multibusiness company should implement its corporate strategy is impossible due to the fact that all companies are unique in terms of its portfolio of products and markets, resources and capabilities, corporate culture and administrative heritage. Considering all this it is impossible to lay out accurate guidelines. Managing multibusiness organization is a tough job and requires abstracting from the complexity of the large, multifunctional, multiproduct and multinational firms. The key to its complexity is strategic fit, corporate strategy, business strategy, the external environment, in combination with the firms resources, capabilities, structure, system, leadership style and culture need to be consistent and closely linked. Another major challenge is that business environment in general entered into a new phase of continuous change in need of rapid adaptation process.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 451-452

90. What is corporate strategy and how it is related to other organizational strategies?

Corporate strategy defines the scope of the firm in terms of the industries and markets in which it competes. It deals with the wide and long term choices of what businesses the organization is in or wants to be in future. It can be applied to both single business and multiple business organizations. The corporate strategy facilitates the establishment of the overall direction the organization, whereas the other organizational strategies contribute to ensuring the presence of means for getting there. Corporate strategy decisions include choice in diversification, vertical integration, acquisitions and new ventures and the allocation of resources between the different businesses of a company.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, p. 19

91. Explain the Business Strategy

Business strategy deals with the idea of how the firm competes within a particular industry or market. If a company wants to be successful it must establish and develop competitive advantage over competitors, must perform much better than competitors, must establish the competitive strategy enabling the business to prosper and thrive. It refers to a successful plan of how the company must use assets and resources successfully to the benefit of their long term goals.

It commences with the idea of what strategy to establish, how to implement it effectively and how to evaluate. Formulation of a business strategy is a complex job for managers requiring relentless efforts fitted within the excellent business idea.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, p. 19,
http://www.briefcasebooks.com/formisano01.pdf, p. 5-6

92. How can Value Chain be applied in identifying the opportunities for differentiation advantage?

Using the value chain to identify opportunities for differentiation advantage involves four principal stages:

- Construct a value chain for the firm and the customer – it is worth considering both immediate customers and firms further downstream in the value chain
- Identify the drivers of uniqueness in each activity - evaluate the company's potential for differentiation by examining each activity in the firm's value chain and by

identifying variables and actions enabling the company to achieve the uniqueness in relation to competitors offerings.

- Select the most promising differentiation variables for the firm – identifying where the firm has potential for differentiation, identifying linkages between the activities, since some differentiation variables may involve interaction among several activities, and which type of differentiation can be sustained
- Locate linkages between the value chain of the firm and that of the buyer – differentiation has to yield price premium, this is dependent on the ability of the offered differentiation to create value for the customer

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 260-261

93. Explain the meaning of Agency Problems /Agency Costs

When one party to an exchange delegates the decision making authority to another party of exchange, an agency relationship takes place between the parties. Agency problem can be referred to as a conflict of interest generated between shareholders, creditors and management due to conflicting goals. In numerous situations the interests of the outside equity holders and mangers diverge. Parties in an agency can be involved in actions reducing the agency problems, though such actions are costly. It does represent a problem existent in every organization and parties try to sort it out by instituting measures such as screening process, incentives for superior action and punishment for wrong actions, watchdogs can be involved for the monitoring reasons, but full remedy is hard since it costs company a lot . the cost of actions undertakes for the purpose of reducing the agency problems are called agency costs.

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002, p. 446

94. Explain Competitive Advantage/Competitive Parity and Competitive Disadvantage

Competitive advantage – when a company experiences strategic advantage over competitors, when its actions in the industry or market create value and few competing firms are engaged in the similar actions. Company gains competitive advantage when the theory of how to compete within an industry is consistent with the economic processes in that industry and market and only few other firms share it.

Competitive parity – when a company crates value, but numerous other firms are engaged in the similar actions and have similar success. Company gains competitive parity when the theory of how to compete within an industry is consistent with the economic processes in that industry and market and numerous other firms share it.

Competitive disadvantage – when company actions in the industry or market fail to create any economic value

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 9-22

95. Identify the sources of competitive advantage

Competitive advantage – when a company experiences strategic advantage over competitors, when its actions in the industry or market create value and few competing firms are engaged in the similar actions. Company gains competitive advantage when the theory of how to compete within an industry is consistent with the economic processes in that industry and market and only few other firms share it.

There are three types of competitive advantage: Cost, Product/Service Differentiation and Niche Strategy.

Sources of cost competitive advantage are – experience curve, efficient labor, no-frill goods and services, government subsidies, product design, reengineering, product innovation and new methods of service delivery

A product /service differentiation source is uniqueness that is valuable to a customer

Niche competitive advantage comes from targeting unique segments with specific needs and wants

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 58

96. Explain the meaning of Core Competence and Distinctive Organizational Capabilities

Core competences has been defined by Harnel and Prahalad as "The collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies", Core competence can be considered as a set of resources and capabilities that connects different businesses in a diversified company through managerial and technical know-how experience and wisdom. Distinctive organizational capabilities – are the particular and exceptional capabilities that differentiate an organization from its competitors and three features are characterizing for them:

1 - greatly contributes to delivering superior customer value.

2 - facilitates to create product which is difficult for competitor to imitate

3 - can be applied in a variety of ways to the benefit of the company. Distinctive capabilities can directly lead to a competitive advantage

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition,
Prentice-Hall, NJ, 2002, p. 415

97. Discuss different types of industry structure

Assessment of a competitive environment is an essential element providing basis for generating an idea of how to develop a competitive advantage, and how to compete effectively, how to outperform competitors in providing more valuable service or product. Economists describe four main types of competition:

- Perfect competition – characterized by a large number of competing firms, homogeneous products, low cost entry and exit.
- Monopolistic competition- characterized by large number of competing firms, heterogeneous products , low cost entry and exit
- Oligopoly- small number of competing firms, homogenous and heterogeneous products, costly entry and exit
- Monopoly –exists when an industry comprises of a single organization protected by high barriers of entry

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, p. 77

98. Discuss different types of industries

Fragmented industries – where a large number of small or medium –sized firms operate and no small set of firms has dominant market share or creates dominant technologies.

Emerging industries - newly created/recreated industries formed by technological innovations, changes in demand, the emergence of new customer needs, etc. e.g. microprocessor industry, personal computers industry, medical industries etc.

Mature industry - has passed both the emerging and the growth phases of industry growth and where the rate of innovation has dropped

Declining industry – has experienced absolute decline over sustainable period of time. Obviously

Internationalization of firms became very popular for the last few years and it applies to both large and small companies.

Network industry – value of a product or service being sold is dependent on the number of those products being sold e.g. telephone is not valuable product when only small number is sold

Hypercompetitive industry – stable and predictable bases of competition makes it easier to understand the range of opportunities within the industry, the opposite environment where industry is both unstable and unpredictable is called hypercompetitive industry

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, p. 110

99. Explain Porter's Five Forces

5 forces help the marketer to contrast a competitive environment. It has similarities with other tools for environmental audit, such as PESTEL analysis, but tends to focus on the single business or SBU Strategic Business Unit rather than a single product or range of products.

1. Threat of new entrant – new entrants are those who have recently started the business, where they need to establish themselves. For that reason they are motivated to enter the industry by above – the normal profit, in other words they prefer low profit and more recognition and establishment of themselves into the market. If there are no barriers of entry, this will increase the competition and reduce the performance of incumbent firms.
   If the cost of entry to the industry is higher that the potential profit of the company, the entry won't be an attractive step. If the cost of entry is lower than the potential profit the entry will be attractive step. So the threat of entry depends on the Barriers to entry
2. Competitive Rivalry – there are too many competing firms of the same size having the similar influence, which reduces the industry growth, inhibits the product differentiation, all this has the tendency of reducing the economic profit.
3. Threat of substitute - substitute products play an increasingly huge role in reducing the profitability of an industry
4. Bargaining power of suppliers – suppliers can threaten the profitability of a company by increasing the service price or reducing the service quality. This can be the case if the number of companies dominate over suppliers, if suppliers are selling unique product, if there is no substitution for suppliers.
5. Bargaining power of customers – buyers have bigger options for choosing the product, bargaining power of customer increases when the supply exceeds demand, offered product is standard and easily available.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 63-83

100. According to Porter's 5 forces, discuss the 5 main barriers to entry

A. Economies of scale- When more units of a good or a service can be produced on a larger scale, yet with on average less input costs, economies of scale ES are said to be achieved. With the economy of scale supply can be increased over demand, which discourages the entry.

B. Product differentiation – means that already existent companies have brand identification and customer loyalty, which is the advantage for them. If the cost of overcoming this advantage Is higher than potential profit it will discourage the entry.

C. Cost advantage independent of scale – cost advantage can deter the entry. There are 5 cost advantages 1 proprietary technology 2 know –how 3 favorable access to raw material 4 favorable geographic location 5 learning curve cost advantage

- 1 proprietary technology – the development of this technology can be expensive as well as copying will be expensive step
- 2 know –how - is practical knowledge of how to get something done, Know-how is often tacit knowledge, which means that it is difficult to transfer to another person by means of writing it down or verbalizing it. Acquiring this know-how will be costly and will take too much time for new entrants
- 3 Favorable access to raw material – e.g. being closer to raw material resource is a big advantage ,
- 4 Favorable geographic location
- 5 learning curve advantage, e.g. airplane benefit over the new entrant is the gained experience and knowledge

D. contrived deterrence - companies sometimes deliberately invest heavily in upgrading and maximizing their manufacturing capacity in order to send a signal to new entrant that coming to a market can be costly and full of competitive pressure

E. government regulation of entry – government can impose strict regulations in order to protect the already existent incumbent companies.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 63-83

101. Explain Porter's Generic Strategy

In 1980 Michael Porter identified three generic strategies for achieving success in a competitive market:

- Overall cost leadership – achieving the lowest production and distribution costs so that it can price lower than competitors and win a larger market share.
- Differentiation – focus on achieving superior performance in an important customer benefit area valued by the market
- Focus – concentrating on a product range or a unique segment of the market or a combination of them both.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition,
Prentice Hall, 2007, p. 31

102. Discuss four part framework identified by M. Porter for predicting the competitors behavior

Competitive intelligence is not only about gathering information. The problem is gathering relevant and required information and identifying the purpose of using this information. The objective is to understand the rival, their weaknesses and strengths. Michael Porter proposed a four part framework for predicting competitors' behavior. It comprises of the following:

- Competitors current strategy – predict how a competitor is competing now and how it will act in future, identifying the main strategy for competition
- Competitors' objectives – identifying competitors current goals, to what degree whose goals are met and how likely they are to change
- Competitors' assumptions about the industry – identifying the competitors assumptions regarding the industry and environment in general
- Competitors' resources and capabilities – identifying the likelihood and seriousness of competitors' strength, resources and capabilities, what are the key strengths and weaknesses of the rival company.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 105-106

103. Discuss SWOT analysis

SWOT analysis draws the critical strengths, weaknesses, opportunities and threats SWOT from the strategic audit. The audit contains data of differing importance and reliability. SWOT analysis distils these data to show the critical items from the internal and external audit. The number of items is small for forceful communications, and they show where a business should focus its attention.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 76-77

104. Discuss PESTEL analysis

There are many factors in the macro-environment that will affect the decisions of the managers of any organization. Tax changes, new laws, trade barriers, demographic change and government policy changes are all examples of macro change. To help analyze these factors managers can categorize them using the PESTEL model. This classification distinguishes between:

- *Political factors.* These refer to government policy such as the degree of intervention in the economy. Political decisions can impact on many vital areas for business such as the education of the workforce, the health of the nation and the quality of the infrastructure of the economy such as the road and rail system.
- *Economic factors.* These include interest rates, taxation changes, economic growth, inflation and exchange rates
- *Social factors.* Changes in social trends can impact on the demand for a firm's products and the availability and willingness of individuals to work.
- *Technological factors:* new technologies create new products and new processes. Technology can reduce costs, improve quality and lead to innovation. These developments can benefit consumers as well as the organizations providing the products.
- *Environmental factors:* environmental factors include the weather and climate change. Changes in temperature can impact on many industries including farming, tourism and insurance. With major climate changes occurring due to global warming and with greater environmental awareness this external factor is becoming a significant issue for firms to consider.
- *Legal factors:* these are related to the legal environment in which firms operate. Legal changes can affect a firm's costs (e.g. if new systems and procedures have to be developed) and demand (e.g. if the law affects the likelihood of customers buying the good or using the service).

http://www.oup.com/uk/orc/bin/9780199296378/01student/additional/page_12.htm

105. Explain BCG Matrix

- Stars are SBUs with a high market share in a high growth industry and it has a good earning potential. However, at what is probably an early stage in its life cycle, the product is probably costly to maintain in terms of having to engage in aggressive marketing effort and this probably means high advertising costs.
- Cash cows have a high market share but have probably matured in a slow, or zero, growth market. They are typically well established with loyal customers and product development costs are relatively low as the initial research and development expenditure has been recovered. These are profitable ‘safe’ products and a strong company has many in its portfolio. Generally, stars move into this position when the overall market has stabilized.
- Question marks are sometimes referred to as ‘problem children’ or ‘wildcats’. Here, market growth prospects are favorable, but they have a relatively low market share, so the SBU has only a weak foothold in an expanding, but probably highly competitive, marketplace. If the SBU is to become a star then substantial marketing

or research and development expenditure might be needed and this is a problem that marketing management must address.

- Dogs are sometimes referred to as 'pets' in this respect and this is an SBU characterized by low market share and low growth. These are SBUs for potential liquidation, but as the 'pet' term implies they are probably still there for nostalgic reasons on the part of management. Indeed, when companies are in difficulties and creditors take over the first thing that is done is to prune the dogs from the portfolio. It is accepted that in some circumstances the retention of dogs might be necessary in order that the company can provide a comprehensive portfolio of products that it offers as part of its overall product mix.

  In practice companies tend to have a balanced portfolio, but those with a preponderance of 'dog' products are clearly in difficulty. Stronger companies will have a preponderant mixture of 'stars' and 'cash cows'. It does not follow that SBUs must progress around each of the boxes in a sequential manner. However, the matrix is dynamic and will change over time as market conditions get better or worse and indeed as products move through their product life cycle stages. Marketing management must attempt to ensure that 'star' and 'cash cow' SBUs remain in their respective positions for as long as possible, for these are the ones which provide most of the company's profits and such SBUs are indeed the company's insurance for the future. Clearly 'question marks' must be looked at in terms of pushing them into the 'star' category through marketing actions. 'Dogs' clearly need careful evaluation to see whether any pruning of the range is needed.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 68-69

106. Discuss new external environment of business

Unprecedented market turbulences have been obvious for the last few years and are likely to remain so. The natural world has emerged as a source of instability. On top of all the scientific evidence suggests that climate change has reached tipping points which can be interpreted as a higher risk of natural disaster.

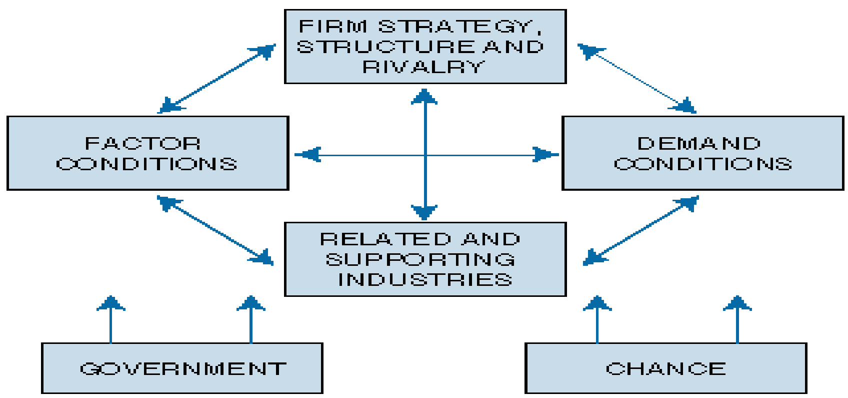
Present economic downturn impact is beyond our current assessment, but whatever the length of current recession, few general features of prevailing business environment can still be identified.

- The economy: volatility and low growth – it seems likely that the level of volatility and unpredictability we experienced in the past will remain in future. A key feature of the global economy is the high level of interconnectedness that results from high level of trade, internationalization of financial markets, flexibility of exchange and interest rates, and speed of communication.

- Technology – technological advancement has greatly contributed to perfection of business. we have witnessed transition from an industrial economy to a knowledge economy, where software rather than hardware is the primary source of value.
- Societal pressures – the only basis for survival for companies is the ability to be adapt to the values and expectations of society. Adapting to society's growing demand for fairness, ethics and sustainability presents challenges for businesses.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 457- 459

107. Explain Porter's Diamond



Porter introduced group of interconnected firms, suppliers, related industries, institutions.

Competitive advantage of nations have been the outcome of four interlinked advanced factors and activities: these interrelated links Factors for Competitive Advantage for the countries or regions in Porter's Diamond are as follows:

1. Factor conditions - such as skilled labor, land, natural resources, capital and infrastructure. Porter argues that the "key" factors of production or specialized factors are created, not inherited. Specialized factors of production are skilled labor, capital and infrastructure. Non-key" factors or general use factors, such as unskilled labor and raw materials, can be obtained by any company and, hence, do not generate sustained competitive advantage. However, specialized factors involve heavy, sustained investment. They are more difficult to duplicate. This leads to a competitive advantage because if other firms cannot easily duplicate these factors, they are valuable
2. Demand conditions -Porter argues that a sophisticated domestic market is an important element to producing competitiveness. Firms that face a sophisticated domestic market are likely to sell superior products because the market demands high quality and a close proximity to such consumers enables the firm to better understand the needs and desires of the customers.

3. Related and supporting industries -Porter also argues that a set of strong related and supporting industries is important to the competitiveness of firms. This includes suppliers and related industries. This usually occurs at a regional level as opposed to a national level.
4. Firm strategy, structure and rivalry - conditions for organization of companies, and the nature of domestic rivalry. The structure and management systems of firms in different countries can potentially affect competitiveness. Likewise, if rivalry in the domestic market is very fierce, companies may build up capabilities that can act as competitive advantages on a global scale. Home markets with less rivalry may therefore be counterproductive, and act as a barrier in the generating of global competitive advantages such as innovation and development

http://www.businessmate.org/Article.php?ArtikelId=49
Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 376-378

108. Explain benchmarking and its objective

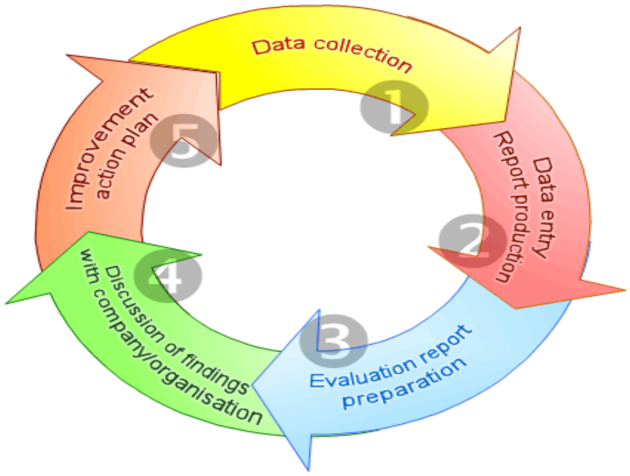
Benchmarking can be considered as a method of identifying the "best practice" in relation to delivery of products/processes. The purpose of benchmarking is to understand and evaluate the current position of a business or organization in relation to the "best practice" and to identify weak areas in need of perfection

The evaluation is carried in the following fields:

1. Finance
2. Management of Resources and Personnel
3. Strategy
4. Research and Development
5. Production Technology
6. Product and Marketing
7. Quality and Customer Satisfaction
8. Warehouse management
9. Supply chain

The benchmarking procedure comprises of five steps:

1. Data Collection from the corporation / organization.
2. Entering the data into the Best Practice database and compiling the evaluation diagrams.
3. Composing the evaluation report based on results and diagrams from the database.
4. Discussing the evaluation results with the corporation / organization and with experts, in order to explore new solutions.
5. Stating proposals for improvement and applying innovation methods



http://www.e-benchmarking.org/benchmarking.html

109. Discuss the terms Business Process Re-engineering BPR

Michael Hammer and James Champy defined Business process reengineering – as the fundamental rethinking and radical resign of business processes to achieve dramatic improvements in critical contemporary measures of performance, such as cost, quality, service and speed.

Business process Reengineering can be referred to analysis and design of processes within the organization that can facilitate the achievement of substantial efficiency. BPR includes

- Combining several jobs into one
- Allowing workers to make decision
- Performing the steps of a process in a natural order
- Recognizing that processes have multiple versions and designing processes to take account of different situations
- Performing processes where it makes the most sense
- Reducing checks and controls to the point where they make economic sense
- Minimizing reconciliation

Despite major gains BPR is complex sometimes resulting into disappointing outcomes.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 235-236

110. What is Strategy/ discuss difference between the Corporate and Business Strategy

As the business environment undergoes dramatic changes, the definition of strategy from being a detailed plan has changed into quest for success. In a turbulent environment strategy must be flexible and easily adjustable. In order to effectively respond to external changes, M porter empathized that Strategy is not about doing things better it is about doing things differently. Strategic choice is revealed in two questions, where to compete and how to compete. The answer to these questions refers to business and corporate strategy.

Corporate strategy- defines the scope of the firm in terms of industries and markets in which it competes corporate diversification includes choices over diversification, vertical integration, acquisition, new ventures and allocation of resources

Business strategy – refers to how a firm competes within a particular industry or market

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 17-18

111. Discuss Diversification Strategy

Diversification strategy is applied for the purpose of expanding a firms' operations by adding markets, products, services, or stages of production to the existing business. The motive behind the diversification strategy is that this strategy enables the company to enter lines of business that are different from current operations. In case the new venture is strategically related to the existing lines of business, it is called concentric diversification. Conglomerate diversification takes place when a new venture is not strategically related to the existing lines of business, in other worlds new and old businesses are unrelated. Diversification represents a form of growth strategy that is associated with risk reduction. Shareholders can diversify risk by holding diversified portfolios

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 407-409

112. Discuss International Strategy

Strategic Alliance, Corporate Diversification, M&A are different strategies that the firm uses in order to use their resources and capabilities in one business activity aimed at gaining the competitive advantage over competitors.

Firms can engage their resources and capabilities in other geographic markets and the motivation behind it is to facilitate the entry into another geographical country. Firms that operate in multiple courtiers are pursuing the international strategy. International strategy existed even before throughout the whole history, when trade between the borders was the source of income and way of survival. For the last few years international strategy has become actual part of a business, 2005 saw many big companies plunging into the international strategy e.g. GE, Exxon Mobile, Citigroup, Microsoft.

For the strategic alliance to be successful it must be capable of generating economic profit, exploit a firm's rare and costly to imitate resources and capabilities. The valuable international strategies must exploit the real economies of scope, which are rare and costly to imitate. In other words it must allow the company to exploit environmental opportunities and neutralize all the threats. International strategy helps the company gain access to potential new customers that in its turn increases the volume of production. So if successfully implemented international strategy can gain access to new customers and change the domestic demand as well

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 516 -548

113. Discuss Internationalization and its benefits

Gaining access to new customers and markets not only increases the revenue but also enables the company to manage the product effectively though the product life cycle.

A typical product life cycle comprises of the following steps: Introduction, Growth, Maturity, Decline. Introduction – demand is low, Growth – demand increases, Maturity – demand growth level goes off, and decline- demand drops off. From an international strategy viewpoint, the observations reveal that product/ service in different countries at different levels of product life cycle can be at different stages, so companies can use different sources and capabilities it developed during the particular product life cycle stage in non-domestic market. Internationalization and cost reduction – gaining access to new markets increases the volume of production. Firm's production process is sensitive to economies of scale. So at the expense of the economies of scale firm can gain cost advantage in domestic and non – domestic markets. In general study revealed that exploiting the economies of scale is becoming more important source of economic value in most international businesses. Gaining access to international markets also provides low cost raw material and low cost labor. Another benefit of operating in the international market can be the technology, in other words having access to foreign technology. Gaining access to international markets enables the development of new core competencies by learning and sharing experience and knowledge from the international operations.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 516 -548

114. Explain Maslow's Theory of Needs

A. MASLOW'S THEORY OF NEEDS. Abraham Maslow sought to explain why people are driven by particular needs at particular times. Why does one person spend much time and energy on personal safety and another on gaining the esteem of others? Maslow's answer is that human needs are arranged in a hierarchy, from the most pressing to the least pressing. Maslow's hierarchy of needs are: 1 physiological needs, 2 safety needs, 3 social needs, 4 esteem needs and 5 self-actualization needs.

A person tries to satisfy the most significant need first. When that important need is satisfied, it will stop being a motivator and the person will then try to satisfy the next most important need. For example, a starving man need 1 will not take an interest in the latest happenings in the art world need 5, or in how he is seen or esteemed by others need 3 or 4, or even in whether he is breathing clean air need 2. But as each important need is satisfied, the next most important need will come into play

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 172-173

115. Discuss Value Chain Analysis

Value Chain Analysis helps identify the core competencies of the company and those activities that drive competitive advantage. The value chain is a systematic approach to examining the development of competitive advantage. It was created by M. E. Porter in his book, Competitive Advantage 1980. The chain consists of a series of activities that create and build value. They culminate in the total value delivered by an organization. The 'margin' depicted in the diagram is the same as added value. The organization is split into 'primary activities' and 'support activities.

<u>Primaryactivities:</u>

1. Inbound logistics: materials handling, receiving and warehousing raw material, inventory control;
2. Operations: machine operating, assembly, packaging, testing and maintenance, process of transforming inbound into finished goods and services
3. Outbound logistics: order processing, warehousing, transportation and distribution of finished goods;
4. Marketing and sales: advertising, promotion, selling, pricing, channel management;

5. Service: installation, servicing, spare part management;

Support activities:

6. Firm infrastructure: general management, planning, finance, legal, investor relations, culture;
7. Human resource management: recruitment, education, promotion, reward systems;
8. Technology development: research & development, IT, product and process development;
9. Procurement: purchasing raw materials, lease properties, supplier contract negotiations.

By subdividing an organization into its key processes or functions, Porter was able to link classical accounting to strategic capabilities by using value as a core concept, i.e. the ways a firm can best position itself against its competitors given its relative cost structure, how the composition of the value chain allows the firm to compete on price, or how this composition allows the firm to differentiate its products to specific customer segments.

Value chain analysis will help to make outsourcing decision. Margin here is presented as a value delivered, therefore a firm's margin depends on its effectiveness to perform each activity.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 45

116. Explain Vertical Integration

Value chain represents set of activities that must be accomplished in order to design, sell and distribute a product or service. Different companies make different decision about which activities they would like to perform themselves and in which activities they would like to engage other firms. The higher the level of engaged firms the higher the level of vertical integration. Over time firms can become more vertically integrated or less vertically integrated

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002

Vertical integration – is the process in which several steps in the production and/or distribution of a product or service are controlled by a single company or entity, in order to increase that company's or entity's power in the marketplace.

http://www.investorwords.com/5977/vertical_integration.html

117. Discuss 3 types of vertical integration

- Backward upstream vertical integration: when a company controls subsidiaries that produce some of the inputs used in the production of its products

Example: When company owns a tire company automobile

- Forward vertical integration: when a company owns the subsidiaries that market the product.

Example: Movie studio that also owns a chain of theaters

- Balanced Vertical Integration: when a company that sets up subsidiaries that supply them with inputs and also markets the product

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002, p. 194

118. Explain different types of Vertical Integration

Different Types of Vertical Integration

1. Long Term Contracts – that encompass series of transactions over a period of time. It works effectively in the absence of need for transaction specific investment by either party.. Long term contracts always include provisions for arbitration of contract or dispute.
2. Vendor Partnership – e.g. contract between two companies. One company crafts a partnership program to provide a sales outlet to the trader for a fee, which typically includes rates for featuring, or exhibiting, the vendor's products.
3. Franchising - contractual agreement between the owner of a business and trademark that permits the franchisee to produce and market the franchiser's product or service in a specific area.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, pp. 362-363

119. What is Strategic Alliance and Types of Strategic Alliance?

Strategic alliance takes place when two or more independent organizations collaborate in the advancement, manufacture or sale of product or service. It can be equity, non-equity or joint venture.

Non-Equity Alliance– parties to the strategic alliance do not take equity position on each other's firms e.g. supply agreement, distribution agreement

Equity Alliance - parties to the strategic alliance supplement their contracts with equity holdings

Joint Venture – parties of the strategic alliance create legally independent firm in which they invest and share profit.

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002, p. 369

120. Discuss cost and benefit of vertical integration

Vertical integration allows better coordination and consequently lower risk. Other benefits associated with the benefits of vertical integration can be summarized as follows:

- Outsourcing
- Enhanced flexibility
- Reduced transportation costs
- Increased entry barriers to potential competitors
- Increased control on input

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey &Sons Ltd Publication, 2010, p. 352

121. How does internationalization strategy help in managing the Product Life Cycle?

Gaining access to new customers not only increases the revenue but also enables the company to manage the product though the product life cycle. A typical product life cycle includes: Introduction, Growth, Maturity, Decline.

Introduction – demand is low, Growth – demand increases, Maturity – demand growth level goes off, and decline- demand drops off.

From an international strategy perspective, the observations show that product/ service in different countries at different levels of product life cycle can be at different stages, so companies can use different sources and capabilities it developed during the particular product life cycle stage in non-domestic market.

Internationalization and cost reduction – gaining access to new markets increases the volume of production. Firm's production process is sensitive to economies of scale. So at the expense of the economies of scale firm can gain cost advantage in domestic and non – domestic markets. Overall research showed that exploiting the economies of scale, no matter what resources are, is becoming a more important source of economic value in most international *businesses*

Barney, J.B. "Gaining and Sustaining Competitive Advantage" , 2nd edition, Prentice-Hall, NJ, 2002, pp. 523- 524

122. Discuss Balanced Scorecards

The performance management system problem is that the performance goals are long term, though effective system control is required over a short period of time. One solution to posed dilemma is to link the overall corporate goal of value maximization to strategic and operational targets to ensure that the pursuit of financial goals is not at the expense of the longer term strategic positioning of the company. The well-known method of doing so is balanced scorecard developed by Robert Kaplan and David Norton. This method provides a framework for balancing strategic and financial goals and bringing performance measures down to the organization to individual business units and departments. This approach combines the answers to 4 questions.

- How do we look to shareholders?
- How do customers see us?
- What must we excel at?
- Can we continue to improve and create value?.

By balancing the set of financial and strategic goals, the scorecards methodology enables the business strategy to be linked to the creation of shareholder value.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 50-51

123. Discuss why "Complements" is considered as a missing force in Five Forces identified by M. Porter

M. Porter identified the suppliers of substitute product and services as one of the forces of competition that can reduce profit to the company within the industry. However, economic theory identifies relationship between the substitutes and compliments. The presence of substitute product decreases value of a product, while a presence of compliment product increases the value of a product. Considering the importance of compliments to most of products – e.g. The value of a car depends on the availability of gasoline, insurance and repair service – the compliment can be viewed as one of the forces to be taken into account while assessing the competitive environment. Compliments have the opposite effect to substitutes. Indeed when products are close compliments they have little value to customers individually – through customers value the whole system.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 96-97

PRINCIPLES OF BUYING BEHAVIOR AND THE IMPORTANCE OF PRICING

Product pricing

124. Discuss the importance of pricing a product

Price is the only element of the marketing mix that generates profit. Price can be considered as one of the flaxiest elements, which can be changed easily. Price communicates the intended value positioning on the market. Pricing decisions are always complex and difficult.

Organizations should consider pricing in conjunction with marketing objectives in terms of reaching organization goals through marketing planning. Therefore, pricing can be viewed as the means for reaching the marketing objectives. However, when setting price, it must be set at a realistic level.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 218

125. Discuss the price setting policy procedure

When setting a price multiple factors must be considered. There are six –step procedures for setting the price:

- Selecting the pricing objective
- Determining demand
- Estimating costs
- Analyzing competitors costs, prices and offers
- Selecting a pricing method
- Selecting the final price

A company must set price for the first time when they develop a new product and introduce regular product into a new distribution channel. Decision must be made as well regarding to where to position the product

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 219

Buying behavior

126. Discuss types of buying decision behavior

Complex buying behavior - takes place when a consumer is highly involved in a purchase and perceives differences among brands. This mostly takes place when a product is expensive

Dissonance-reducing buying behavior – takes place when consumers are highly involved in a luxurious, rare or risky purchase, but perceive little difference among brands.

Habitual buying behavior – takes place under conditions of modest consumer involvement and modest significant brand difference. For example, salt.

Consumers refer to variety-seeking buying behavior under conditions characterized by little consumer involvement, but perceived brand differences.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 177-178

127. Explain AIDA Method, the buying decision process

AIDA concept outlines the process for achieving the promotional goals in terms of stages of consumer involvement with the message. The AIDA – stands for Attention, Interest, Desire and Action.

Attention – advertisers first need to get the attention of target market, nothing can be sold unless market has information regarding the existence of a certain product.

Interest – increased awareness of a product has to trigger interest in a particular product

Desire – interest should grow into desire of obtaining the product

Action – action of actually obtaining the product

Most buyers highly involved in purchase situation pass through all those stages. Promoter's task is to understand where the target consumers are located and design a promotion plan to meet their needs. The 'AIDA' model encompasses the steps leading to a purchase in the form of a sequential problem-solving process.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,pp. 491-492

128. What are the steps incorporated in customer buying process?

A: Steps involved in customer buying process comprise of the following:

- Problem recognition – customer recognizes the need for buying product
- Information search – internal/group sources, marketing source, experiential source
- Evaluation of Alternatives
- Purchase decision –

- Post-purchase evaluation

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 179

129. Explain the meaning of buying center

Buying center is composed of all those individuals and groups who participate in the purchasing decision making process, sharing common goals and risks. Buying center includes organizational members who play any of the seven roles in purchase decision process:

- Initiators – people who request something be purchased
- Users - users of the product
- Influencers – people who influence the buying decision
- Deciders – people who decide on product requirements
- Approvers – people who authorize the proposed action
- Buyers
- Gatekeepers – people who have the power to prevent sellers or information from reaching members of the buying center e.g. purchasing agents, receptionists and telephone operators

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 106

130. Why marketing managers need to understand customer behavior?

Understanding customer behavior is of high importance for marketing managers, since it can describe how consumers make purchasing decisions, what triggers their desire to get certain product, what are the stages customer undergoes before taking a final decision of buying a product. Understanding such relevant details will enable marketers to fit to customers' requirements, it also reduces uncertainty of marketing managers when defining target market and designing marketing mix.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 188

131. Identify the types of consumer buying decisions and discuss the significance of consumer involvement

Consumer decision making can be divided into three categories. First consumer exhibits respond to low price items that require very little attention and little effort for buying, routine behavior is characterized by brand loyalty.

Second consumers are engaged in limited decision making for occasional purchases or for unfamiliar brands in familiar product category.

Third consumers are engaged in extensive decision making process when deciding what to buy and it refers to expensive infrequent purchase, when customer goes to alternative evaluation process.

The main factors affecting the customer decision making process is previous decision, perceived risk of negative consequences and social visibility.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 18

132. Explain the role of demand in price determination

Demand is the key determinant of price. When setting prices demand must be considered first in terms of setting a reasonable price. A typical demand schedule shows an inverse relationship between quantity demand and price. At the low price demand tend to increase. At the increased price demand for a certain product is tend to decrease. . for prestige products, there may be a direct relationship between demand and price.

Marketing managers must understand demand elasticity when setting prices. Elasticity of demand is the degree to which the quantity demanded fluctuates with the changes in price, if consumers are sensitive to price change demand is elastic, if consumers are not sensitive to price change then the demand is inelastic. Thus increase in price will result into lower sales for elastic products and no loss in sales in inelastic product.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 611

133. What is Every Day Low Price EDLP ?

Pricing strategy that offers consumers the lowest available price without waiting for special offers and discount promotions - also called value pricing. One of the benefits of EDLP is that it greatly saves retailers time and expense of periodic price markdowns, also reduces cost of distributing and processing coupons, and is believed to trigger shopper loyalty. A successful EDLP wholesale pricing strategy may reduce volatility in production and shipping quantities and decrease the number of time-degraded product units that consumers receive. EDLP has been successfully applied by Wal-Mart and Procter & Gamble.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 227 and http://www.answers.com/topic/edlp

BRANDING AND ADVERTISING/PR

134. Explain the goals and tasks of promotion

The key and the major goal of promotion is to induce, modify or reinforce behavior by informing , persuading and reminding .Hence there are several types of promotional activities

Informative promotions are aimed at increasing awareness on the purpose and benefits of offered product or services. Such action is likely to contribute to increasing demand on the product.

Persuasive promotion is designed to stimulate a purchase or an action. Persuasive promotion acquires particular importance at the growth stage of the product life cycle, when competition becomes fierce.

Reminder promotion – is applied with the purpose to keep the product or brand name in the minds of customers. Such promotions are usually applied at the maturity stage of the product life cycle

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 500

Branding

135. What is Brand?

Abrandisaname,term,sign,symbol,designoracombinationofthemthatidentifiesthe goods or services of one seller and distinguish them from competitors. Brand represents an important part of a product and is capable of adding value to a product. Brand can be name, trademark logo or another symbol. A brand is viewed as seller's promise to offer unique features, benefits and services different from others. Brand is even a more complex symbol.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 404

136. Discuss 6 levels of Brand

There are six levels of brand:

- Attributes – brand creates certain attributes
- Benefits- functional and emotional benefits
- Values – brand says something about the value
- Culture – brands create and represent certain culture
- Personality – brand can project certain personality
- User – brand suggests the kind of consumer who buys or uses the product

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 404-405

137. Guidelines for selecting brand name

Brand name should be selected carefully with the consideration of the following important aspects:

1. Brand should suggest something - e.g. beauty rest
2. Brand should suggest something - benefits or function e.g. march First, Agilent Technologies
3. Brand should be easy to pronounce, recognize and remember
4. Brand should be distinctive
5. Brand should not carry poor meaning in other countries and languages

Brand names should be easy to remember, it increases brand awareness. Marketers can also shorten the names e.g. Coca cola is also coke. Short names facilitate the recall.

The brand name should also be familiar and meaningful.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 413

138. What is Brand Equity/its components?

Brand Equity evaluates the strength, power and value of a brand in the marketplace. Some brands are not known to customers, whereas there are some enjoying a high level of brand awareness among customers, there are also brands with high level of acceptability, with high level of preference and finally brands with a high level of loyalty

Brand equity is highly related to the degree of brand name recognition, perceived brand quality, strong mental and emotional association, patents, trademarks and channel relationship. Brand equity is not reflected on the company's balance sheet.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 405

139. Discuss criteria for choosing brand elements

Brand elements are those trademark able devices that help to identify and differentiate the brand. There are six criteria in choosing brand elements. Brand elements must be:

Memorable – the element must be easily memorable, easily recalled and realized

Meaningful – the element should be meaningful, credible and suggestive, must suggest something about the ingredient

Likeable – the element must be aesthetically appealing, visually and verbally likeable

Protectable – the element must be legally and competitively protectable and difficult to copy

Adaptable – element to be adaptable and updated

Transferable – easy to introduce new products in the same or different categories

Kotler, P. & Armstrong, G. "Marketing. An Introduction", 2nd edition, Northwestern University, 1990,pp. 138-140

140. Define promotion and elements of promotional mix

Promotion refers to coordination of different seller- initiated efforts to increase awareness about the product to set up channels for spreading information and persuasion with the aim to boost the sale of goods and services or promote an idea.

The elements of promotional mix encompasses four elements: advertising, sales promotion, public relations, and personal selling. Advertising is a form of one way mass communication. Public relations is the function of promotion regarding the company's public image. Buying good publicity is impossible, though significant steps can be undertaken by any company aimed at creating the positive image. Sales promotion represents an element of promotional mix aimed at boosting sales and stimulating demand. Personal selling involved direct communication with customer aimed at informing and persuading one or more potential buyers.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p.500

141. Discuss the role of advertising

Communication with the existing and potential customers is of high importance to business success. Experience showed that even the best products can't sell themselves without the adequate support through advertising. The non-personal method of communication in the form of advertising, catalogs, internet and trade shows have a unique and often critical role in the communication process. Advertising and promotion are an essential part of our social and economic systems. Advertising supports and supplements personal selling efforts. Advertising and sales promotion are rarely applied separately. Advertising and other promotional methods have unique ability to deliver carefully prepared messages to target audiences. Both Large and small companies increasingly rely on advertising and promotion to help them market products and services.

Hutt, M.D.&Speh, T.W. "Business Marketing Management: B2B", Miami University, Thomson South Western, 2007,pp. 391-392

142. How to successfully develop advertising message?

Developing accurate message for the target audience is a tough and very complex task. Focusing on irrelevant features of a product will result not only into the wasted efforts but into a loss of money. Both the appeal and the way appeal is conveyed is critical to successful communication. Initially advertising objectives has to be determined, followed by evaluating the buying criteria of the target audience, as well as identification of the right language, format and style for presenting the message. For the message to be successful first individual must be exposed to it in order to identify the perceptual barriers. Advertisers should connect two important things attention and interpenetration, how correctly the audience will interpret the launched message. Another important aspect is to understand the buyers' motive, which product benefits are important for the target group. So intensive marketing research must be in place aimed at fully describing the key buying criteria of each buying influencer in each of the firms different target markets.

Hutt, M.D.&Speh, T.W. "Business Marketing Management: B2B", Miami University, Thomson South Western, 2007,pp. 397-399

143. Discuss the importance and contribution of trade shows

One of the non-direct communication methods- trade shows have long been proved as a unique source of being exposed to a larger audience. Trade shows offer opportunity to publicize significant contribution to technology or to demonstrate new and old products. Trade shows can contribute to the following aspects:

- An effective message can be delivered to relatively large and interested audience at one time
- New products can be introduced to mass audience
- Customers can get hands- on experience with the product in a one-on-one selling situation
- Potential customers can be obtained
- General goodwill can be enhanced
- Free publicity is often generated for the company
- Greatly affects sales efficiency
- Can be valuable for building corporate image, gathering competitive intelligence and enhancing sales force morale

Hutt, M.D.&Speh, T.W. "Business Marketing Management: B2B", Miami University, Thomson South Western, 2007,pp. 407-408

PUBLIC RELATIONS

144. What does Public Relations mean and functions of PR department?

Public Relations represent an important marketing communication tool. Public Relations – is applied both inside and outside the organization. PR is sometimes considered as an external marketing tool aimed at reaching the large audience in a positive light, which is very limited thinking. PR also has a great role as an internal marketing communication tool. Public Relations involve multiple programs designed to promote or protect a company's image and individual products. PR departments usually perform five functions such as

- press relations presenting news and information
- product publicity publicizing specific products
- corporate communication promoting understanding of the organization though internal and external communications
- lobbying dealing with legislators and government officials
- counseling advising management about public issues and company positions

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 308

145. Discuss PR and Publicity

Public relations does not represent only pitching stories to the media. The Public Relations umbrella encounters several related activities, all of which are concerned with communicating specific messages to specific target audiences.

One of the key activities under the public relations umbrella is publicity — getting visibility for your products, the company, and the owners in print and broadcast media. Publicity can be defined as a practical management and placement of information in the media in order to protect and enhance a brand or reputation

The appeal of public relations and publicity is based on three distinctive qualities:

- High credibility – news stories are more credible and reliable in the eyes of audience rather than ads
- Ability to catch buyers off guard – public relations can reach prospects who prefer to avoid salespeople and advertisements.
- Dramatization – public relations has the potential to dramatize a company or product.

Marketers tend to underuse public relations, through well prepared programs in combination with other marketing mix elements can be extremely effective and deliver the desired outcome.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 565

146. Explain the role of PR in Crisis Management

Public Relations represent an important marketing communication tool. Public Relations – is applied both inside and outside the organization. PR is sometimes considered as an external marketing tool aimed at reaching the large audience in a positive light, which is very limited thinking. PR also has a great role as an internal marketing communication tool. Public relations has extremely vital role to play in 'crisis management' scenarios. In case of unexpected catastrophe, especially if it affects the lives of people by injuring or loss of lives, the presence of the right public relations activities is essential, which will facilitate the putting of a fair and balanced account of events forward to the general public and thus mitigating the adverse effects of the disaster to the organization concerned.

Based on Geoff Lancaster, London School of Commerce. Lecture notes, 2009

147. Define the term -Marketing Public Relations

Marketing managers and public relations specialists not always use the same language. Marketing managers are bottom line oriented, whereas public relations specialists are more oriented on preparing and disseminating information. Many companies are now turning to marketing public relations that facilitate the mitigation of the difference between the two above mentioned points, thus focus is made on supporting corporate or product promotion and image making.

Thus Marketing Public Relations MPR serves as a special constituency**-** marketing department and goes beyond the simple publicity and plays an important role in the following tasks:

- Assisting the launch of a new product
- Assisting in repositioning the nature product
- Building interest in a product category
- Influencing specific target groups
- Defending products that have encountered pubic problems
- Building the corporate image in a way that reflects favorably on its product.

MPR is also very effective in reaching specific ethnic and other groups. MPR carries more credibility than advertising

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, *Prentice Hall, New Jersey,2000, pp. 606-607*

148. Identify the impact of technology on a firm

The world economy undergoes dramatic changes. Geographical and cultural distances have shrunk with the advent of global computer and technology development. This enabled many companies to expand their geographical market coverage, facilitated purchasing and manufacturing processes. Many companies commenced creating global structure in order to move ideas swiftly around the world.

Technological developments have significantly affected the process of doing business. Monitoring new technology is an essential aspect in terms of keeping up with competitors at the background of today's marketing environment. Another greatest impact of technological advancement is increased productivity and innovation, which provides basis for remaining competitive at the global market.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 100

149. Discuss benefits of the global strategy

Global strategy considers world as a single fragmented market. Those companies operation only at the national level remain very vulnerable to those companies competing at the global level. Global strategy, at the background of immense technological developments offers multiple benefits such as access to scale economies in product development, manufacturing and marketing. Globally operating companies are having access to global customers, are exposed to opportunities to exploit efficiency from locating different activities In different places, can learn benefits of multinational operations, share the experience, vision and knowledge of global companies. Operating at the global market enables companies to compete strategically.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey &Sons Ltd Publication, 2010, pp. 386-387

150. Describe the external environment facing global marketers

Global marketers face the same environmental factors as at the local market such as culture, economic and technological developments, political structure and actions, demographical issues, natural resources.

Cultural aspects encompass societal values, attitudes and believes, language and normal business practice.

Country's economic and technological status is hinged on industrial development, which in turn has great impact on family profitability.

Political structure is created by the political environment and political ideology such as tariffs, quotas, boycotts, trade agreements and market groupings

Demographic variables include the size of a population and its age and demographic distribution.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006,p. 138

MANAGEMENT

MANAGEMENT – GENERAL CONCEPTS AND HISTORY

1. What is management?

A **manager** is someone who coordinates and oversees the work of other people so that organizational goals can be accomplished. A manager's job is not about *personal* achievement – it's about helping *others* do their work.

Management is a process of coordination and overseeing the work activities of others so that their activities are completed efficiently (getting the most output from the least amount of input; doing things right) and effectively (doing those work activities that help the organization reach in goals; doing the right things).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 7-8
See Mind-Map 1

2. Describe how to classify managers in organizations.

The manager's job is about things to be done through and with the help of others, at the same time helping others do their work. <u>First-line managers</u> – managers at the lowest level of the organization that manage the work of no managerial employees. <u>Middle managers</u> – managers between the first level and the top level of the organization who manage the work of first-line managers. <u>Top managers</u> – managers at or near the upper levels of the organization structure who are responsible for making organization-wide decisions and establishing the goals and plans that affect the entire organization.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 4-7
See Mind-Map 1

3. What do managers do in terms of functions?

<u>Planning</u> – defining goals, establishing strategies, and developing plans.
<u>Organizing</u> – arranging and structuring work.
<u>Leading</u> – working with and through people.
<u>Controlling</u> – monitoring, comparing and correcting work performance; evaluating whether things are going as planned.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 8-10
See Mind-Map 1

4. What are the main managers' roles?

Management roles are specific categories of managerial behavior.

Interpersonal roles involve people and other duties that are ceremonial and symbolic in nature (figurehead, leader, liaison).

Informational roles involve collecting, receiving and disseminating information (monitor, disseminator, spokesperson).

Decisional roles revolve around making choices (entrepreneur, disturbance handler, resource allocator, negotiator).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 10-12
See Mind-Map 1

5. What are the main managers' skills?

Technical skills – job specific knowledge and techniques needed to proficiently perform specific tasks.

Human skills – the ability to work well with other people individually and in a group.

Conceptual skills – the ability to think and to conceptualize about abstract and complex situations.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 12-14
See Mind-Map 1

6. How the manager's job is changing?

The following changes impact all managerial functions:

- changing technology (digitization) – leads to shifts in organizational boundaries, virtual workplaces, mobile workforce, flexible work arrangements, empowering employees;
- security threats – leads to risk management, work life-personal life balance, restructurization or workplaces, discrimination concepts, globalization concerns, employee assistance;
- organizational and managerial ethics emphasis – leads to redefining values, rebuilding trust, increased accountability;
- competitiveness – leads to customer service issues, innovation issues, globalization issues, efficiency/productivity.

Specifically customers and innovation are most urgent changes that impact managerial work.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 15-17
See Mind-Map 1

7. What is organization?

Organization is a deliberate arrangement of people to accomplish some specific purpose. Any organization has three indivisible and interconnected elements: People, Purpose, Structure.

Organizations are (1) social entities that (2) are goal-directed, (3) are designed as deliberately structured and coordinated activity systems, and (4) are linked to the external environment.

Organizations are made up of people and their relationships with one another. An organization exists when people interact with one another to perform essential functions that help attain goals. Recent trends in management recognize the importance of human resources, with most new approaches designed to empower employees with greater opportunities to learn and contribute as they work together toward common goals.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 17-19
Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 10-14
See Mind-Map 1

8. What are the rewards and challenges of being a manager?

Rewards: create a work environment in which organizational members can work to the best of their ability; have opportunities to think creatively and use imagination; help others find meaning and fulfillment in work; support, coach and nurture others; work with a variety of people; receive recognition and status in organization and community; play a role in influencing organizational outcomes.

Challenges: do hard work; may have duties that are more clerical than managerial; have to deal with a variety of personalities; often have to make do with limited resources; motivate workers in chaotic and uncertain situations; successfully blend knowledge, skills, ambitions, and experiences of a diverse work group; success depends on others' work performance.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 19-21
See Mind-Map 1

9. Describe two historical events are especially significant to the study of management.

1) Adam Smith (1776) – The Wealth of Nations
   He argued the economic advantages that organizations and society would gain from the division of labor (job specification) – breakdown of jobs into narrow and repetitive tasks.
2) Industrial Revolution – late 18th century – machine power was substituted for human power, making it more economical to manufacture goods in factories rather than at home. Formal theories to guide managers in large organizations were needed.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 28-29
See Mind-Map 2

10. Describe major ideas of scientific management.

Modern management theory was born in 1911 with the name of Frederick Winslow Taylor – Principles of Scientific Management. Scientific management is the use of scientific methods to define the “one best way” for a job to be done.

The followers of scientific management were Frank and Lillian Gilbreth. They studied work to eliminate inefficient hand-and-body motions, they also experimented with the design and use of the proper tools and equipment for optimizing work performance.

There are four main Taylor’s principles of management:

1) Develop a science for each element of an individual’s work.
2) Scientifically select and then train, teach, and develop the worker.
3) Cooperate with the workers so as to ensure that all work is done in accordance with the principles of the science that has been developed.
4) Divide work and responsibility almost equally between management and workers. Management takes over all work for which it is better fitted than the workers.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 30-32
See Mind-Map 2

11. What is General Administrative Theory?

General Administrative Theory is focused on describing what managers do and what constitutes good management practice. The two major approaches within the theory are Henri Fayol’s and Max Weber’s.

Henri Fayol defined the functions of management as planning, organizing, commanding, coordinating and controlling. Henri Fayol was concentrated on the activities of all managers, he described the practice of management as something different from accounting, finance, production, distribution and other business practices. Fayol's major consideration that management must be applied to every business endeavors, government and home allowed him to present 14 main principles of management – fundamental rules of management.

Max Weber – German sociologist studying organizations – developed a theory of authority structures and relations. Weber presented bureaucracy as an ideal type of organization – a form of organization characterized by division of labor, a clearly defined hierarchy, authority, detailed formal rules and regulations, and impersonal relationships, career orientation.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 32-34
See Mind-Map 2

12. What is a quantitative approach to management?

Quantitative approach to management involves the use of quantitative methods to improve decision making, it is called also operations research or management science.

Quantitative approach uses applications of statistics, optimization models, information models, computer simulations to management activities. Quantitative approach contributes mostly decision making in planning and control areas, however it doesn't influence organizational behavior a lot as far as it is based more on behavioral problems which are deeper and more real than quantitative models.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 34-36
See Mind-Map 3

13. What are some basic ideas of organizational behavior?

Management is about doing things through other people. Some writers focused on people in organizations, which led to *OB (organizational behavior)* field of management – the field of study concerned with the actions (behaviors) of people at work. Early advocates of OB believed that people were the most important asset in organization and must be managed accordingly. They developed such ideas as group ethic, differences in individual and group behavior, using psychological tests for employee selections, studying employee motivation and learning process, organizations as open systems, working conditions, etc.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 36-38
See Mind-Map 2

14. Describe Hawthorne Studies and its importance for management development.

Most important contribution to OB field is the Hawthorne Studies. They were started in 1924 by the engineers in the Western Electric and were in the form of experiment, studying the effect of various lightning levels on worker productivity. The experiment showed that as the light level was increased in experimental group output for both groups increased and as the light level was decreased in experimental group productivity continued to increase in both groups. The engineers concluded that lightning intensity was not directly related to group productivity, and there was “something else” which had a greater impact. In 1927 Harvard professor Elton Mayo and his associated began consulting and experimenting to give the name to this “something else”. Hawthorn Studies was the great step in management development. Mayo concluded that people’s behavior and attitudes are closely related, group standards influence individual output, - all these conclusions emphasized people behavior as important factor in management of organizations.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 36-38
See Mind-Map 2

15. What is the systems approach?

During 1960s, management researchers began to analyze organizations from the systems point of view. *System* is a set of interrelated and interdependent parts arranged in a manner that produces a unified whole.

Systems can be closed and open. Open system interacts with dynamically with the environment. Organizations are treated as open systems – “open” to and interacting with its environment.

The **systems approach** implies that decisions and actions taken in one organizational area will affect others and vice versa. The systems approach recognized that organizations are not self-contained. They follow environmental influences.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 38-39
See Mind-Map 3

16. What is the contingency approach?

Most early theories of management treated their principles as universally applicable. Later research showed that there are many exceptions. Management is not based on the simplistic principles that work in all situations. Vice versa different situations make managers use different methods, techniques and principles. The **contingency approach** (situational approach) suggests that organizations are different, face different situations (contingencies) and require different ways of managing.

The contingency approach is about "if, then". Some popular contingency variables are: organization size, routineness of task technology, environmental uncertainty, individual differences.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 39-40
See Mind-Map 3

17. What are the current trends and issues in management?

Globalization – managers are less constrained by national borders, which leads to the challenges as working with people from different cultures, movement of jobs to countries with low-cost labor, etc.

Ethics – there are more and more ethical dilemmas in making decisions.

Workforce diversity – managing people with different cultural backgrounds, work styles, family needs etc.

Entrepreneurship – an important global activity is the process of starting new businesses, generally in response to opportunities. Innovation is included in this issue, as far as it involves changing, revolutionizing, transforming, introducing new products or services or new ways of doing businesses.

E-Business – is the way an organization does its work by using electronic (Internet-based) linkages with its key constituencies in order to efficiently and effectively achieve its goals.

Knowledge Management and Learning Organization – contemporary organizations must learn and be ready for new challenges and changes; organizational members systematically gather knowledge and share it with others in the organization so as to achieve better performance.

Quality Management – is a philosophy of management that is driven by continual improvement and responding to customer needs and expectations.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 39-40
See Mind-Map 4

18. What is the difference between omnipotent and symbolic views on management? Can they be synthesized?

According to the *omnipotent view*, managers are directly responsible for an organization's success or failure. However, the *symbolic view* argues that much of an organization's success or failure is due to external forces outside managers' control.

Although omnipotent and symbolic view represents two different views on management, reality suggests synthesis, i.e. environment defines the ways of managing organizations, but managers are not powerless and can influence the performance.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 58-59
See Mind-Map 1

19. What is organizational culture?

Organizational culture is a cognitive framework consisting of attitudes, values, behavioral norms, principles, traditions, and ways of doing things shared by organizational members and that influence the way they act. Research results are suggesting that in organizations with strong cultures: employees tend to be more committed to their organizations; recruitment efforts and socialization practices are used to build employee commitment; and there is higher organizational performance. The impact of a strong culture on managers is that as the culture becomes stronger, it has an increasing impact on what managers do and constrains their decision-making options as they plan, organize, lead, and control. Culture plays three major roles in organizations. It provides a sense of identity for its members, it generates commitment to the organization's mission, and it also serves to clarify and reinforce standards of behavior.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 59-62
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 544-549
See Mind-Map 5

20. Describe culture in organizations by the source and the ways employees learn culture

An organization's culture and general way of doing things are largely the result of what it has done before and how successful it has been doing things that way. The original source of the culture usually reflects the vision or mission of the organization's founders.

Culture is transmitted to employees through stories (narratives of significant events or people); rituals (repetitive sequences of activities); material symbols (objects, facilities, and other aspects of the physical work environment); and language (special and unique terms, acronyms, and jargon). These elements help employees "learn" what values and behaviors are important as well as who exemplifies those values.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 63-66
See Mind-Map 5

21. What kinds of cultures managers can create in organizations?

Organizational cultures play a crucial role today, managers face some current cultural issues, creating different kinds of culture and nurturing workplace spirituality.

Ethical culture – a culture that is most likely to shape high ethical standards is high in risk tolerance, low to moderate in aggressiveness, and focuses on means as well as outcomes. An innovative culture is characterized by the following: challenge and involvement, freedom, trust and openness, idea time, playfulness/humor, conflict resolution, debates, and risk-taking. A customer-responsive culture has six characteristics: employees who are outgoing and friendly; few rigid rules, procedures, and regulations; widespread use of empowerment; clear roles and expectations; and employees who are conscientious in their desire to please the customer.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 69-71
See Mind-Map 5

22. How organizational culture affects managers?

Culture affects managers in many ways, specifically in planning by the degree of risk, teams or individual level of plans development, degree of environment scanning; in organizing by how much autonomy should be designed into employees' job, degree of interaction; in leading by the degree to which managers are concerned with employees' job satisfaction, appropriate leadership styles; in controlling by whether to use external controls, criteria in employee performance evaluation and others.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 67; 71-73
See Mind-Map 5

23. What influence does the environment have on managers?

The specific environment (those external forces that have a direct impact on manager's decisions and actions and are directly relevant to an organization's goals) includes customers, suppliers, competitors, and pressure groups. The general environment (those broad external forces that affect the organization) includes economic, political/legal, socio-cultural, demographic, technological, and global conditions.

Stakeholders are any constituencies in the organization's environment that are affected by the organization's decisions and actions. The most common ones are customers, social and political action groups, competitors, trade and industry associations, governments, media, suppliers, communities, shareholders, unions, and employees.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 73-82
See Mind-Map 6

24. What are the differences between traditional and contemporary organizations?

Traditional organization is more stable, inflexible, job-focused, individual-oriented, command-oriented, with permanent jobs and defined job positions, managers always make decisions, rule-oriented with hierarchical relations. Contemporary organization tends to be more dynamic, flexible, skills-focused, team-oriented, involvement-oriented, with temporary jobs, customer-oriented, with diverse workforce, lateral and networked relations.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 15-18
See Mind-Map 1

25. Define possible global perspectives in business. Explain why it's important for managers to be sensitive to global differences

An ethnocentric attitude is the belief that the best work approaches and practices are those of the home country. A polycentric attitude is the view that the managers in the host country know the best work approaches and practices for running their business. And a geocentric attitude is a world-oriented view that focuses on using the best approaches and people from around the globe.

Successful global management requires managers to be sensitive to global differences in national customs and practices in order to find which work best and to prevent making costly blunders.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 91-93
See Mind-Map 7

26. What is social responsibility? Contrast with social responsiveness and social obligation

In the four-stage *stakeholder model of social responsibility*, at stage 1 manager feels responsible to only the stockholders. At stage 2, managers expand their responsibility to the employees. At stage 3, managers expand their responsibilities to other stakeholders in the specific environment, primarily customers and suppliers. Finally, at stage 4, managers feel they have a responsibility to society as a whole. Social obligation is when a firm engages in social actions because of its obligation to meet certain economic and legal responsibilities. Social responsiveness is when a firm engages in social actions in response to some popular social need. Social responsibility is a business's intention, beyond its economic and legal obligations, to pursue long-term goals that are good for society.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 116-122
See Mind-Map 8

27. Explain the greening of management and values-based management

Organizations can "**go green**" by using different approaches. The *light green approach* is simply doing what is required legally, or the social obligation approach. Using the *market approach*, organizations respond to the environmental preferences of their customers. Using the *stakeholder approach*, organizations respond to the environmental demands of multiple stakeholders. Both the market and stakeholder approaches can be viewed as social responsiveness. The *activist* or dark green approach involves an organization looking for ways to respect and preserve the earth and its natural resources, which can be viewed as social responsibility.

Values-based management is an approach to managing in which managers are guided by the organization's shared values in their management practices. An organization's values have a big influence on whether employees act ethically.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 122-128
See Mind-Map 8

28. Present the main issues of managerial ethics

Ethics can be defined as principles, values, beliefs that define what is right and wrong behavior. The factors that affect ethical and unethical behavior include: an individual's level of moral development (preconventional, conventional, or principled); individual characteristics (values and two personality variables – ego strength and locus of control); structural variables (structural design, use of goals, performance appraisal systems, and reward allocation procedures); organizational culture (content and strength); and issue intensity.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 128-134
See Mind-Map 9

29. How ethical behavior in organizations can be improved?

Managers play a significant role in improving ethical behavior in organizations. Some of the measures as hiring individuals with high ethical standards, establishing codes of ethics and decision rules, leading by example, delineating job goals and performance appraisal mechanisms, providing ethics training, conducting social audits, and providing support to individuals facing ethical dilemmas. These measures can be integrated into a program, which has a potential to improve ethical climate in organization.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 134-138
See Mind-Map 9

PLANNING

30. How do managers make decisions?

A **decision** is a choice. Decision-making is considered as the essence of managerial job. There exist different perspectives on making decisions: rationality, bounded rationality and intuition. The assumptions of *rationality* are as follows: the problem is clear and unambiguous; a single, well-defined goal is to be achieved; all alternatives and consequences are known; preferences are clear, constant, and stable; no time or cost constraints exist; and the final choice will maximize the payoff. *Bounded rationality* says that managers make rational decisions but are bounded (limited) by their ability to process information. *Intuitive decision making* is making decisions on the basis of experience, feelings, and accumulated judgment.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 156-164
See Mind-Map 10

31. What types of problems and decisions, conditions and styles do managers face and choose?

Programmed decisions are repetitive decisions that can be handled by a routine approach and are used when the problem being resolved is straightforward, familiar, and easily defined (structured). Non programmed decisions are unique decisions that require a custom-made solution and are used when the problems are new or unusual and for which information is ambiguous or incomplete.

Managers face certainty, risk and uncertainty as specific decision-making conditions.

Certainty is a situation when a manager can make accurate decisions because all outcomes are known. *Risk* is a situation when a manager can estimate the likelihood of certain outcomes. *Uncertainty* is a situation where a manager is not certain about the outcomes and can't even make reasonable probability estimates.

There are four decision-making styles managers can use: *directive style*; *analytic style*; *conceptual style*; *behavioral style*.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 164-172
See Mind-Map 10

32. What is planning? Why it is important in management?

Planning involves defining the organization's goals, establishing an overall strategy for achieving those goals, and developing plans for organizational work activities.

Formal planning has three characteristics: (1) specific goals cover a defined period of years, (2) these goals are written and shared with organizational members, and (3) specific action plans exist for achieving these goals. Informal planning is general and lacks continuity. Also, nothing is written down and there is little or no sharing of goals.

The four *purposes* of planning include: provides direction, reduces uncertainty, minimizes waste and redundancy, and establishes the goals or standards used in controlling.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 184-185
See Mind-Map 11

33. How do managers plan?

Planning involves two important elements: goals and plans. **Goals** are desired outcomes. **Plans** are documents that outline how goals are going to be met. Organizations do have multiple *goals*. These goals might be strategic or financial and they might be stated or real.

Strategic plans apply to the entire organization while operational plans specify how the overall goals are going to be achieved. Long-term plans are those with a time frame beyond three years. Short-term plans are those covering one year or less. Specific plans are clearly defined and leave no room for interpretation. Directional plans are flexible and set out general guidelines. A single-use plan is a one-time plan designed to meet the needs of a unique situation. Standing plans are ongoing plans that provide guidance for activities performed repeatedly.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 186-191
See Mind-Map 11

34. What techniques in planning can managers use to assess the environment?

There are three techniques to assess the environment including environmental scanning, forecasting, and benchmarking. Environmental scanning – the screening of large amounts of information to anticipate and interpret changes in the environment. Forecasting – predicting outcomes. Forecasting can be qualitative and quantitative. Qualitative forecasting uses the judgment and options of knowledgeable individuals to predict outcomes. Quantitative forecasting applies a set of mathematical rules to a series of past data to predict outcomes. Benchmarking is the search for best practices among competitors or noncompetitors that lead to their superior performance.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 238-244
See Mind-Map 12

35. What techniques in planning can managers use to allocate resources?

The four techniques for allocating resources include budgeting, scheduling, breakeven analysis, and linear programming.

Budget – a numerical plan for allocating resources to specific activities. Scheduling – detailing what activities have to be done, the order in which they are to be completed, who is to do each, and when they are to be completed. Breakeven analysis is a set of techniques used to determine point where revenue just equals costs. Managers can use linear programming – a mathematical technique to help solve resource allocation problems as it shows the optimum way to combine resources to produce a certain number of outputs.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 244-252
See Mind-Map 12

36. Describe contemporary planning techniques (project management and scenario planning)

Flexibility is important to today's planning techniques because the environment can be both dynamic and complex.

Project management is the task of getting a project's activities done on time, within budget, and according to specifications. The steps in the project planning process include defining objectives; identifying activities and resources; establishing sequences; estimating time for activities; determining project completion date; comparing with objectives; and determining additional resource requirements.

Scenario planning – contingency planning – is important because managers can use it to play out potential situations under different environmental conditions. Scenario is a consistent view of what the future is likely to be.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 252-256
See Mind-Map 12

37. Define strategic management and its importance

Strategic management is what managers do to develop the organization's strategies. **Strategies** are the decisions and actions that determine the long-run performance of the organization. A **business model** is a strategic design for how a company intends to profit from its strategies, work processes, and work activities.

Strategic management is important for four reasons: it makes a difference in how well organizations perform; it's important for helping managers cope with continually changing situations; it helps coordinate diverse divisions, departments, functions, and work activities, and keeps all focused on achieving the organization's goals; and finally, it's important because it's involved in many of the decisions that managers make.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 208-210
See Mind-Map 13

38. Describe the strategic management process

The six steps in the strategic management process are: (1) identify the current mission, goals, and strategies; (2) do an external analysis; (3) do an internal analysis – steps 2 and 3 collectively are known as SWOT analysis; (4) formulate strategies; (5) implement strategies; and (6) evaluate strategies.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 210-216
See Mind-Map 13

39. Define the types of organizational strategies

The three major types of ***corporate strategies*** are growth, stability, and renewal. A growth strategy is used when an organization wants to grow its business and does so by expanding the number of products offered or markets served. A stability strategy is when an organization stays as it is; that is, it makes no significant change in what it's doing. Renewal strategies address organizational weaknesses that are leading to performance declines.

The BCG matrix is a way to analyze a company's portfolio of businesses. The analysis is based on a business's market share and its industry's anticipated growth rate. The four categories of the BCG matrix are cash cows, stars, question marks, and dogs.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 216-226
See Mind-Map 13

ORGANIZING

40. What are the essence of organizing and elements of organizational structure?

Organizing is arranging and structuring work to accomplish the organization's goals. Organizing includes managing organizational structure and organizational design. **Organizational structure** – the formal arrangement of jobs within an organization. When managers develop or change the structure, they're engaged in **organizational design**, a process that involves decisions about six key elements: work specialization, departmentalization, chain of command, span of control, centralization and decentralization, and formalization.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; p. 266
See Mind-Map 14

41. What are the factors affecting the type of organizational structure managers design?

Organizations have different structures. Managerial decisions on what kind of design to use depend on contingency factors. Organization can exist in one of two forms: mechanistic or organic. A mechanistic organization is a rigid and tightly controlled structure. An organic organization is highly adaptive and flexible. The contingency factors influencing the choice of more organic or more mechanistic design are the following: strategy; size; technology; degree of environmental uncertainty.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 274-278
See Mind-Map 14

42. What are the common organizational designs – traditional and contemporary?

Traditional designs: Simple structure is one with low departmentalization, wide spans of control, authority centralized in a single person, and little formalization. Functional structure groups similar or related occupational specialties together. Divisional structure is made up of separate business units or divisions.

Contemporary designs: In a team structure, the entire organization is made up of work teams. Matrix structure assigns specialists from different functional departments to work on one or more projects being led by project managers. A project structure is one in which employees continuously work on projects. Virtual organization consists of a small core of full-time employees and outside specialists temporarily hired as needed to work on projects.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 278-285
See Mind-Map 14

43. What is communication? What are its foundations?

Communication is the transfer and understanding of meaning. Communication plays an important role in organizations, specifically it served four major functions: control (control employees in several ways, hierarchical elements of control; interpersonal leverages to control behavior), motivation (clarifying goals, processes, what to do to improve performance, assessing the progress, feedback), emotional expression (organizations are sources of social interaction, feeling of satisfaction, fulfillment of social needs), and information (to get things done).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 292-294
See Mind-Map 15

44. Define organizational and interpersonal communication

Interpersonal communication is communication between two or more people. **Organizational communication** is all the patterns, networks, and systems of communication within an organization.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 294-296
See Mind-Map 15

45. What are the possible communication methods managers can use?

Managers have a wide variety of communication methods from which to choose. These include face-to-face, telephone, group meetings, formal presentations, memos, traditional mail, fax machines, employee publications, bulletin boards, other company publications, audio- and videotapes, hotlines, e-mail, computer conferencing, voice mail, teleconferences, and videoconferences. All of these communication channels include oral or written symbols, or both.

Interpersonal communication is impossible without its nonverbal dimension (nonverbal communication is communication transmitted without words). **Body language** refers to gestures, facial expressions, and other body movements that convey meaning. Knowing the meaning behind someone's body moves and learning how to put forth your best body language can help you personally and professionally.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 296-298
See Mind-Map 15

46. What are the possible barriers to effective communication and how they can be overcome?

The barriers to effective communication include filtering, emotions, information overload, defensiveness, language, and national culture.

Filtering is the deliberate manipulation of information to make it appear more favorable to the receiver. Emotions: How a receiver feels when a message is received influences how he or she interprets it. Information overload: when the information we have to work with exceeds our processing capacity. Defensiveness: When people feel that they're being threatened, they tend to react in ways that reduce their ability to achieve mutual understanding. Language: Words mean different things to different people. National Culture: Communication differences can arise from national culture as well as different languages that individuals use.

Managers can overcome these barriers by using feedback, simplifying language, listening actively, constraining emotions, and watching for nonverbal clues.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 298-303
See Mind-Map 15

47. Describe how communication exists in organizations

Organizational communication includes formal versus informal, and direction of communication flow.

Formal communication – communication that follows the official chain of command or is part of the communication required to do one’s job. Informal communication – not defined by the organization’s structural hierarchy. Employees form friendship and communicate with each other in no formal situations.

Communication flow can be of different directions: downward – from manager to employees; upward – flows from employees to managers; lateral – among employees on the same organizational level; diagonal – cuts across both work areas and organizational levels.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 303-306
See Mind-Map 16

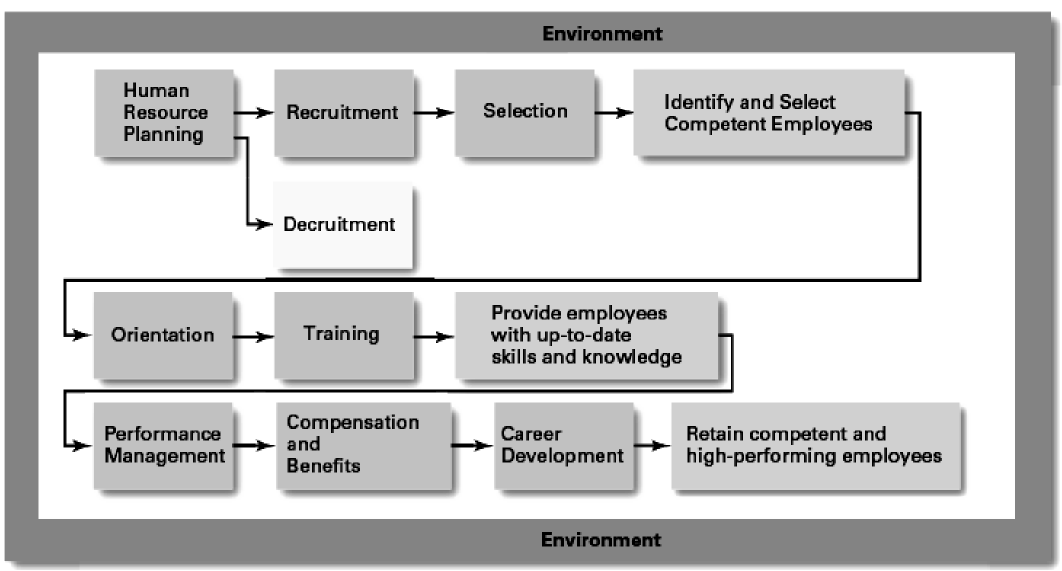
48. Explain how an organization's human resources can be a significant source of competitive advantage

Organization's human resources can be a significant source of competitive advantage, but achieving competitive success through people requires a fundamental change in the work relationship. It involves working with and through people and seeing them as partners. It also involves high-performance work practices – work practices that led to both high individual and high organizational performance. High-performance work practices (as e.g. self-managed teams, decentralized decision making, training programs to develop knowledge, skills, and abilities, flexible job assignments, open communication) common thread is a commitment to improving the knowledge, skills, and abilities of an organization's employees, increasing their motivation, reducing loafing on the job, and enhancing the retention of quality employees while encouraging low performers to leave.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 322-324
See Mind-Map 17

49. What are the key components of an organization's human resource management process?

Human resource management process consists of eight activities necessary for staffing the organization and sustaining high employee performance: first three activities ensure that competent employees are identified and selected; the next two involve providing employees with up-to-date knowledge and skills; and the final three ensure that the organization retains competent and high-performing employees.



Source: Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007, p. 324

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 322-324
See Mind-Map 17

50. Describe human resource planning

Human resource planning is the process by which managers ensure that they have the right number and kinds of capable people in the right places and at the right times. HR planning consists of two steps: (1) assessing current human resources and (2) meeting future HR needs.

Current Assessment: a) managers begin HR planning by reviewing the organization's current human resource status; b) *job analysis* **-** an assessment that defines jobs and the behaviors necessary to perform them; with information from the job analysis, managers develop or revise job descriptions and job specifications.

Meeting Future Human Resource Needs**:** future human resource needs are determined by the organization's mission, goals and strategies. Demand for employees is a result of demand for the organization's products or services.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 326-328
See Mind-Map 18

51. Define human resource recruitment and decruitment

Recruitment is locating, identifying, and attracting capable applicants. If HR planning shows a surplus of employees, management may want to reduce the organization's workforce through **decruitment.**

Recruitment**:** potential job candidates can be found by using several sources – internet, employee referrals, company website, college recruiting, professional recruiting organizations.

Decruitment**:** firing, layoffs, attrition, transfers, reduced workweeks, early retirements, job sharing.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 326-328
See Mind-Map 18

52. Explain the selection process and define selection devices

Selection - screening job applicants to ensure that the most appropriate candidates are hired, the key of selection is prediction of future performance.

Selection Devices**:** application forms, written and performance-simulation tests, interviews, background investigations, and in some cases, physical exams. For different jobs different devices can be valid. Managers must monitor the accuracy of using them, watching how they portray the organization and the work an applicant will be doing.

For increasing job satisfaction and decreasing turnover there is a tool, called **realistic job preview (RJP),** which includes both positive and negative information about the job and the company.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 328-333
See Mind-Map 18

53. Define orientation; describe employee training

Orientation is a type of introduction to job and the organization, needed for a person starting a new job.

Organization provide trainings to their employees as specific learning programs. Training can be general (communication skills, computer systems application and programming, customer service, executive development, management skills and development, personal growth, sales, supervisory skills, and technological skills and knowledge) and specific (basic life/work skills, creativity, customer education, diversity/cultural awareness, remedial writing, managing change, leadership, product knowledge, public speaking/presentation skills, safety, ethics, sexual harassment, team building, wellness, and others).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 334-336
See Mind-Map 18

54. What is employee performance management?

Performance management system establishes performance standards that are used to evaluate employee performance. Performance management includes the appraisal, which can be done by different methods. Most popular is GRS (graphic rating scale). Graphic Rating Scales lists a set of performance factors such as quantity and quality of work, job knowledge, cooperation, loyalty, attendance, honesty, and initiative. The evaluator goes down the list and rates the employee on each factor using an incremental scale. Non-traditional method is 360-Degree Feedback**:** a method that utilizes feedback from supervisors, employees, and co-worker (this appraisal utilizes information from the full circle of people with whom the manager interacts).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 337-338
See Mind-Map 19

55. How compensation and benefits can be managed in organizations?

Developing an effective and appropriate **compensation system** is an important part of the HRM process, because it can help attract and retain competent and talented individuals who help the organization accomplish its mission and goals; an organization's compensation system has an impact on its strategic performance. Organizational compensation can include many different types of rewards and benefits such as base wages and salaries, wage and salary add-ons, incentive payments, and other benefits and services. Organizations can use skill-based pay systems and variable pay systems. *Skill-based pay systems* reward employees for the job skills and competencies they can demonstrate; in *variable pay systems* an individual's compensation is contingent on performance. Managers must establish a fair, equitable, and motivating compensation system that allows the organization to recruit and keep a talented and productive workforce.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 338-340
See Mind-Map 19

56. How careers are managed?

Career is the sequence of positions held by a person during his or her lifetime. Career development programs were typically designed to help employees advance their work lives within a specific organization, which meant focus to provide employees the information, assessment, and training needed to help them realize their career goals. Career development is also a way for organizations to attract and retain highly talented people.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 340-342
See Mind-Map 19

57. What factors create the need for change?

Change is an organizational reality, and managers usually become communicators and “administrators” of it. Need for change is created by both external and internal forces.

External forces – *governmental laws and regulations*; *technology; fluctuation in labor markets*; *economic changes.* Internal forces tend to originate from the internal operations of the organization or from the impact of external changes – redefinition or modification of an organization's *strategy; workforce* is dynamic, its composition changes in terms of age, education, ethnic background, sex, etc.; introduction of new *equipment*; *employee attitudes* such as job dissatisfaction may lead to increased absenteeism, more voluntary resignations, and even labor strikes (often lead to changes in management policies and practices).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 356-357
See Mind-Map 20

58. Explain the two view of the change process. Is change episodic or ongoing?

Change can be perceived in two views: 1) metaphorically the organization as a large ship crossing a calm sea, and change comes in the form of an occasional storm, a brief distraction in an otherwise calm and predictable trip – the calm waters metaphor, change is seen as an occasional disruption in the normal flow of events; 2) metaphorically the organization is seen as a small raft navigating a raging river with uninterrupted white-water rapids, aboard the raft are half-a-dozen people who have never worked together, who are totally unfamiliar with the river, who are unsure of their eventual destination, and who, as if things weren't bad enough, are traveling at night – the white-water rapids metaphor, change is an expected and natural state, and managing change is a continual process.

Managers can face both constant and chaotic change. Some industries are considered to be more like in white-waters as software companies, some more like in the calm waters as banking. However days of stability and predictability seem to be long gone. Managers must be ready to efficiently and effectively manage the changes facing their organization or their work area.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 357-360
See Mind-Map 20

59. How organizational change is managed?

Organizational change – is any alteration of people, structure, or technology. Organizational changes often need someone to act as a catalyst and assume the responsibility for managing the change process – *change agent*. Usually changes are initiated and coordinated by managers. Change agent can be a nonmanager.

Change can be of different types (and must be managed in accordance): Structure – work specialization, departmentalization, span of control, centralization, formalization, chain of command, job or structural redesign; Technology – work processes, methods, equipment; People – attitudes, expectations, perceptions, behavior.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 360-366
See Mind-Map 20

60. How innovation and creativity can be managed in organizations?

Creativity in organizational settings is the process by which individuals or small groups produce novel and useful ideas. Creativity in organizations is based on three fundamental *components*: domain-relevant skills (basic knowledge needed to perform the task at hand), creativity-relevant skills (special abilities needed to generate creative new ideas), and intrinsic task motivation (people's willingness to perform creative acts).

Innovation refers to the implementation of creative ideas within organizations. It takes different forms depending on three factors: impact on existing business (sustaining innovation if impact is minor, and disruptive innovation if impact is major), the degree of uncertainty involved (incremental innovation if uncertainty is low, and radical innovation if uncertainty is high), and its sources (manufacturer innovation if ideas come from within, and end-user innovation if ideas come from customers).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 372-376
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 561-574
See Mind-Map 20

LEADING

61. Why organizational behavior is important to be studied? (Explain the focus and goals of OB)

Organizational behavior is concerned specifically with studying how people act at work. Organizational behavior focuses on two major areas: 1) *individual behavior* – includes such topics as attitudes, personality, perception, learning, and motivation; 2) *group behavior* - includes norms, roles, team building, leadership, and conflict. The goals of OB are to *explain*, *predict*, and *influence* (possibly change) behavior. OB is needed to be studied simply in order to manage behavior. Manager's success depends on getting things done through people, for this purpose manager needs to be able to *explain* why employees engage in some behaviors rather than others, *predict* how employees will respond to various actions the manager might take, and *influence* how employees behave. Six important employee behaviors are identified in OB studies: employee productivity, absenteeism, turnover, organizational citizenship behavior (OCB), job satisfaction, and workplace misbehavior.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 388-390
See Mind-Map 21

62. What are the levels of analysis in organizations?

<u>Four levels of analysis</u> normally characterize organizations – individual, group, organizational, interactions with external environment. The individual human being is the basic building block of organizations; individual is to the organization what a cell is to a biological system. The group or department are collections of individuals who work together to perform group tasks. An organization is a collection of groups or departments that combine into the total organization. Organizations themselves can be grouped together into the interorganizational set and community. The interorganizational set is the group of organizations with which a single organization interacts. Other organizations in the community also make up an important part of an organization's environment.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 33-34
See Mind-Map 21

63. What perspectives on organizations do exist?

Important perspectives on organizations are the open-systems approach, the organizational-configuration framework, and contemporary vision of organizations as learning organization.

Open Systems: A closed system is not depend on its environment; it is autonomous, enclosed, and sealed off from the outside world. Organizations as open systems interact with the environment to survive, and can be enormously complex.

Organizational Configuration: various parts of the organization are designed to perform the key subsystem functions. Henry Mintzberg proposed the framework suggesting that every organization has five parts: the technical core, top management, middle management, technical support, and administrative support.

Contemporary organization design – learning organization: the science of chaos theory suggests that relationships in complex, adaptive systems – including organizations – are nonlinear and made up of numerous interconnections and divergent choices that create unintended effects and render the universe unpredictable, because of that many organizations are shifting from strict vertical hierarchies to flexible, decentralized structures that emphasize horizontal collaboration, widespread information sharing, and adaptability.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 14-17

64. Identify four different forms of organizational justice and the organizational impact of each

Organizational justice refers to people's perceptions of fairness in organizations. People respond to how they perceive things, which may or may not be based on objective truths. The forms of organizational justice are distributive justice, procedural justice, interpersonal justice, and informational justice. Distributive justice refers to the perceived fairness of rewards (e.g., pay) received. People who feel they have received fair amounts of reward feel satisfied with their jobs. Procedural justice refers to people's perceptions of the fairness of the procedures used to determine the outcomes they receive. When high levels of procedural justice are perceived, people are inclined to follow organizational rules and policies. Interpersonal justice refers to the fairness of interpersonal treatment by others. High levels of interpersonal justice are related to high levels of satisfaction with one's supervisor. Finally, informational justice refers to people's perceptions of the fairness of the information used as the basis for making a decision. People tend to be highly valued by organizations in which they perceive high levels of informational justice.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 43-49

65. Describe strategies that can be used to promote organizational justice

Promoting organizational justice can be done in several ways: 1) it is important to pay workers what they deserve—the "going rate" for the work done wherever they work.

Underpaying workers promotes dissatisfaction, leading to turnover; 2) workers should be given a voice – that is, some input into decisions. This may involve such strategies as holding regular meetings, conducting employee surveys, keeping an "open door policy," and using suggestion systems; 3) follow openly fair procedures. Specifically, promote procedural fairness, such as by using unbiased, accurate information and applying decision rules consistently. Managers also should openly describe the fair procedures they are using; 4) managers should explain decisions thoroughly in a manner demonstrating dignity and respect; 5) workers should be trained to be fair, such as by adhering to the principles.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 49-54

66. What is learning and how it can be managed in terms of OB?

Learning is a relatively permanent change in behavior that occurs as a result of experience. People learn through operant conditioning, social or observational learning. One of the possible managerial tools in learning can be shaping behavior. There are four ways to shape behavior: positive reinforcement, negative reinforcement, punishment, or extinction. *Positive reinforcement* - when a behavior is followed by something pleasant; *negative reinforcement* - rewarding a response with the elimination or withdrawal of something unpleasant; *punishment* – penalizes undesirable behavior and will eliminate it; *extinction* - eliminating any reinforcement that's maintaining a behavior. Employees anyway are going to learn on the job, and for managers the significant issue is to manage their learning through the rewards they allocate and the examples they set.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 409-413
See Mind-Map 21

67. Describe how principles of learning are involved in organizational behavior management

Learning is involved directly in efforts to teach people to acquire new job skills, the process known as training. Training is most effective when people can actively participate in the learning process, repeat the desired behaviors, receive feedback on their performance, and learn under conditions closely resembling those found on the job. Today, companies are experimenting with innovative reward systems that include skill-based pay (i.e., paying people for the various skills they have demonstrated on the job) and team-based rewards (i.e., paying people for their contributions to team performance).

Organizational behavior management is a systematic attempt to apply principles of reinforcement to the workplace so as to improve organizational functioning. Reinforcing desired behaviors can improve organizational functioning greatly. In contrast to applications of reinforcement, discipline is the systematic application of punishments to minimize undesirable organizational behaviors. The effects of discipline are most effective when punishment is applied immediately after the undesirable activity, moderately severe, focused on the activity rather than the individual, applied consistently over time, and for all employees, clearly explained and communicated, and not weakened by the use of inadvertent rewards.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 121-125
See Mind-Map 21

68. How does personality influence behavior in organizations?

An individual's **personality** is a unique combination of emotional, thought, and behavioral patterns that affect how a person reacts and interacts with others. Personality can be accessed through different approaches. One of the most popular in organizations is MBTI indicator. As it lacks research evidence to support its validity, there is another tool – Big Five Model of personality (extroversion, agreeableness, conscientiousness, neuroticism, openness to experience). Additionally there are five other personality traits that have proved to be the most powerful in explaining individual behavior in organizations: locus of control, Machiavellianism, self-esteem, self-monitoring, and risk-taking.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 397-405
See Mind-Map 21

69. Differentiate among cognitive intelligence, practical intelligence, and emotional intelligence

Cognitive intelligence is the ability to understand complex ideas, to adapt effectively to the environment, to learn from experience, to engage in various forms of reasoning, and to overcome obstacles by careful thought. Practical intelligence, the ability to come up with effective ways of getting things done, and emotional intelligence, a cluster of abilities relating to the emotional or “feeling” side of life. Emotional intelligence(EI) refers to the ability to make accurate judgments of emotions and to use such knowledge to enhance the quality of one’s thinking. Much as tests of cognitive intelligence are used to derive intelligence quotient (IQ scores), tests of emotional intelligence are used to derive emotional quotient (EQ scores).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 154-161

70. Distinguish between emotions and moods. Explain how emotions and mood influence behavior in organizations

Whereas **emotions** are overt reactions that express people's feelings about a specific event, **moods** are more general. Specifically, moods are unfocused, relatively mild feelings that exist as background to our daily experiences. Emotions have the following characteristics: emotions always have an object; the spread of emotions is contagious; expression of emotions is universal; culture determines how and when people express emotions.

Emotions and mood affect behavior in organizations in various ways. Generally, happier people are more successful on their jobs; they perform at higher levels, and they make higher incomes. Furthermore, happier people tend to make better decisions, remember positive events, give positive evaluations when appropriate, and cooperate with others. People manage their emotions in organizations differently, for instance by keeping their negative feelings to themselves. The inconsistency between the emotions we express and the emotions we feel is known as *emotional dissonance*. People in organizations also manage their emotions by *managing their anger* and by *displaying compassion for others* when needed. This is especially important during major crises and emergencies.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 170-181

71. What is stereotyping? Explain the dangers of using stereotypes

Stereotypes – beliefs that members of specific groups tend to share similar traits and are prone to behave identically. We rely on stereotypes because people tend to do as little cognitive work as possible when it comes to thinking about others; we tend to rely on mental shortcuts.

The following dangers exist in organizations, related to negative effect of stereotyping: inaccurate information – stereotypes often are inaccurate (negative organizational impact); stereotype threats (negative individual impact) – people tend to live down to – the negative stereotypes that people hold about them. The idea that stereotypes constrain behavior when a member of a stereotyped group is placed in a situation in which poor performance can be taken as an indication of the group’s deficiency – is the basis of what is known as a stereotype threat. *Stereotype threat* is the uncomfortable feeling that people have when they run the risk of fulfilling a negative stereotype associated with a group to which they belong.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 101-103

72. Identify the major causes of organizational stress and its adverse effect

Stress is the pattern of emotional and physiological reactions occurring in response to demands from within or outside organizations. Stress is caused by many different factors, including occupational demands, conflicts between the work and non-work aspects of one's life (i.e., role conflict), not knowing what one is expected to do on the job (i.e., role ambiguity), overload and underload, having responsibility for other people, and experiencing sexual harassment (unwanted contact or communication of a sexual nature, usually against women).

Experiencing high levels of organizational stress has negative effects on task performance. It also adversely affects people's physical and mental health in a variety of ways. Stress also is a major cause of such serious problems as desk rage (lashing out at others in response to stressful encounters on the job) and burnout (a syndrome of emotional, physical, and mental exhaustion coupled with feelings of low self-esteem or low self-efficacy, resulting from prolonged exposure to intense stress, and the strain reactions following from them).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 181-195

73. How does perception affect behavior?

Perception is a process by which individuals give meaning to their environment by organizing and interpreting their sensory impressions. People interpret what they see and call it reality, and behave according to perceptions. Our perceptions of people differ from our perception of inanimate objects because we make inferences about the behaviors of people that we don't make about objects.

Managers need to recognize that their employees react to perceptions, not to reality. Employees organize and interpret what they see, so there is always the potential for perceptual distortion. Managers should pay close attention to how employees perceive both their jobs and management actions, and remember, the valuable employee who quits because of an inaccurate perception is just as great a loss to an organization as the valuable employee who quits for a valid reason.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 405-409

See Mind-Map 21

74. Define attitudes and describe their basic components

Attitudes are the stable clusters of feelings, beliefs, and behavioral tendencies directed toward some aspect of the external world. **Work-related attitudes** – lasting feelings, beliefs, and behavioral tendencies toward various aspects of the job itself, the setting in which the work is conducted, the people involved and/or the organization as a whole. All attitudes consist of a cognitive component (what you believe), an evaluative component (how you feel), and a behavioral component (the tendency to behave a certain way).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 206-215

75. Distinguish between prejudice and discrimination, and identify various victims of prejudice in organizations

Prejudice refers to negative attitudes toward members of specific groups, and *discrimination* refers to treating people differently because of these prejudices. Today's workforce is characterized by high levels of diversity, with many groups finding themselves victims of prejudicial attitudes and discriminatory behaviors (based on many different factors, including age, sexual orientation, physical condition, racial or ethnic group membership, gender, and people from different religions than our own). Although people are becoming more tolerant of individuals from diverse groups, prejudicial attitudes persist.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 206-215

76. Explain the concept of job satisfaction and describe three major theories

Job satisfaction involves positive or negative attitudes toward one's work. The dispositional model of job satisfaction suggests that job satisfaction is a relatively stable characteristic that stays with people over various situations. Value theory suggests that job satisfaction reflects the apparent match between the outcomes individuals desire from their jobs (what they value) and what they believe they are actually receiving. Finally, the social information processing model specifies that people adopt attitudes and behaviors in keeping with the cues provided by others with whom they come into contact.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 221-234

77. What can be the consequences of job dissatisfaction and the possible ways to promote job satisfaction?

When people are dissatisfied with their jobs, they tend to withdraw. That is, they are frequently absent (*absenteeism*) and are likely to quit their jobs (*voluntary turnover*). However, evidence suggests that job performance is only very weakly associated with dissatisfaction. Levels of job satisfaction can be raised by paying people fairly, improving the quality of supervision, decentralizing control of organizational power, and assigning people to jobs that match their interests.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 221-234

78. Describe the concept of organizational commitment, its major forms, the consequences of low level of organizational commitment, and how to overcome them

Organizational commitment focuses on people's attitudes toward their organizations. There are three major types of organizational commitment: <u>continuance commitment</u> – the strength of a person's tendency to continue working for an organization because he or she has to and cannot afford to do otherwise; <u>normative commitment</u> – commitment to remain in an organization stemming from social obligations to do so; <u>affective commitment</u> – the strength of a person's tendency to continue working for an organization because he or she agrees with its goals and values, and desires to stay with it. Low levels of organizational commitment have been linked to high levels of absenteeism and voluntary turnover, the unwillingness to share and make sacrifices for the company, and negative personal consequences for employees. However, organizational commitment may be enhanced by enriching jobs, aligning the interests of employees with those of the company, and recruiting and selecting newcomers whose values closely match those of the organization.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 234-239

79. What is motivation?

Motivation – the process by which a person's efforts are energized, directed, and sustained toward attaining a goal. Three key elements are important to motivation: energy, direction, and persistence. The *energy (arousal)* element is a measure of intensity or drive. High levels of effort don't necessarily lead to favorable job performance unless the effort is channeled in a *direction* that benefits the organization. Finally, motivation includes a *persistence (maintenance)* dimension. We want employees to persist in putting forth effort to achieve those goals. Motivation is one of the determinants of job performance.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 452-453
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 248-254
See Mind-Map 24

80. What can be some practical suggestions for motivating employees?

The following suggestion tips the summary how to motivate employees effectively: Recognize Individual Differences: contemporary motivation theories recognize that employees have different needs, attitudes, personality, and other important individual variables. Match People to Jobs: the motivational benefits of carefully matching people to jobs, not everybody is motivated by jobs that are high in autonomy, variety, and responsibility. Use Goals: managers should ensure that employees have hard, specific goals and feedback on how well they're doing in achieving those goals. Ensure That Goals Are Perceived As Attainable**:** managers must be sure, that employees feel confident that increased efforts *can* lead to achieving performance goals. Individualize Rewards: managers should use their knowledge of employee differences to individualize the rewards they control, such as pay, promotions, recognition, desirable work assignments, autonomy, and participation. Link Rewards to Performance: managers need to make rewards contingent on performance, managers should also look for ways to increase the visibility of rewards, making them potentially more motivating. Check the System for Equity: employees should perceive that rewards or outcomes are equal to the inputs, one person's equity is another's inequity, so an ideal reward system should probably weigh inputs differently in arriving at the proper rewards for each job. Use Recognition: using recognition is a low-cost means to reward employees, and it's a reward that most employees consider valuable. Show Care and Concern for Your Employees: employees perform better for managers who care about them, so when managers care about employees, performance results typically follow. Don't Ignore Money: if money is removed as an incentive, people aren't going to show up for work. The same can't be said for removing goals, enriched work, or participation.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 476-479
See Mind-Map 24

81. Distinguish among job enlargement and job enrichment and the job characteristics model as techniques for motivating employees

Motivation may be enhanced at the organizational level by designing or redesigning jobs in certain ways. Popular approaches include job enlargement (performing more tasks at the same level) and job enrichment (giving people greater responsibility and control over their jobs). A more sophisticated approach, the job characteristics model, identifies the specific job dimensions that should be enriched (skill variety, task identity, task significance, autonomy, and feedback), and relates these to the critical psychological states influenced by including these dimensions on a job. These psychological states will, in turn, lead to certain beneficial outcomes for both individual employees (e.g., job satisfaction) and the organization (e.g., reduced absenteeism and turnover). Jobs may be designed to enhance motivation by combining tasks, opening feedback channels, establishing client relationships, and loading jobs vertically (i.e., enhancing responsibility for one's work).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 274-281

82. How do groups develop in organizations?

Group is defined as two or more interacting and interdependent individuals who come together to achieve specific goals – formal and informal. Groups development is a dynamic process, treated in five stages: forming, storming, norming, performing, adjourning.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 424-427
See Mind-Map 22

83. Explain the factors which affect work group behavior

The explanation of differences in group behavior is complex, including variables such as the abilities of the group's members, the size of the group, the level of conflict, and the internal pressures on members to conform to the group.

External Conditions Imposed on the Group include the organization's strategy, authority relationships, formal rules and regulations, availability of organizational resources, employee selection criteria, the organization's performance management system and culture, and general physical layout of the group's work space.

Group Member Resources: group’s performance potential depends to a large extent on the individual resources its members bring to the group, including members' knowledge, abilities, skills, and personality characteristics.

Group Structure: work groups have an internal structure that shape members' behavior and defines member roles, norms, conformity, status systems, group size, group cohesiveness, and formal leadership positions.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 427-433
See Mind-Map 22

84. What are the characteristics of effective team?

Nowadays organizations without teams are exclusions. Teams typically outperform individuals when the tasks being done require multiple skills, judgment, and experience. Managers have found that teams are more flexible and responsive to changing events than are traditional departments or other permanent work groups. **Work teams** are groups whose members work intensely on a specific, common goal using their positive synergy, individual and mutual accountability, and complementary skills.

There exist some insights into the characteristics associated with effective teams: clear goals, relevant skills, mutual trust, unified commitment, good communication, negotiating skills, appropriate leadership, internal and external support. To build successful teams, it is needed: to provide training in team skills, compensate team performance, provide managerial support, promote employee support, promote cooperation, select team members based on their skills or potential skills.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 438-442
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 307-325
See Mind-Map 23

85. What is interpersonal behavior? Define the range of its major types

Interpersonal behavior is a variety of behaviors involving the ways in which people work with and against one another. Interpersonal behaviors along a continuum range from those that involve working with others (prosocial behavior, cooperation, e.g. organizational citizenship) to those that involve working against others (competition, conflict, deviations). *Prosocial behavior* – the tendency for people to help others on the job, sometimes even when there doesn't appear to be anything in it for them. There are situations in which people help each other and receive help from them – that is, the tendency to *cooperate*. People and entire companies don't always work with each other; they also *compete* against each other – that is, as one tries to win, it forces the other to lose. Under such circumstances, it is not unusual for *conflict* to emerge, breeding ill-will. And, when taken to the extreme, this results in *deviant behavior* – acts intended to bring harm, such as stealing from the company or even harming another person.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 426-432

86. Describe the types of psychological contracts

Psychological contract – a person’s beliefs about what is expected of another in a relationship. One type of psychological contract is the *transactional contract*. It is characteristic of relationships that have an exclusively economic focus, last for a brief period of time, are unchanging in nature, and have a narrow, well-defined scope. Another kind is the *relational contract*. It applies to relationships that are longer-term in scope and go beyond basic economic issues such as pay for performance. A third type is the *balanced contract*; this involves elements of both transactional and relational contracts.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 426-432

87. Define organizational citizenship behavior and its major forms

Organizational citizenship behavior (OCB) – an informal form of behavior in which people go beyond what is formally expected of them to contribute to the well-being of their organization and those in it (actions which exceed the formal requirements of one's job). The main forms OCB can take are: altruism, conscientiousness, civic virtue, sportsmanship, courtesy. Organizational citizenship behavior can be directed both at an *individual* (**OCB-I**)and at the *organization* itself (**OCB-O**).Examples of OCB-I: assisting a coworker with a personal problem, bringing in food to share with others. Examples of OCB-O: offering ideas to improve the functioning of the organization, expressing loyalty toward the organization.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 432-434

88. Explain how individual performance in groups is affected by the social facilitation and social loafing

Social facilitation is the tendency for the presence of others sometimes to enhance an individual’s performance and at other times to impair it. According to drive theory of social facilitation, individual productivity is influenced by the presence of other group members. Sometimes, a person's performance improves in the presence of others (when the job he or she is doing is well learned), and sometimes performance declines in the presence of others (when the job is novel). People perform better on tasks in the presence of others if that task is very well learned, but poorer if it is not well learned.

On additive tasks (i.e., ones in which each member's individual contributions are combined), **social loafing** occurs, **-** the tendency for group members to exert less individual effort on an additive task as the since of the group increases; in other words the more people who work on a task, the less each group member contributes to it.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 302-307

89. Distinguish between various forms of individual power in organizations

Overall, **power** refers to the capacity to influence others. One major type of power, *position power*, resides within one's formal organizational position. It includes (1) reward power, (2) coercive power, (3) legitimate power, and (4) information power. A second major type of power, *personal power*, resides within an individual's own unique qualities or characteristics. It includes (1) rational persuasion, (2) expert power, (3) referent power, and (4) charisma.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 471-474

90. What is leadership and who are leaders?

Leader is someone who can influence others and who has managerial authority. **Leadership** – the process whereby one individual influences other group members toward the attainment of defined group or organizational goals. More specifically, it's the process of influencing a group to achieve goals. Because leading is one of the four management functions, ideally, all managers should be leaders. Leaders from managerial perspective are positional leaders mostly. Informal leaders may be able to influence others.

Leadership involves *noncoercive influence*, the influence is *goal-directed*; leadership requires *followers*. Although leaders do indeed influence subordinates in various ways, leaders are also influenced by their subordinates.

Management, *9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; p. 488*
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 500-502
See Mind-Map 25

91. What are the contemporary views on leadership?

There can be determined three contemporary approaches to leadership including transformational-transactional leadership, charismatic-visionary leadership, and team leadership.

Transformational-Transactional Leadership: one view is that leaders lead primarily by using social exchanges (or transactions), transactional leaders guide or motivate followers to work toward established goals by exchanging rewards for their productivity; another view suggests that there's another type of leader who stimulates and inspires (transforms) followers to achieve extraordinary outcomes. Charismatic-Visionary Leadership: enthusiastic, self-confident leader whose personality and actions influence people to behave in certain ways.

Vision is often linked with charismatic leadership, visionary leadership goes beyond charisma since it's the ability to create and articulate a realistic, credible, and attractive vision of the future that improves upon the current situation. Team Leadership: managers have to learn skills such as having the patience to share information, being able to trust others and to give up authority, and understanding when to intervene.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 500-504
See Mind-Map 25

92. Differentiate between leadership and management

Typically the person who actually exercises the most influence over the group is identified as its **leader**. These facts point to the following definition of leadership – one accepted by many experts on this topic: **Leadership** is the process whereby one individual influences other group members toward the attainment of defined group or organizational goals. Leadership involves influencing others (followers) in ways that help attain goals and in a manner that is noncoercive and goal-directed. A leader's primary function is to envision and articulate the essential purpose or mission of an organization and the strategy for attaining it. The job of the manager is to implement the leader's vision, putting into practice ways of bringing that vision to fruition. In practice, this distinction is often difficult to make because many leaders and followers also do things that are in keeping with the other's role.

Leaders and managers play several overlapping roles in actual practice - a fact that blurs the distinction between them. Some managers are considered leaders, whereas others are not. Similarly, some leaders assume more of a management role than others. Thus, although the differences are not always obvious, they are real.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 502-503
See Mind-Map 25

CONTROL

93. What is control and why it is important?

Control is the process of monitoring, comparing, and correcting work performance. An effective control system ensures that activities are completed in ways that lead to the attainment of goals, and the criterion that determines the effectiveness of a control system is how well it helps employees and managers achieve their goals. There exist three different types of control systems: *Market control* is an approach that emphasizes the use of external market mechanisms. *Bureaucratic control* emphasizes organizational authority and relies on administrative rules, regulations, procedures, and policies. Under *clan control*, employee behaviors are regulated by the shared values, norms, traditions, rituals, beliefs, and other aspects of the organization's culture.

Control is important, because it's the only way managers know whether organizational goals are being met and if not, the reasons why. The value of the control function can be seen in three specific areas: planning, empowering employees, and protecting the workplace.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 526-529
See Mind-Map 26

94. Explain the elements of control process

The **control process** is a three-step process: measuring actual performance, comparing actual performance against a standard, and taking managerial action to correct deviations or inadequate standards (in control process we assume that standards already exist).

<u>Measuring</u>: four sources of information frequently used by managers to measure actual performance are personal observation, statistical reports, oral reports, and written reports. <u>Comparing:</u> determines the degree of variation between actual performance and the standard. <u>Making Managerial Action</u>: managers can choose among three possible courses of action – do nothing; correct the actual performance (managers can use immediate corrective actions correcting problems at once to get performance back on track and basic corrective action looking at how and why performance has deviated and then proceeds to correct the source of deviation); or revise the standards (the variance possible can be a result of an unrealistic standard, in this case standard itself needs corrective action).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 529-534
See Mind-Map 26

95. How managers can control for organizational performance?

Performance is the end result of an activity. **Organizational performance** – the accumulated end results of all the organization's work activities. Managers *want* their organizations, work units, or work groups to achieve high levels of performance. Managers must know what organizational performance measures will give them the information they need. The most frequently used measures include organizational productivity, organizational effectiveness, and industry rankings.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 534-537
See Mind-Map 26

96. What are the tools for controlling organizational performance?

Managers can implement controls *before an* activity begins (*feed forward control*), *during* the time the activity is going on (*concurrent control*), and *after* the activity has been completed (*feedback control*).

The tools for control are:
Financial control, the balanced scorecard(a performance measurement tool that looks at four areas – financial, customer, internal processes, and people/innovation/growth assets – that contribute to a company's performance. According to this approach, managers should develop goals in each of the four areas and then measure if the goals are being met), information control: (1) as a tool to help managers control other organizational activities and (2) as an organizational area that managers need to control.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 537-546
See Mind-Map 26

97. What is operations management? Why is it important?

Operations management is the design, operation, and control of the transformation process that converts resources into finished goods and services. Every organization has an operations system that creates value by transforming inputs into outputs. The system takes in inputs – people, technology, capital, equipment, materials, and information—and transforms them through various processes, procedures, work activities, and so forth into finished goods and services. Operations management is important to organizations and managers, because: it encompasses both services and manufacturing, it's important in effectively and efficiently managing productivity, and it plays a strategic role in an organization's competitive success.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 564-568
See Mind-Map 27

98. What responsibilities do operations managers have?

Direct responsibilities include the translation of into operational action, the design of the operation (not only products and services themselves but as well the systems or processes which produce them), the planning and controlling of the activities of the operation, and the improvement of the operation over time.

Indirect responsibilities include working closely with other functional areas of the business.

Broad responsibilities include understanding the impact on the operation of globalization, environmental responsibility, social responsibility, new technologies and knowledge management.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 27-32
See Mind-Map 27

99. What is TQM?

TQM – **Total Quality Management** – is a holistic approach to the management of quality that emphasizes the role of all parts of an organization and all people within an organization to influence and improve quality; heavily influenced by various quality ‘gurus’ (as W.E. Deming, J.M. Juran, K. Ishikawa and others).

TQM can be seen as being an extension of the traditional approach to quality – inspection based quality control being replaced by the concept of quality assurance with in turn has been suppressed by TQM. Some core ideas of TQM are:

- TQM puts customers at the forefront of quality decision making.
- TQM takes an organization-wide perspective.
- TQM places emphasis on the role and responsibilities of every member of staff within an organization to influence quality.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 651-661
See Mind-Map 27

100. What is value chain management?

Organizations must provide the value to attract and keep customers. *Value* is defined as the performance characteristics, features and attributes, and any other aspects of goods and services for which customers are willing to give up resources (usually money). The **value chain** is the entire series of organizational work activities that add value at each step from raw materials to finished product; the value chain can encompass the suppliers to the customer.

Value chain management is the process of managing the sequence of activities and information along the entire product chain, is externally oriented and focuses on both incoming materials and outgoing products and services; is effectiveness oriented and aims to create the highest value for customers. The goal of value chain management is to create a value chain strategy that meets and exceeds customers' needs and desires and allows for full and seamless integration among all members of the chain.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 568-574

See Mind-Map 27

MANAGING DESIGN AND BEHAVIOR IN ORGANIZATIONS; OPERATIONS MANAGEMENT

101. What are the levels of analysis in organizations?

Organizations are (1) social entities that (2) are goal-directed, (3) are designed as deliberately structured and coordinated activity systems, and (4) are linked to the external environment. The key element of an organization is not a building or a set of policies and procedures; organizations are made up of people and their relationships with one another. Three elements constitute any organization: people, strategy, structure. Four levels of analysis normally characterize organizations – individual, group, organizational, interactions with external environment. The individual human being is the basic building block of organizations; individual is to the organization what a cell is to a biological system. The group or department are collections of individuals who work together to perform group tasks. An organization is a collection of groups or departments that combine into the total organization. Organizations themselves can be grouped together into the interorganizational set and community. The interorganizational set is the group of organizations with which a single organization interacts. Other organizations in the community also make up an important part of an organization's environment.

Organizational behavior(psychology of organizations) is the micro approach to organizations because it focuses on the individuals within organizations as the relevant units of analysis. Organizational behavior examines concepts such as motivation, leadership style, and personality and is concerned with cognitive and emotional differences among people within organizations.

Organization theory(sociology of organizations) is a macro examination of organizations because it analyzes the whole organization as a unit. Organization theory is concerned with people aggregated into departments and organizations and with the differences in structure and behavior at the organization level of analysis. A new approach to organization studies is called meso theory ("in between"), concerning the integration of both micro and macro levels of analysis. Individuals and groups affect the organization and the organization in return influences individuals and groups. To thrive in organizations, managers and employees need to understand multiple levels simultaneously.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 33-34

102. What perspectives on organizations do exist? Define the organizational configuration elements (model by Henry Mintzberg)?

Important perspectives on organizations are the open-systems approach, the organizational-configuration framework, and contemporary vision of organizations as learning organization.

Open Systems: A closed system is not depend on its environment; it is autonomous, enclosed, and sealed off from the outside world. Concerning organizations, a true closed system cannot exist, however early organization studies focused on internal systems. An open system must interact with the environment to survive; it both consumes resources and exports resources to the environment; it cannot seal itself off; it must continuously adapt to the environment. Open systems can be enormously complex.

Organizational Configuration: various parts of the organization are designed to perform the key subsystem functions. Henry Mintzberg proposed the framework suggesting that every organization has five parts: the technical core, top management, middle management, technical support, and administrative support. The five parts of the organization may vary in size and importance depending on the organization's environment, technology, and other factors. *The technical core* includes people who do the basic work of the organization; it performs the production subsystem function and actually produces the product and service outputs of the organization; this is where the primary transformation from inputs to outputs takes place. The *technical support* function helps the organization adapt to the environment; it is responsible for creating innovations in the technical core, helping the organization change and adapt. Technical support employees such as engineers and researchers scan the environment for problems, opportunities, and technological developments. The *administrative support* function is responsible for the smooth operation and upkeep of the organization, including its physical and human elements; this includes human resource activities such as recruiting and hiring, establishing compensation and benefits, and employee training and development, as well as maintenance activities such as cleaning of buildings and service and repair of machines. *Management* is a distinct subsystem, responsible for directing and coordinating other parts of the organization. Top management provides direction, strategy, goals, and policies for the entire organization or major divisions. Middle management is responsible for implementation and coordination at the departmental level.

Contemporary organization design – learning organization: with the turbulence of recent years, managers can no longer maintain an illusion of order and predictability. The science of chaos theory suggests that relationships in complex, adaptive systems – including organizations – are nonlinear and made up of numerous interconnections and divergent choices that create unintended effects and render the universe unpredictable. The world is full of uncertainty, characterized by surprise, rapid change, and confusion. Managers can’t measure, predict, or control in traditional ways the unfolding drama inside or outside the organization. However, chaos theory also recognizes that this randomness and disorder occurs within certain larger patterns of order. The ideas of chaos theory suggest that organizations should be viewed more as natural systems than as well-oiled, predictable machines. Many organizations are shifting from strict vertical hierarchies to flexible, decentralized structures that emphasize horizontal collaboration, widespread information sharing, and adaptability.

Many managers are redesigning their companies toward something called the learning organization. The *learning organization* promotes communication and collaboration so that everyone is engaged in identifying and solving problems, enabling the organization to continuously experiment, improve, and increase its capability; it is based on equality, open information, little hierarchy, and a culture that encourages adaptability and participation, enabling ideas to bubble up from anywhere that can help the organization seize opportunities and handle crises. In a learning organization, the essential value is problem solving, as opposed to the traditional organization designed for efficient performance. Efficient performance and the learning organization orientation are different in the following areas of organization design: structure (from vertical to horizontal), tasks (from routine tasks to empowered roles), systems (from formal control systems to shared information), culture (from rigid to adaptive), and strategy (from competitive to collaborative).

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 14-17

103. Define the dimensions of organization design

The dimensions describe organizations in much the same way that personality and physical traits describe people.

<u>Structural Dimensions:</u>

1. Formalization pertains to the amount of written documentation in the organization.
2. Specialization is the degree to which organizational tasks are subdivided into separate jobs.
3. Hierarchy of authority describes who reports to whom and the span of control for each manager. The hierarchy is related to span of control (the number of employees reporting to a supervisor). When spans of control are narrow, the hierarchy tends to be tall. When spans of control are wide, the hierarchy of authority will be shorter.
4. Centralization refers to the hierarchical level that has authority to make a decision. When decision making is kept at the top level, the organization is centralized. When decisions are delegated to lower organizational levels, it is decentralized.
5. Professionalism is considered high when employees require long periods of training to hold jobs in the organization. Professionalism is generally measured as the average number of years of education of employees.
6. Personnel ratios refer to the deployment of people to various functions and departments. Personnel ratios include the administrative ratio, the clerical ratio, the professional staff ratio, and the ratio of indirect to direct labor employees. A personnel ratio is measured by dividing the number of employees in a classification by the total number of organizational employees.

<u>Contextual Dimensions:</u>

1. Size is the organization's magnitude as reflected in the number of people in the organization.
2. Organizational technology refers to the tools, techniques, and actions used to transform inputs into outputs. It concerns how the organization actually produces the products and services it provides for customers and includes such things as flexible manufacturing, advanced information systems, and the Internet.

3. The environment includes all elements outside the boundary of the organization; key elements include the industry, government, customers, suppliers, and the financial community.
4. The organization's goals and strategy define the purpose and competitive techniques that set it apart from other organizations. Goals are often written down as an enduring statement of company intent. A strategy is the plan of action that describes resource allocation and activities for dealing with the environment and for reaching the organization's goals. Goals and strategies define the scope of operations and the relationship with employees, customers, and competitors.
5. An organization's culture is the underlying set of key values, beliefs, understandings, and norms shared by employees. These underlying values may pertain to ethical behavior, commitment to employees, efficiency, or customer service, and they provide the glue to hold organization members together. An organization's culture is unwritten but can be observed in its stories, slogans, ceremonies, dress, and office layout.

The eleven contextual and structural dimensions are interdependent. They dimensions provide a basis for the measurement and analysis of characteristics that cannot be seen by the casual observer, and they reveal significant information about an organization.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 17-24

104. Explain the role of strategic direction in organization design, including organizational purpose – mission, operative goals

An organization is created to achieve some purpose, which is usually displayed in strategic direction. The direction-setting process typically begins with an assessment of the opportunities and threats in the external environment, including the amount of change, uncertainty, and resource availability. The next step is to define overall mission and official goals based on the correct fit between external opportunities and internal strengths. Specific operational goals or strategies can then be formulated to define how the organization is to accomplish its overall mission.

Organization design is used to implement goals and strategy and also determines organization success. The <u>overall goal</u> for an organization is often called the mission – the organization's reason for existence. The <u>mission</u> describes the organization's vision, its shared values and beliefs, and its reason for being. One of the primary purposes of a mission statement is to serve as a communication tool. The <u>mission statement</u> communicates to current and prospective employees, customers, investors, suppliers, and competitors what the organization stands for and what it is trying to achieve. A mission statement communicates legitimacy to internal and external stakeholders, who may join and be committed to the organization because they identify with its stated purpose. <u>Operative goals</u> designate the ends sought through the actual operating procedures of the organization and explain what the organization is actually trying to do. Operative goals describe specific measurable outcomes and are often concerned with the short run. Operative versus official goals represent actual versus stated goals. Operative goals typically pertain to the primary tasks an organization must perform, similar to the subsystem activities. These goals concern overall performance, boundary spanning, maintenance, adaptation, and production activities. Specific goals for each primary task provide direction for the day-to-day decisions and activities within departments.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 156-162

105. Define the contingency effectiveness approaches

Organizational effectiveness is the degree to which an organization realizes its goals. Effectiveness is a broad concept. It implicitly takes into consideration a range of variables at both the organizational and departmental levels. Effectiveness evaluates the extent to which multiple goals – whether official or operative – are attained. **Contingency approaches** to measuring effectiveness focus on different parts of the organization: the *goal approach* to organizational effectiveness is concerned with the output side and whether the organization achieves its goals in terms of desired levels of output; the *resource-based approach* assesses effectiveness by observing the beginning of the process and evaluating whether the organization effectively obtains resources necessary for high performance; the *internal process approach* looks at internal activities and assesses effectiveness by indicators of internal health and efficiency.

Goal Approach: operative goals are to be considered, as they reflect activities the organization is actually performing.

Resource-based Approach: obtaining and successfully managing resources is the criterion by which organizational effectiveness is assessed; indicators of effectiveness according to the resource-based approach encompass the following dimensions: bargaining position – the ability of the organization to obtain from its environment scarce and valued resources, including financial resources, raw materials, human resources, knowledge, and technology, the abilities of the organization's decision makers to perceive and correctly interpret the real properties of the external environment, the abilities of managers to use tangible (e.g., supplies, people) and intangible (e.g., knowledge, corporate culture) resources in day-to-day organizational activities to achieve superior performance, the ability of the organization to respond to changes in the environment.

Internal Process Approach: one indicator of internal process effectiveness is the organization's economic efficiency. However, the best-known proponents of a process model are from the human relations approach to organizations. There are seven indicators of an effective organization as seen from an internal process approach: strong corporate culture and positive work climate; team spirit, group loyalty, and teamwork; confidence, trust, and communication between workers and management; decision making near sources of information, regardless of where those sources are on the organizational chart; undistorted horizontal and vertical communication; sharing of relevant facts and feelings; rewards to managers for performance, growth, and development of subordinates and for creating an effective work group; interaction between the organization and its parts, with conflict that occurs over projects resolved in the interest of the organization.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 170-175

106. What is an integrated effectiveness model?

The **model** is based on the assumption that there are disagreements and competing viewpoints about what constitutes effectiveness. Analyzing them produced underlying dimensions of effectiveness criteria that represents competing management values in organizations.

Following are indicators of the model – value dimensions: 1) value dimension pertains to organizational focus, which is whether dominant values concern issues that are internal or external to the firm. Internal focus reflects a management concern for the well-being and efficiency of employees, and external focus represents an emphasis on the well-being of the organization itself with respect to the environment; 2) pertains to organization structure, and whether stability versus flexibility is the dominant structural consideration. Stability reflects a management value for efficiency and top-down control, whereas flexibility represents a value for learning and change.

The combination of dimensions provides four approaches to organizational effectiveness. In real organizations, these competing values can and often do exist together. Each approach reflects a different management emphasis with respect to structure and focus.

A combination of external focus and flexible structure leads to an open systems emphasis. Management's primary goals are growth and resource acquisition. The organization accomplishes these goals through the sub goals of flexibility, readiness, and a positive external evaluation. The dominant value is establishing a good relationship with the environment to acquire resources and grow. The rational goal emphasis represents management values of structural control and external focus. The primary goals are productivity, efficiency, and profit. The organization wants to achieve output goals in a controlled way. Sub goals that facilitate these outcomes are internal planning and goal setting, which are rational management tools. The internal process emphasis reflects the values of internal focus and structural control. The primary outcome is a stable organizational setting that maintains itself in an orderly way. Organizations that are well established in the environment and simply want to maintain their current position would reflect this emphasis. Sub goals include mechanisms for efficient communication, information management, and decision making.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 175-179

107. Define organization structure and explain the information-processing perspective on organizational structure

Definition of **organization structure** consists of three issues: 1. organization structure designates formal reporting relationships, including the number of levels in the hierarchy and the span of control of managers and supervisors; 2. organization structure identifies the grouping together of individuals into departments and of departments into the total organization; 3. organization structure includes the design of systems to ensure effective communication, coordination, and integration of efforts across departments. These three elements pertain to both vertical and horizontal aspects of organizing. Organization structure is reflected in the *organization chart*. The *organization chart* is the visual representation of a whole set of underlying activities and processes in an organization. It can be useful in understanding how a company works, as it shows the various parts of an organization, how they are interrelated, and how each position and department fits into the whole.

The organization should be designed to provide both vertical and horizontal information flow as necessary to accomplish the organization's overall goals. There is an inherent tension between vertical and horizontal mechanisms in an organization. Whereas vertical linkages are designed primarily for control, horizontal linkages are designed for coordination and collaboration, which usually means reducing control. Organizations can choose whether to orient toward a traditional organization designed for efficiency, which emphasizes vertical communication and control, or toward a contemporary learning organization, which emphasizes horizontal communication and coordination.

VERTICAL INFORMATION LINKAGES		**HORIZONTAL INFORMATION LINKAGES**	
hierarchical referral	vertical device is the hierarchy, or chain of command	**information systems**	cross-functional information systems; computerized information systems enabling managers or frontline workers throughout the organization to routinely exchange information about problems, opportunities, activities, or decisions
rules and plans	• can be established so employees know how to respond without communicating directly with their manager • rules provide a standard information source enabling employees to be coordinated without actually communicating about every task • a plan provides standing information for employees	**direct contact**	direct contact between managers or employees affected by a problem (liaison role; direct contact on a regular basis; between two units)
		task forces	temporary committee composed of representatives from each organizational unit affected by a problem; each member represents the interest of a unit and can carry information from the meeting

			back to that unit
formal vertical management information systems	include the periodic reports, written information, and computer-based communications distributed to managers; make communication up and down the hierarchy more efficient	**full-time integrator**	the integrator is located outside the departments and has the responsibility for coordinating several departments (e.g. project manager, brand manager)
		teams	permanent task forces , used in conjunction with a full-time integrator; when activities among departments require strong coordination over a long period of time

Organization design facilitates the communication among employees and departments that is necessary to accomplish the organization's overall task. Linkage is the extent of communication and coordination among organizational elements; linkages can be vertical and horizontal. *Vertical linkages* are used to coordinate activities between the top and bottom of an organization and are designed primarily for control of the organization (hierarchical referral, rules, plans, and formal management information systems). *Horizontal linkages* refer to the amount of communication and coordination horizontally across organizational departments (information systems, direct contact, task forces, full-time integrator, teams).

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 191-199

108. Define functional, divisional, and geographical designs; matrix structure with conditions

In **functional structure** activities are grouped together by common function from the bottom to the top of the organization; all human knowledge and skills with respect to specific activities are consolidated, providing a valuable depth of knowledge for the organization. This structure is most effective when in-depth expertise is critical to meeting organizational goals, when the organization needs to be controlled and coordinated through the vertical hierarchy, and when efficiency is important. The structure can be quite effective if there is little need for horizontal coordination.

Divisional (product) structure – with this structure, divisions can be organized according to individual products, services, product groups, major projects or programs, divisions, businesses, or profit centers. The distinctive feature of a divisional structure is that grouping is based on organizational outputs. The divisional structure promotes flexibility and change because each unit is smaller and can adapt to the needs of its environment; it decentralizes decision making, because the lines of authority converge at a lower level in the hierarchy. The divisional structure is suited to fast change in an unstable environment and provides high product or service visibility.

Another basis for structural grouping is the organization's users or customers. The most common structure in this category is **geography**. Each region of the country may have distinct tastes and needs. Each geographic unit includes all functions required to produce and market products or services in that region.

Matrix structure: the matrix can be used when both technical expertise and product innovation and change are important for meeting organizational goals; the matrix structure often is the answer when organizations find that the functional, divisional, and geographical structures combined with horizontal linkage mechanisms will not work. The matrix is a strong form of horizontal linkage. The unique characteristic of the matrix organization is that both product division and functional structures (horizontal and vertical) are implemented simultaneously. The product managers and functional managers have equal authority within the organization, and employees report to both of them.

The matrix is the correct structure when the following conditions are met: 1) pressure exists to share scarce resources across product lines; 2) environmental pressure exists for two or more critical outputs, such as for in-depth technical knowledge (functional structure) and frequent new products (divisional structure); 3) the environmental domain of the organization is both complex and uncertain. Under these three conditions, the vertical and horizontal lines of authority must be given equal recognition.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 202-222

109. Define horizontal structure, virtual network structure and hybrid structure

Horizontal structure organizes employees around core processes. Process is an organized group of related tasks and activities that work together to transform inputs-into outputs that create value for customers (e.g. order fulfillment, new product development, and customer service). Organizations typically shift toward a horizontal structure during a procedure called reengineering. *Reengineering* basically means the redesign of a vertical organization along its horizontal workflows and processes. Rather than focusing on narrow jobs structured into distinct functional departments, they emphasize core processes that cut horizontally across the organization and involve teams of employees working together to serve customers. Organization structured horizontally has the following characteristics:

- Structure is created around cross-functional core processes rather than tasks, functions, or geography. Self-directed teams, not individuals, are the basis of organizational design and performance.
- Process owners have responsibility for each core process in its entirety.
- People on the team are given the skills, tools, motivation, and authority to make decisions central to the team's performance. Team members are cross-trained to

perform one another's jobs, and the combined skills are sufficient to complete a major organizational task.

- Teams have the freedom to think creatively and respond flexibly to new challenges that arise.
- Customers drive the horizontal corporation. Effectiveness is measured by end-of-process performance objectives (based on the goal of bringing value to the customer), as well as customer satisfaction, employee satisfaction, and financial contribution.
- The culture is one of openness, trust, and collaboration, focused on continuous improvement. The culture values employee empowerment, responsibility, and well-being.

Many of today's organizations farm out some of their activities to other companies that can do it more efficiently. *Outsourcing* means to contract out certain corporate functions, such as manufacturing, information technology, or credit processing, to other companies. This is a significant trend in all industries that is affecting organization structure. With a **virtual network structure**, sometimes called a modular structure, the firm subcontracts many or most of its major processes to separate companies and coordinates their activities from a small headquarters organization. The virtual network organization may be viewed as a central hub surrounded by a network of outside specialists.

Organizations often use a **hybrid structure** that combines characteristics of various approaches tailored to specific strategic needs. Most companies combine characteristics of functional, divisional, geographical, horizontal, or network structures to take advantage of the strengths of various structures and to avoid some of the weaknesses. Hybrid structures tend to be used in rapidly changing environments because they offer the organization greater flexibility. One type of hybrid often used is to *combine characteristics of the functional and divisional structures*. A second hybrid approach used today is to *combine characteristics of functional and horizontal structures*.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 202-222

110. What are the characteristics of organizations in contemporary context and what are the new challenges?

Organizations are not static; they continuously adapt to shifts in the external environment. Today, many companies are facing the need to transform themselves into dramatically different organizations because of new challenges in the environment: dealing with globalization, maintaining high standards of ethics and social responsibility, responding rapidly to environmental changes and customer needs, managing the digital workplace, and supporting diversity.

Globalization: with rapid advances in technology and communications, the time it takes to exert influence around the world from even the most remote locations has been reduced from years to only seconds; markets, technologies, and organizations are becoming increasingly interconnected. Companies can locate different parts of the organization wherever it makes the most business sense: top leadership in one country, technical brainpower and production in other locales. A related trend is to contract out some functions to organizations in other countries or to partner with foreign organizations to gain global advantage. This growing interdependence means that the environment for companies is becoming extremely complex and extremely competitive. Organizations have to learn to cross lines of time, culture, and geography in order to survive. Companies large and small are searching for the right structures and processes that can help them reap the advantages of global interdependence and minimize the disadvantages.

Ethics and Social Responsibility have become some of the hottest topics in contemporary business. The list of executives and major corporations involved in financial and ethical scandals continues to grow (as Enron in America for instance). Leaders face tremendous pressure from the government and the public to hold their organizations and employees to high ethical and professional standards.

Speed of Responsiveness: to respond quickly and decisively to environmental changes, organizational crises, or shifting customer expectations. Today, globalization and advancing technology has accelerated the pace at which organizations in all industries must roll out new products and services to stay competitive. Today’s customers also want products and services tailored to their exact needs. Technology brought another shift – financial basis of today's economy is information, not machines and factories. One result of concern to organizational leaders is that the primary factor of production becomes knowledge (knowledge management), to which managers must respond by increasing the power of employees, who have knowledge needed to keep the company competitive. Considering the changes in today's world, the mindset needed by organizational leaders is to expect the unexpected and be prepared for rapid change and potential crises. Crisis management has moved to the forefront in light a tough economy, rocky stock market, and weakening consumer confidence; widespread ethical scandals; and, in general, an environment that may shift dramatically at a moment's notice.

The Digital Workplace: organizations have been engulfed by information technology that affects how they are designed and managed; in today's workplace, many employees perform much of their work on computers and may work in virtual teams, connected electronically to colleagues around the world. In addition, organizations are becoming enmeshed in electronic networks. E-business world is developing as more and more business takes place by digital processes over a computer network rather than in physical space.

Diversity is a fact of life that no organization can afford to ignore. As organizations increasingly operate on a global playing field, the workforce and the customer base are changing dramatically – towards diversification. Growing diversity brings a variety of challenges, such as maintaining a strong corporate culture while supporting diversity, balancing work and family concerns, and coping with the conflict brought about by varying cultural styles. People from diverse ethnic and cultural backgrounds offer varying styles, and managing diversity may be one of the most rewarding challenges for organizations competing on a global basis, moreover not only accepting diverse people in the working places, but valuing their differences, embracing them and build based on it a tool for organizational success is a challenge for today’s companies.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 25-32

111. What is the difference of adaptability, clan, mission, and bureaucratic organizational cultures?

Culture can be assessed along many dimensions, such as the extent of collaboration versus isolation among people and departments, the importance of control and where control is concentrated, or whether the organization's time orientation is short range or long range. In organizational culture we focus on two specific dimensions: (1) the extent to which the competitive environment requires flexibility or stability; and (2) the extent to which the organization's strategic focus and strength are internal or external. Four categories of culture associated with these differences: adaptability, mission, clan, and bureaucratic. These four categories relate to the fit among cultural values, strategy, structure, and the environment. Each can be successful, depending on the needs of the external environment and the organization's strategic focus.

The adaptability culture is characterized by strategic focus on the external environment through flexibility and change to meet customer needs. The culture encourages entrepreneurial values, norms, and beliefs that support the capacity of the organization to detect, interpret, and translate signals from the environment into new behavior responses. This type of company, however, doesn't just react quickly to environmental changes – it actively creates change. Innovation, creativity, and risk taking are valued and rewarded.

The mission culture is characterized by emphasis on a clear vision of the organization's purpose and on the achievement of goals, such as sales growth, profitability, or market share, to help achieve the purpose. Individual employees may be responsible for a specified level of performance, and the organization promises specified rewards in return. Managers shape behavior by envisioning and communicating a desired future state for the organization. Because the environment is stable, they can translate the vision into measurable goals and evaluate employee performance for meeting them.

The clan culture has a primary focus on the involvement and participation of the organization's members and on rapidly changing expectations from the external environment. This culture focuses on the needs of employees as the route to high performance. Involvement and participation create a sense of responsibility and ownership and, hence, greater commitment to the organization. In a clan culture, an important value is taking care of employees and making sure they have whatever they need to help them be satisfied as well as productive.

The bureaucratic culture has an internal focus and a consistency orientation for a stable environment. This organization has a culture that supports a methodical approach to doing business. Symbols, heroes, and ceremonies support cooperation, tradition, and following established policies and practices as ways to achieve goals. Personal involvement is somewhat lower here, but that is outweighed by a high level of consistency, conformity, and collaboration among members. This organization succeeds by being highly integrated and efficient.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 245-249

112. Explain a general analytical model of the decision-making process

Decision making – is the process of making choices from among several alternatives. **Organizational decision making** is formally defined as the process of identifying and solving problems. The process has two major stages. In the problem identification stage, information about environmental and organizational conditions is monitored to determine if performance is satisfactory and to diagnose the cause of shortcomings. The problem solution stage is when alternative courses of action are considered and one alternative is selected and implemented.

Analytical model of the decision-making process conceptualizes the process of decision making as a series of steps that groups or individuals take to solve problems. This approach highlights three important phases of the general decision-making process: formulation (the process of coming to understand the nature of the problem that is being confronted); consideration (the process of determining and selecting a possible decision to solve that problem); implementation (the process of carrying out the decision that has been made so as to solve the problem).

Decision Formulation: 1. Identifying the problem (acknowledge problem's existence; it's easy to distort, omit, ignore, and/or discount information that might have provided important cues about the existence of problems); 2. Defining objectives (to conceive of problems in such a way that possible solutions can be identified); 3. Making a predecision (a predecision is a decision about how to make a decision).

Decision Consideration: 4. Generating alternatives (possible solutions to the problem are identified); 5. Evaluating alternative solutions (Of the alternatives, which are best? What would be the most effective way of raising the revenue needed to meet the payroll?); 6. Making a choice (after several alternatives are evaluated, one is chosen).

Decision Implementation: 7. Implementing the decision (carrying out the decision that was made in step 6); 8. Following up (monitoring the effectiveness of the decisions that were put into action is important to the success of the organization).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 380-383

113. Present the spectrum of organizational decisions

Programmed versus nonprogrammed decisions: *programmed decisions* are repetitive and well defined, and procedures exist for resolving the problem. They are well structured because criteria of performance are normally clear, good information is available about current performance, alternatives are easily specified, and there is relative certainty that the chosen alternative will be successful. *Nonprogrammed decisions* are novel and poorly defined, and no procedure exists for solving the problem. They are used when an organization has not seen a problem before and may not know how to respond. Clear-cut decision criteria do not exist. Alternatives are fuzzy. There is uncertainty about whether a proposed solution will solve the problem.

Programmed decisions are made on tasks that are common and routine, whereas nonprogrammed decisions are made on unique and novel tasks. In making programmed decisions, the decision maker can count on guidance from statements of organizational policy and procedure. However, nonprogrammed decisions require the use of creative solutions that are implemented for the first time; past solutions may provide little guidance. Nonprogrammed decisions typically are made by upper-level organizational personnel, whereas the more routine, well-structured, programmed decisions are usually relegated to lower-level personnel. Certain types of nonprogrammed decisions are known as *strategic decisions*. Such decisions typically are made by groups of high-level executives and have important long-term implications for the organization. Strategic decisions reflect a consistent pattern for directing the organization in some specified fashion – that is, according to an underlying organizational philosophy or mission.

Certain versus uncertain decisions: certainty about the factors on which decisions are made is highly desired in organizational decision making – understanding risk: objective and subjective probabilities (degrees of certainty and uncertainty are expressed as statements of risk; to make the best possible decisions in organizations, people seek to "manage" the risks they take, minimizing the riskiness of a decision by gaining access to information relevant to the decision. In addition to making decisions using objective probabilities, people also make decisions based on subjective probabilities – personal beliefs or hunches about what will happen); reducing uncertainty in decision making (uncertainty is an undesirable characteristic in decision-making situations; it can be reduced by establishing linkages with other organizations, by information).

Top-down versus empowered decisions: top-*down decision making* puts decision-making power in the hands of managers and leaves lower-level workers little or no opportunities to make decisions. Today, however, a new approach has come into vogue, which is in many ways exactly the opposite. The idea of *empowered decision making* allows employees to make the decisions required to do their jobs without first seeking supervisory approval; it gives them the power to decide what they need to do so as to perform their jobs effectively. The rationale for this philosophy of decision making is that the people who do the jobs know what's best, so having someone else make the decision may not make the most sense. In addition, when people are empowered to make their own decisions, they are more likely to accept the consequences of those decisions. If the decision was a good one, they can feel good about it. If not, then they have learned a valuable lesson for the next time. In either case, people are more committed to courses of action based on decisions they have made themselves than ones based on decisions that others have made (particularly if those decisions affect them). And such commitment can be important to keeping the organization functioning effectively.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 384-388

114. What factors affect decisions in organizations? Distinguish among three approaches to how decisions are made

Decisions in organizations are influenced by individual factors and group factors.

<u>Individual Differences:</u>

Decision style is the particular manner in which an individual approaches the decisions confronting him or her is known as this – directive style (people who prefer simple, clear solutions to problems); analytical style (individuals who are willing to consider complex solutions based on ambiguous information); conceptual style (people who are socially oriented in their approach to problems); behavioral style (people who have a deep concern for the organizations in which they work and the personal development of their coworkers).

Indecisiveness – the degree to which individuals approach decisions eagerly as opposed to putting them off.

<u>Group influences:</u>

Potential benefits of decision-making groups – bringing people together may increase the amount of knowledge and information available for making good decisions – *pooling of resources. A* related benefit is that in decision-making groups there can be a *specialization of labor.* With enough people around to share the work load, individuals can perform only those tasks at which they are best, thereby potentially improving the quality of the group's efforts. Another benefit is that group decisions are likely to enjoy *greater acceptance* than individual decisions. People involved in making decisions generally understand those decisions better and are more committed to carrying them out than decisions made for them by someone else.

Potential problems of decision-making groups – groups are likely to waste time; potential disagreement over important matters may breed ill will and group conflict; members' intimidation by group leaders.

Groupthink: group members tend to isolate themselves from outside information, and the process of critical thinking deteriorates.

There are three main approaches to how decisions are made.

The *rational-economic model* characterizes decision makers as thoroughly searching through perfect information to make an optimal decision. This is a normative approach, in that it describes how decision makers ideally ought to behave to make the best possible decisions. In contrast, the *administrative model* is a descriptive approach, which describes how decision makers actually behave. It recognizes that limitations imposed by people's ability to process the information needed to make complex decisions (bounded rationality and bounded discretion) restrict decision makers to making satisficing decisions— solutions that are not optimal, but good enough. An alternative approach, *image theory*, recognizes that decisions are made in an automatic, intuitive fashion. It claims that people will adopt a course of action that best fits their individual principles, current goals, and plans for the future.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 388-398

115. What are the models of organizational decision-making?

Research into organization-level decision making has identified four primary types of organizational decision-making processes: the management science approach, the Carnegie model, the incremental decision process model, and the garbage can model.

The management science approach to organizational decision making is the analog to the rational approach by individual managers. Today, many corporations have assigned departments to use these techniques. The computer department develops quantitative data for analysis. Operations research departments use mathematical models to quantify relevant variables and develop a quantitative representation of alternative solutions and the probability of each one solving the problem. These departments also use such devices as linear programming, Bayesian statistics, PERT charts, and computer simulations.

The Carnegie model of organizational decision making suggests that organization-level decisions involve many managers and that a final choice is based on a coalition among those managers. A *coalition* is an alliance among several managers who agree about organizational goals and problem priorities. Management coalitions are needed during decision making for two reasons: organizational goals are often ambiguous, and operative goals of departments are often inconsistent; individual managers intend to be rational but function with human cognitive limitations and other constraints. The process of coalition formation has several implications for organizational decision behavior: decisions are made to *satisfice* rather than to optimize problem solutions (*satisficing* means organizations accept a satisfactory rather than a maximum level of performance, enabling them to achieve several goals simultaneously); managers are concerned with immediate problems and short-run solutions (they engage *problemistic search* – managers look around in the immediate environment for a solution to quickly resolve a problem); discussion and bargaining are especially important in the problem identification stage of decision making.

Incremental decision process model places less emphasis on the political and social factors described in the Carnegie model, but tells more about the structured sequence of activities undertaken from the discovery of a problem to its solution. Many organizational decisions are a series of nibbles rather than a big bite. Organizations move through several decision points and may hit barriers along the way – *decision interrupts* – meaning an organization has to cycle back through a previous decision and try something new. Decision loops or cycles are one way the organization learns which alternatives will work. Possible steps in decision sequence take place in three major decision phases: *identification* (recognition– one or more managers become aware of a problem and the need to make a decision;

diagnosis – more information is gathered if needed to define the problem situation); *development* (search procedures may be used to seek out alternatives within the organization's repertoire of solutions; design*ing* a custom solution happens when the problem is novel so that previous experience has no value), and *selection* (judgment form of selection is used when a final choice falls upon a single decision maker, and the choice involves judgment based upon experience; bargaining occurs when selection involves a group of decision makers; when a decision is formally accepted by the organization, *authorization* takes place).

The garbage can model deals with the pattern or flow of multiple decisions within organizations, whereas the incremental and Carnegie models focus on how a single decision is made. The garbage can model was developed to explain the pattern of decision making in organizations that experience extremely high uncertainty, such as the growth and change required in a learning organization. The highly uncertain conditions are an organized anarchy**,** which is an extremely organic organization. Organized anarchies do not rely on the normal vertical hierarchy of authority and bureaucratic decision rules, as they result from three characteristics:1. *problematic preference* (goals, problems, alternatives, and solutions are ill-defined); 2. u*nclear, poorly understood technology*(cause-and-effect relationships within the organization are difficult to identify); 3. Turnover (organizational positions experience turnover of participants, participation in any given decision will be fluid and limited). Decisions are the outcome of independent streams of events within the organization:1. Problems (points of dissatisfaction with current activities and performance, represent a gap between desired performance and current activities); 2. Potential solutions (is an idea somebody proposes for adoption, such ideas form a flow of alternative solutions through the organization); 3. Participants (employees who come and go throughout the organization; people are hired, reassigned, and fired; participants vary widely in their ideas, perception of problems, experience, values, and training); 4. Choice opportunities (are occasions when an organization usually makes a decision, they occur when contracts are signed, people are hired, or a new product is authorized, and when the right mix of participants, solutions, and problems exists). When a problem, solution, and participant happen to connect at one point, a decision may be made and the problem may be solved; but if the solution does not fit the problem, the problem may not be solved.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 331-355

116. Define major factors contributing to the imperfect nature of individual decisions

The major factors contributing to the imperfect nature of individual decisions are: *framing, heuristics,* and *biases*.

People make imperfect decisions due to cognitive biases. One such bias, framing, refers to the tendency for people to make different decisions based on how a problem is presented. For example, when a problem is presented in a way that emphasizes positive gains to be received, people tend to make conservative, risk-averse decisions, whereas when the same problem is presented in a way that emphasizes potential losses to be suffered, people tend to make riskier decisions. Simple rules of thumb, known as heuristics, also may bias decisions. For example, according to the availability heuristic, people base their judgments on information readily available to them, and according to the representativeness heuristic, people are perceived in stereotypical ways if they appear to be representatives of the categories to which they belong. People also are biased toward *implicit favorites*, alternatives they prefer in advance of considering all the options. Other alternatives, confirmation candidates, are considered for purposes of convincing oneself that one's implicit favorite is the best alternative. Decisions also are biased because of the tendency to believe that we were far better at judging past events than we actually were (known as the *hindsight bias*) and the tendency for people to give too little credit to others when things are going poorly and too much credit when things are going well (known as the *person sensitivity bias*). Finally, decisions are biased insofar as people tend to *escalate commitment to unsuccessful courses of action* because they have sunk costs invested in them. This occurs in large part because people need to justify their previous actions and wish to avoid having to admit that their initial decision was a mistake.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 398-406

117. Describe various techniques that can be used to enhance the quality of individual decisions and group decisions

Decision quality may be enhanced in several different ways. First, the quality of individual decisions has been shown to improve following individual training in problem-solving skills. Training in ethics also can help people make more ethical decisions. Group decisions may be improved in four ways. First, in the Delphi technique, the judgments of experts are systematically gathered and used to form a single joint decision. Second, in the nominal group technique, group meetings are structured so as to elicit and evaluate systematically the opinions of all members. Third, in the stepladder technique, new individuals are added to decision-making groups one at a time, requiring the presentation and discussion of new ideas. Contemporary techniques also employ the use of computers as aids in decision making. Finally, group decision support systems may be used. These are interactive computer-based systems that combine communication, computer, and decision technologies to improve the effectiveness of group problem-solving meetings.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 409-413

118. Identify four different forms of organizational justice and the organizational impact of each

Organizational justice refers to people's perceptions of fairness in organizations. People respond to how they perceive things, which may or may not be based on objective truths. Organizational justice takes into account the particular focus or target of people's perceptions and people may take into account different foci when assessing fairness (multifocal approach to justice). The forms of organizational justice are distributive justice, procedural justice, interpersonal justice, and informational justice. Distributive justice refers to the perceived fairness of rewards (e.g., pay) received. People who feel they have received fair amounts of reward feel satisfied with their jobs. Procedural justice refers to people's perceptions of the fairness of the procedures used to determine the outcomes they receive. When high levels of procedural justice are perceived, people are inclined to follow organizational rules and policies. Interpersonal justice refers to the fairness of interpersonal treatment by others. High levels of interpersonal justice are related to high levels of satisfaction with one's supervisor. Finally, informational justice refers to people's perceptions of the fairness of the information used as the basis for making a decision. People tend to be highly valued by organizations in which they perceive high levels of informational justice.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 43-49

119. Describe strategies that can be used to promote organizational justice

Promoting organizational justice can be done in several ways: 1) it is important to pay workers what they deserve—the "going rate" for the work done wherever they work. Underpaying workers promotes dissatisfaction, leading to turnover; 2) workers should be given a voice – that is, some input into decisions. This may involve such strategies as holding regular meetings, conducting employee surveys, keeping an "open door policy," and using suggestion systems; 3) follow openly fair procedures. Specifically, promote procedural fairness, such as by using unbiased, accurate information and applying decision rules consistently. Managers also should openly describe the fair procedures they are using; 4) managers should explain decisions thoroughly in a manner demonstrating dignity and respect; 5) workers should be trained to be fair, such as by adhering to the principles.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 49-54

120. What is ethics? Describe the individual and situational factors responsible for unethical behavior in organizations and methods for minimizing such behavior. Explain ways of behaving ethically when conducting business internationally

Ethics – standards of conduct that guide people's decisions and behavior. People behave ethically or unethically due to a combination of individual and situational factors. A key individual factor is the individual's level of cognitive moral development. According to *Kohlberg's theory of cognitive level of moral development*, over time people develop the capacity to make moral judgments. The more highly developed this capacity, the more likely people are to engage in ethical behavior. However, situational factors also dictate behavior. For example, some organizational norms (e.g., stonewalling) discourage ethical behavior, managerial values sometimes discourage ethical behavior, and subordinates emulate their manager's unethical acts. Unethical behavior may be minimized by corporate ethics programs that use codes of ethics, use ethics training, have bodies formally responsible for ethics, have a mechanism for communicating ethical standards, and use ethics audits.

Behaving ethically when conducting international business is challenging because different norms of ethics apply in different cultures. Managers should resist the temptation to engage in ethical relativism by blindly adopting whatever ethical norms prevail in a certain country and ethical imperialism by insisting on applying their own country's ethical standards wherever they do business. Instead, it is preferable to adopt a stance between these two extremes. This involves following the guiding principles of global ethics: (1) show respect for core human values, (2) demonstrate sensitivity to local traditions, and (3) recognize that context matters when distinguishing between right and wrong.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 54-65

121. Explain the difference between social perception and social identity, and how the attribution process works and describe the various sources of bias in social perception

Social perception is the process through which people select, organize, and interpret the information around them as it pertains to other people. According to **social identity theory**, the way we perceive others and ourselves is based on both our own unique characteristics (known as personal identity) and our membership in various groups (known as social identity).

The process of **attribution** involves judging the underlying reasons for people's behavior. Some of our judgments are based on inferences made on the basis of observing others' behavior. These judgments, known as *correspondent inferences*, are often inaccurate. Our search for explanations about the causes of others' behavior leads us to make either judgments of internal causality (the individual is responsible for his own actions) or external causality (someone or something else is responsible). *Kelley's theory of causal attribution* explains that such judgments will be based on three types of information: consensus (whether others act in a similar manner), consistency (whether the individual previously acted this way in the same situation), and distinctiveness (whether this person acted similarly in different situations).

Several types of systematic errors, known as **perceptual biases**, limit the accuracy of social perception. These include the fundamental attribution error (the tendency to attribute others' actions to internal causes), the halo effect (the tendency to perceive others in either consistently positive or negative terms), the similar-to-me effect (the tendency to perceive similar others in a favorable light), first-impression error (the tendency for initial impressions to guide subsequent ones), and selective perception (the tendency for people to focus on only certain aspects of the environment). Perceptual inaccuracies also result from the tendency for people to rely on the use of stereotypes (the judgments of others based on the categories to which they belong).Perceptual biases can result in *self-fulfilling prophecies* (the tendency for someone's expectations about another to cause that individual to behave in a manner consistent with those expectations). These can be positive in nature, such as when expecting someone's performance to be good actually makes it so (known as the Pygmalion effect). They also can be negative, such as when someone's performance is bad because it was expected to be bad (known as the Golem effect).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 90-101

122. Define learning and describe the two types most applicable to OB

Learning refers to relative permanent changes in behavior occurring as a result of experience. In organizations, learning generally takes the form of operant conditioning and observational learning. In operant conditioning, individuals learn to behave certain ways based on the consequences of those actions. Stimuli that increase the probability of the behaviors preceding it are known as reinforcers. Reinforcement may be either positive, if it is based on the presentation of a desirable outcome, or negative, if it is based on the withdrawal of an unwanted outcome. The probability of certain responses can be decreased if an unpleasant outcome results (punishment), or if a pleasant outcome is withdrawn (extinction). Observational learning involves learning by modeling the behavior of others. By paying attention to and rehearsing the behavior of others, we can learn vicariously, that is, through the model’s experiences.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 110-121

123. Describe how principles of learning are involved in organizational training and innovative reward systems. Compare the way organizations use reward in organizational behavior management programs and how they can use punishment most effectively when administering discipline

Learning is involved directly in efforts to teach people to acquire new job skills, the process known as training. Training is most effective when people can actively participate in the learning process, repeat the desired behaviors, receive feedback on their performance, and learn under conditions closely resembling those found on the job. Today, companies are experimenting with innovative reward systems that include skill-based pay (i.e., paying people for the various skills they have demonstrated on the job) and team-based rewards (i.e., paying people for their contributions to team performance).

Organizational behavior management is a systematic attempt to apply principles of reinforcement to the workplace so as to improve organizational functioning. Reinforcing desired behaviors can improve organizational functioning greatly. In contrast to applications of reinforcement, discipline is the systematic application of punishments to minimize undesirable organizational behaviors. The effects of discipline are most effective when punishment is applied immediately after the undesirable activity, moderately severe, focused on the activity rather than the individual, applied consistently over time, and for all employees, clearly explained and communicated, and not weakened by the use of inadvertent rewards.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 121-125

124. Identify personality, the Big Five dimensions of personality, elements of core self-evaluations, positive and negative affectivity; and describe how they are related to key aspects of organizational behavior

Personality is the unique and relatively stable pattern of behavior, thoughts, and emotions shown by individuals. It, along with abilities (the capacity to perform various tasks) and various situational factors, determines behavior in organizations. This idea is reflected by the inter-actionist perspective, which is widely accepted in the field of organizational behavior today.

The Big Five dimensions of personality – so named because they seem to be very basic aspects of personality – appear to play a role in the successful performance of many jobs. These are conscientiousness (a tendency to show self-discipline, to strive for competence and achievement), extroversion-introversion (a tendency to seek stimulation and to enjoy the company of other people), agreeableness (a tendency to be compassionate toward others), neuroticism (a tendency to experience unpleasant emotions easily), and openness to experience (a tendency to enjoy new experiences and new ideas). Two of these dimensions, conscientiousness and neuroticism (emotional stability), have been found to be good predictors of success in many different jobs. This is especially true under conditions where job autonomy is high. Core self-evaluations are elements of personality reflecting people's fundamental evaluations of themselves, their bottom-line conclusions about themselves. These are self-esteem (the overall value one places on oneself as a person), generalized self-efficacy(a person's beliefs about his or her capacity to perform specific tasks successfully), locus of control(the extent to which individuals feel that they are able to control things in a manner that affects them), and emotional stability (opposite of the Big Five trait neuroticism; the tendency to see oneself as confident, secure, and steady). Each of the four dimensions of core self-evaluations is associated with beneficial organizational outcomes. Positive affectivity and negative affectivity refer to stable tendencies for people to experience positive or negative moods at work, respectively. Compared to people scoring high in negative affectivity, those who are predisposed toward positive affectivity tend to make higher quality individual decisions and are more willing to help others. Negative affectivity on the part of customers can generate negative emotional reactions in service providers, and so reduce customers' satisfaction with the treatment they receive.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 134-147

125. Describe Machiavellianism and the difference between morning and evening persons, and their role in work-related behavior

People who adopt a manipulative approach to their relations with others are described as being high in **Machiavellianism** (known as high Machs). They are not influenced by considerations of loyalty, friendship, or ethics. Instead, they simply do whatever is needed to get their way. The characteristics of high Machs are: lower score on the Big Five dimensions of agreeableness and extraversion, suggesting that getting along with them is not particularly easy; smooth and charming, they lie easily, and they have no qualms about manipulating or conning others; have little remorse or guilt over harming people; show little empathy toward others; tend to be impulsive, irresponsible, and prone to feeling bored. High Machs tend to be most successful in situations in which people cannot avoid them and in organizations in which there are few established rules.

Morning persons are individuals who feel most energetic early in the day. Evening persons are those who feel most energetic at night. People tend to do their best work during that portion of the day that they prefer and during which they are most energetic.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 148-153

126. Differentiate among cognitive intelligence, practical intelligence, and emotional intelligence and explain the influence of social skills on behavior in organizations

Cognitive intelligence is the ability to understand complex ideas, to adapt effectively to the environment, to learn from experience, to engage in various forms of reasoning, and to overcome obstacles by careful thought. Traditionally, this is what we have in mind when we refer to intelligence. However, other forms of intelligence play important roles in organizational functioning. These are practical intelligence, the ability to come up with effective ways of getting things done, and emotional intelligence, a cluster of abilities relating to the emotional or "feeling" side of life. Emotional intelligence(EI) refers to the ability to make accurate judgments of emotions and to use such knowledge to enhance the quality of one's thinking. Four different kinds of ability are involved: appraisal and expression of emotions in oneself (the individual's ability to understand his or her own emotions and to express these naturally); appraisal and recognition of emotions in others (the ability to perceive and understand others' emotions); regulation of emotions in oneself (the ability to regulate one's own emotions); use of emotions to facilitate performance – relationship management (the ability to use emotions by directing them toward constructive activities and improved performance (e.g., by encouraging oneself to do better)). Much as tests of cognitive intelligence are used to derive intelligence quotient (IQ scores), tests of emotional intelligence are used to derive emotional quotient (EQ scores).

Social skills play an important role in success in many business contexts because getting along well with others is essential for obtaining positive outcomes, and may even influence the effects of key aspects of personality (e.g., conscientiousness) on performance. Social skills main types: social perception (accuracy in perceiving others, including accurate perceptions of their traits, motives, and intentions); impression management (proficiency in the use of a wide range of techniques for inducing positive reactions in others); persuasion and social influence (skill at using various techniques for changing others' attitudes or behavior in desired directions); social adaptability (the ability to adapt to a range of social situations and to interact effectively with people from many different backgrounds); emotional awareness/control (proficiency with respect to a cluster of skills relating to the emotional side of life).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 154-161

127. Distinguish between emotions and moods. Explain how emotions and mood influence behavior in organizations

Whereas **emotions** are overt reactions that express people's feelings about a specific event, **moods** are more general. Specifically, moods are unfocused, relatively mild feelings that exist as background to our daily experiences. Emotions have the following characteristics: emotions always have an object; the spread of emotions is contagious; expression of emotions is universal; culture determines how and when people express emotions.

Emotions and mood affect behavior in organizations in various ways. Generally, happier people are more successful on their jobs; they perform at higher levels, and they make higher incomes. One reason for this is that people who are very upset tend to neither listen to nor understand the performance feedback they receive. Furthermore, happier people tend to make better decisions, remember positive events, give positive evaluations when appropriate, and cooperate with others. People manage their emotions in organizations differently. One way people manage their emotions is by keeping their negative feelings to themselves. Rather than offending another with our actual negative feelings, we may engage in the emotional labor of disguising our true feelings. The inconsistency between the emotions we express and the emotions we feel is known as *emotional dissonance*. People in organizations also manage their emotions by *managing their anger* and by *displaying compassion for others* when needed. This is especially important during major crises and emergencies.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 170-181

128. What is stereotyping? Explain the dangers of using stereotypes

Stereotypes – beliefs that members of specific groups tend to share similar traits and are prone to behave identically. We rely on stereotypes because people tend to do as little cognitive work as possible when it comes to thinking about others; we tend to rely on mental shortcuts. If assigning people to groups allows us to assume that we know what they are like and how they may act, then we can save the tedious work of learning about them as individuals. We rely on readily available information – such as someone’s age, race, gender, or job type – as the basis for organizing our perceptions in a coherent way.

The problem with stereotypes is that they lead us to judge people prematurely, without the benefit of learning more about them than just the categories into which they fit. The following dangers exist in organizations, related to negative effect of stereotyping: inaccurate information – stereotypes often are inaccurate (negative organizational impact); stereotype threats (negative individual impact) – people tend to live down to – the negative stereotypes that people hold about them. The idea that stereotypes constrain behavior when a member of a stereotyped group is placed in a situation in which poor performance can be taken as an indication of the group’s deficiency – is the basis of what is known as a stereotype threat. *Stereotype threat* is the uncomfortable feeling that people have when they run the risk of fulfilling a negative stereotype associated with a group to which they belong.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 101-103

129. Describe Affective Events Theory

Affective events theory (AET) identifies various factors that lead to people's emotional reactions on the job and how these reactions affect those individuals. 1) AET recognizes that people's emotions are determined, in part, by various features of the work environment. For example, the way we feel is likely to be determined by various characteristics of the jobs we do, the demands we face, and by requirements for emotional labor. The concept of *emotional labor* refers to the degree to which people have to work hard to display what they believe are appropriate emotions on their jobs. 2) The various features of the work environment are likely to lead to the occurrence of certain events. These include confronting daily hassles, unpleasant or undesirable events that put people in bad moods; and experiencing more positive events known as daily uplifts – these are the opposite – namely, pleasant or desirable events that put people in good moods. 3) People react to these various work events by displaying emotional reactions, both positive and negative. The extent to which this occurs depends on (moderated by) each of two types of personal predispositions: personality and mood. Personality predisposes us to respond in varying degrees of intensity to the events that occur. Mood also influences the nature of the relationship between work events and emotional reactions. 4) The theory notes, that these affective reactions have two important effects. First, they promote high levels of job performance. Second, affective reactions are responsible for people's job performance and job satisfaction – that is, the extent to which they hold positive attitudes toward their jobs.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 176-178

130. Identify the major causes of organizational stress and its adverse effect

Stress is the pattern of emotional and physiological reactions occurring in response to demands from within or outside organizations. Stress is caused by many different factors, including occupational demands, conflicts between the work and nonwork aspects of one's life (i.e., role conflict), not knowing what one is expected to do on the job (i.e., role ambiguity), overload and underload, having responsibility for other people, and experiencing sexual harassment (unwanted contact or communication of a sexual nature, usually against women).

Experiencing high levels of organizational stress has negative effects on task performance. It also adversely affects people's physical and mental health in a variety of ways. Stress also is a major cause of such serious problems as desk rage (lashing out at others in response to stressful encounters on the job) and burnout (a syndrome of emotional, physical, and mental exhaustion coupled with feelings of low self-esteem or low self-efficacy, resulting from prolonged exposure to intense stress, and the strain reactions following from them).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 181-195

131. Define attitudes and describe their basic components. Distinguish between prejudice and discrimination, and identify various victims of prejudice in organizations

Attitudes are the stable clusters of feelings, beliefs, and behavioral tendencies directed toward some aspect of the external world. **Work-related attitudes** – lasting feelings, beliefs, and behavioral tendencies toward various aspects of the job itself, the setting in which the work is conducted, the people involved and/or the organization as a whole. All attitudes consist of a cognitive component (what you believe), an evaluative component (how you feel), and a behavioral component (the tendency to behave a certain way).

Prejudice refers to negative attitudes toward members of specific groups, and *discrimination* refers to treating people differently because of these prejudices. Today's workforce is characterized by high levels of diversity, with many groups finding themselves victims of prejudicial attitudes and discriminatory behaviors (based on many different factors, including age, sexual orientation, physical condition, racial or ethnic group membership, gender, and people from different religions than our own). Although people are becoming more tolerant of individuals from diverse groups, prejudicial attitudes persist.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 206-215

132. Describe some of the things which can be done in today's organizations to manage diversity in their workforces and the effectiveness of these practices

To help tap the rich pool of resources available in today's highly diverse workforce, many companies are using diversity management programs – techniques for systematically teaching employees to celebrate the differences among people. Typically, these programs go beyond efforts to recruit and hire women and members of minority groups, to creating supportive work environments for them (*affirmative action laws* – legislation designed to give employment opportunities to groups that historically have been underrepresented in the workplace, such as women and members of minority groups). To promote diversity, organizations are conducting diversity training, using leaders to send strong messages about diversity, requiring suppliers to promote diversity, and making diversity a top priority. Although implementing diversity management programs is potentially difficult, experts acknowledge that the benefits, both organizational and personal, are considerable. For example, research has shown that companies whose employees systematically embrace diversity tend to be more profitable than those that allow discrimination to occur.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 215-221

133. Explain the concept of job satisfaction and describe three major theories. What can be the consequences of job dissatisfaction and the possible ways to promote job satisfaction?

Job satisfaction involves positive or negative attitudes toward one's work. The dispositional model of job satisfaction suggests that job satisfaction is a relatively stable characteristic that stays with people over various situations. Value theory suggests that job satisfaction reflects the apparent match between the outcomes individuals desire from their jobs (what they value) and what they believe they are actually receiving. Finally, the social information processing model specifies that people adopt attitudes and behaviors in keeping with the cues provided by others with whom they come into contact.

When people are dissatisfied with their jobs, they tend to withdraw. That is, they are frequently absent (*absenteeism*) and are likely to quit their jobs (*voluntary turnover*). However, evidence suggests that job performance is only very weakly associated with dissatisfaction. Levels of job satisfaction can be raised by paying people fairly, improving the quality of supervision, decentralizing control of organizational power, and assigning people to jobs that match their interests.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 221-234

134. Describe the concept of organizational commitment, its major forms, the consequences of low level of organizational commitment, and how to overcome them

Organizational commitment focuses on people's attitudes toward their organizations. There are three major types of organizational commitment: continuance commitment – the strength of a person's tendency to continue working for an organization because he or she has to and cannot afford to do otherwise; normative commitment – commitment to remain in an organization stemming from social obligations to do so; affective commitment – the strength of a person's tendency to continue working for an organization because he or she agrees with its goals and values, and desires to stay with it. Low levels of organizational commitment have been linked to high levels of absenteeism and voluntary turnover, the unwillingness to share and make sacrifices for the company, and negative personal consequences for employees. However, organizational commitment may be enhanced by enriching jobs, aligning the interests of employees with those of the company, and recruiting and selecting newcomers whose values closely match those of the organization.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 234-239

135. Define the concept of Person-Job (P-J) fit. Present key issues in motivation, and describe the motivational-fit approach and what it suggests about how to improve motivation in organizations

Personality often combines with situational factors to influence behavior. Although people possess stable traits and characteristics that predispose them to behave in certain ways, these qualities by themselves do not completely determine how someone will behave in any given setting. Situations also introduce forces that affect how one is likely to behave. Together, both personal factors and situational factors combine to influence behavior. The way someone behaves is the result of both an individual's characteristics (e.g., his or her knowledge, abilities, skills, and personality) and the nature of the situation in which that person operates (e.g., the nature of the job and industry, the country in which the work is being performed, etc.) – the approach known as the *interactionist perspective*. This brings up a key consideration involved in selecting certain career options – **person-job fit** – the degree to which a person's unique blend of characteristics (e.g., personality, skills) is suited to the requirements for success on a particular job. The more closely individuals' personalities, traits, and abilities match those required by a given job, the more productive and satisfied they tend to be on those jobs.

Motivation has the three key points as: motivation and job performance are not synonymous(motivation is just one of several possible determinants of job performance); motivation is multifaceted (people are likely to have several different motives operating at once); people are motivated by more than just money.

Many different personality traits and abilities influence job performance. The **motivational-fit approach** highlights the importance of motivational traits (achievement and anxiety) and motivational skills (emotion control and motivation control) in work motivation. This framework specifies that people will be most highly motivated when these traits and skills best fit the requirements of the job and the organization in which someone works.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 135-138, 248-250, 255-257

136. Distinguish among job enlargement, job enrichment and the job characteristics model as techniques for motivating employees

Motivation may be enhanced at the organizational level by designing or redesigning jobs in certain ways. Popular approaches include job enlargement (performing more tasks at the same level) and job enrichment (giving people greater responsibility and control over their jobs). A more sophisticated approach, the job characteristics model, identifies the specific job dimensions that should be enriched (skill variety, task identity, task significance, autonomy, and feedback), and relates these to the critical psychological states influenced by including these dimensions on a job. These psychological states will, in turn, lead to certain beneficial outcomes for both individual employees (e.g., job satisfaction) and the organization (e.g., reduced absenteeism and turnover). Jobs may be designed to enhance motivation by combining tasks, opening feedback channels, establishing client relationships, and loading jobs vertically (i.e., enhancing responsibility for one's work).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 274-281

137. What is interpersonal behavior? Define the range of its major types. Describe types of psychological contracts and the basic kinds of trust that play a role in work relationships

Interpersonal behavior is a variety of behaviors involving the ways in which people work with and against one another. Interpersonal behaviors along a continuum range from those that involve working with others (prosocial behavior, cooperation, e.g. organizational citizenship) to those that involve working against others (competition, conflict, deviations). *Prosocial behavior* – the tendency for people to help others on the job, sometimes even when there doesn't appear to be anything in it for them. There are situations in which people help each other and receive help from them – that is, the tendency to *cooperate*. People and entire companies don't always work with each other; they also *compete* against each other – that is, as one tries to win, it forces the other to lose. Under such circumstances, it is not unusual for *conflict* to emerge, breeding ill-will. And, when taken to the extreme, this results in *deviant behavior* – acts intended to bring harm, such as stealing from the company or even harming another person.

Psychological contract – a person’s beliefs about what is expected of another in a relationship. One type of psychological contract is the *transactional contract*. It is characteristic of relationships that have an exclusively economic focus, last for a brief period of time, are unchanging in nature, and have a narrow, well-defined scope. Another kind is the *relational contract*. It applies to relationships that are longer-term in scope and go beyond basic economic issues such as pay for performance. A third type is the *balanced contract*; this involves elements of both transactional and relational contracts. **Trust** – a person’s degree of confidence in the words and actions of another. With respect to trust, one type is known as *calculus-based trust*. It is a form of trust based on deterrence, whenever people believe that another will behave as promised out of fear of getting punished for doing otherwise. A second type is *identification-based trust*. It is based on understanding another person plus the acceptance of this person's wants and desires. *Swift trust* is presented in short-term relationships; it’s a trust that occurs as a set of collective perceptions develops among members of temporary groups.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 426-432

138. Explain how individual performance in groups is affected by the presence of others (social facilitation), and the number of others with whom one is working (social loafing)

Social facilitation is the tendency for the presence of others sometimes to enhance an individual’s performance and at other times to impair it. According to drive theory of social facilitation, individual productivity is influenced by the presence of other group members. Sometimes, a person's performance improves in the presence of others (when the job he or she is doing is well learned), and sometimes performance declines in the presence of others (when the job is novel). People perform better on tasks in the presence of others if that task is very well learned, but poorer if it is not well learned. A key explanation of this is based on the idea of evaluation apprehension – the fear of being evaluated or judged by another person. Indeed, people may be aroused by performing a task in the presence of others because of their concern over what those others might think of them.

On additive tasks (i.e., ones in which each member's individual contributions are combined), **social loafing** occurs, **-** the tendency for group members to exert less individual effort on an additive task as the since of the group increases; in other words the more people who work on a task, the less each group member contributes to it.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 302-307

139. Distinguish between various forms of individual power in organizations

Overall, **power** refers to the capacity to influence others. One major type of power, *position power,* resides within one's formal organizational position. It includes (1) reward power (the individual power base derived from an individual’s capacity to administer valued rewards to others) and (2) coercive power (the individual power base derived from the capacity to administer punishment to others), the capacity to control valued rewards and punishments, respectively,(3) legitimate power, the recognized authority that an individual has by virtue of his or her organizational position, and (4) <u>information power</u>, power that stems from having special data and knowledge. A second major type of power, *personal power,* resides within an individual's own unique qualities or characteristics. It includes (1) <u>rational persuasion</u>, using logical arguments and factual evidence to convince others that an idea is acceptable, (2) <u>expert power</u>, the power an individual has because he or she is recognized as having some superior knowledge, skill, or expertise, (3) <u>referent power</u>, influence based on the fact that an individual is admired by others, and (4) <u>charisma</u>, having an engaging and magnetic personality.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 471-474

140. Explain how and where organizational politics occur and the forms such behavior takes

Power has been described as the available force or potential for achieving desired outcomes. **Politics** is the use of power to influence decisions in order to achieve those outcomes. The exercise of power and influence has led to two ways to define politics – as self-serving behavior or as a natural organizational decision process.

Organizational politics occur almost everywhere, the amount of such activity varies greatly. In some settings people spend large amounts of time engaging in organizational politics, although in others, such actions are far less frequent. Both personal and organizational factors encourage or discourage political behavior in organizations.

<u>Personal determinants of organizational politics</u>: people high in Machiavellianism are especially likely to engage in such behavior; some individuals, ones who are particularly adept at monitoring the effects of their behavior on others, are inclined to engage in organizational politics – such "social chameleons" do whatever it takes to get others to like them; people who engage in organizational politics have a particular set of skills and traits that equip them to engage in this behavior.

<u>Organizational determinants of organizational politics</u>: political behavior is likely to occur in situations where goals and roles are ambiguous, the organization has a history or climate of political activity, and resources are scarce. In addition, politics is also encouraged by a high level of centralization and when different individuals or units in the organization have conflicting interests or goals. Politics often occurs in connection with human resources issues and tends to increase as organizations mature and increase in size. Political tactics vary greatly and include such things as blaming and attacking others, controlling access to information, and cultivating a favorable impression.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 488-492

141. Differentiate between leadership and management

Typically the person who actually exercises the most influence over the group is identified as its **leader**. These facts point to the following definition of leadership – one accepted by many experts on this topic: **Leadership** is the process whereby one individual influences other group members toward the attainment of defined group or organizational goals. Leadership involves influencing others (followers) in ways that help attain goals and in a manner that is noncoercive and goal-directed. A leader's primary function is to envision and articulate the essential purpose or mission of an organization and the strategy for attaining it. The job of the manager is to implement the leader's vision, putting into practice ways of bringing that vision to fruition. In practice, this distinction is often difficult to make because many leaders and followers also do things that are in keeping with the other's role. Some of the additional differences are presented below.

Managers	Administer, ask how, focus on systems, do things right, maintain, rely on control, take a short-term perspective, accept the status quo, keep an eye on the bottom line, imitate, emulate the classic good soldier, copy
Leaders	Innovate, ask what and why, focus on people, do the right things, develop, inspire trust, take a longer-term perspective, challenge the status quo, keep an eye on the horizon, originate, are their own person, show originality

Leaders and managers play several overlapping roles in actual practice—a fact that blurs the distinction between them. Some managers are considered leaders, whereas others are not. Similarly, some leaders assume more of a management role than others. Thus, although the differences are not always obvious, they are real.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 502-503

142. Define organizational citizenship, its major forms and the ways in which it may be encouraged

Organizational citizenship behavior (OCB) – an informal form of behavior in which people go beyond what is formally expected of them to contribute to the well-being of their organization and those in it (actions which exceed the formal requirements of one's job). The main forms OCB can take are: altruism, conscientiousness, civic virtue, sportsmanship, courtesy. Organizational citizenship behavior can be directed both at an *individual* (**OCB-I**)and at the *organization* itself (**OCB-O**).Examples of OCB-I: assisting a coworker with a personal problem, bringing in food to share with others. Examples of OCB-O: offering ideas to improve the functioning of the organization, expressing loyalty toward the organization.

One of the factors explaining the OCB occurrence in organizations is that the more people believe they are treated fairly by their organizations, the more they trust its management, and the more willing they are to go the extra mile to help out when needed. By contrast, people who feel that their organizations are taking advantage of them are untrusting and highly unlikely to engage in OCB.OCB also occurs for other reasons as when employees hold positive attitudes toward their organizations and when they have good relationships with their supervisors, because of the personality characteristics.

Some of the ways of encouraging people to engage in OCB are: be a model of helpful behavior, demonstrate courtesy, make voluntary functions worth attending, don't complain, demonstrate conscientiousness, treat employees fairly.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 432-434

143. Explain why people are resistant to organizational change and how this resistance may be overcome. Identify and describe the major organizational development techniques that are used today

In general, people are resistant to change because of individual factors (e.g., economic insecurity, fear of the unknown) and organizational factors (e.g., the stability of work groups, threats to the existing balance of power). However, resistance to change can be overcome in several ways, including shaping political dynamics, educating the workforce about the effects of the changes and involving employees in the change process, involving employees in change efforts, rewarding constructive behaviors, and creating a learning organization.

Organizational development (OD) is a set of social science techniques designed to plan and implement change in work settings for purposes of enhancing the personal development of individuals and improving the effectiveness of organizational functioning. By planning organization-wide changes involving people, OD seeks to benefit organizations and the people who work in them.

Management by objectives (MBO) focuses on attempts by managers and their subordinates to work together at setting important organizational goals and developing a plan to help meet them. Survey feedback uses questionnaires and/or interviews as the basis for identifying organizational problems, which then are addressed in planning sessions. Appreciative inquiry (AI) is an OD intervention that focuses attention away from an organization's shortcomings and toward its capabilities and potential. It involves having small groups of workers discover, dream, design, and deliver changes to their organizations. An action lab is an OD intervention in which teams of participants work off-site to develop and implement new ways of solving organizational problems by focusing on the ineffectiveness of current methods. Quality of work life (QWL) programs seek to humanize the workplace by involving employees in the decisions affecting them (e.g., through quality circle meetings) and by restructuring the jobs themselves. The rationale underlying all of these techniques is that they may enhance organizational functioning by involving employees in identifying and solving organizational problems. Overall, research suggests that they generally are effective in this regard.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 638-653

144. Identify the main concepts of managing careers

Career is the evolving sequence of work experiences over time. Job is a predetermined set of activities one is expected to perform. Occupation is a coherent set of jobs. Careers mean a great deal to individuals, - both financially and psychologically. Careers are important as they give a sense of accomplishment and pride, and they can add meaning to our lives. Careers can be put in several categories: steady-state careers (there is a lifetime of employment in a single occupation); linear careers (someone stays in a certain field and works his or her way up the occupational ladder, from low-level jobs to high-level jobs); spiral careers (people evolve through a series of occupations, each of which requires new skills and that builds upon existing knowledge and skills); transitory careers (someone moves between many different unrelated positions, spending about one to four years in each).

Often we base our career choice on career anchors. **Career anchor** is a person's occupational self-concept based on his or her self-perceived talents, abilities, needs, and motives. The following are five major career anchors: technical or functional; managerial competence; security and stability; creativity or entrepreneurship; autonomy and independence.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 673-681

145. What are the performance objectives of operations and what are the internal and external benefits which derive from excelling in each of them?

At a strategic level, performance objectives relate to the interests of the operation's stakeholders. These relate to the company's responsibility to customers, suppliers, shareholders, employees and society in general.

By 'doing things right', operations seek to influence the quality of the company's goods and services. Externally, **quality**(consistent performance to customers' expectations) is an important aspect of customer satisfaction or dissatisfaction. Internally, quality operations both reduce costs and increase dependability.

By 'doing things fast', operations seek to influence the **speed**(the elapsed time between customers requesting products or services and their receiving them) with which goods and services are delivered. Externally, speed is an important aspect of customer service.

Internally, speed both reduces inventories by decreasing internal throughput time and reduces risks by delaying the commitment of resources.

By ‘doing things on time’, operations seek to influence the **dependability**(delivering, or making available, products or services when they were promised to the customer) of the delivery of goods and services. Externally, dependability is an important aspect of customer service. Internally, dependability within operations increases operational reliability, thus saving the time and money that would otherwise be taken up in solving reliability problems and also giving stability to the operation.

By ‘changing what they do’, operations seek to influence the **flexibility**(the degree to which a operation’s process can change what it does, how it is doing it, or when it is doing it) with which the company produces goods and services. Externally, flexibility can:

- produce new products and services (product/service flexibility);
- produce a wide range or mix of products and services (mix flexibility);
- produce different quantities or volumes of products and services (volume flexibility);
- produce products and services at different times (delivery flexibility).

Internally, flexibility can help speed up response times, save time wasted in changeovers and maintain dependability.

By ‘doing things cheaply’, operations seek to influence the **cost** of the company's goods and services. Externally, low costs allow organizations to reduce their price in order to gain higher volumes or, alternatively, increase their profitability on existing volume levels. Internally, cost performance is helped by good performance in the other performance objectives.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 39-53

146. What are process design and its main issues?

Design is the activity which shapes the physical form and purpose of both products and services and the processes that produce them. This design activity is more likely to be successful if the complementary activities of product or service design and process design are coordinated. Process and product/service design are interrelated – their overlapping has implications for the organization of the design activity: products and services should be designed in such a way that they can be created effectively; processes should be designed so they can create all products and services which the operation is likely to introduce.

The overall purpose of process design is to meet the needs of customers through achieving appropriate levels of quality, speed, dependability, flexibility and cost.

The design activity must also take account of environmental issues. These include examination of the source and suitability of materials, the sources and quantities of energy consumed, the amount and type of waste material, the life of the product itself and the end-of-life state of the product. To help make more rational decisions in the design activity, some industries are experimenting with life cycle analysis – a technique that analyses all the production inputs, life cycle use of a product and its final disposal in terms of total energy used and wastes emitted.

The overall nature of any process is strongly influenced by the volume and variety of what it has to process. The concept of process types summarizes how volume and variety affect overall process design. In manufacturing, these process types are (in order of increasing volume and decreasing variety) project, jobbing, batch, mass and continuous processes. In service operations, although there is less consensus on the terminology, the terms often used (again in order of increasing volume and decreasing variety) are professional services, service shops and mass services.

Processes are designed initially by breaking them down into their individual activities. Often common symbols are used to represent types of activity. The sequence of activities in a process is then indicated by the sequence of symbols representing activities. This is called ‘process mapping’. Alternative process designs can be compared using process maps and improved processes considered in terms of their operations performance objectives. The ‘general approaches’ to designing and managing processes are called process types: project processes (deal with discrete, usually highly customized, products); jobbing processes (deal with very high variety and low volumes, although there can be some repetition of flow and activities); batch processes (treat batches of products together, and where each batch has its own process route); mass processes (produce goods in high volume and relatively low variety); continuous processes (high volume and low variety; usually products made on continuous process are produced in an endless flow, such as petrochemicals or electricity); service processes (professional services – devoted to producing knowledge-based or advice-based services, usually involving high customer contact and high customization – e.g. management consultants, lawyers, architects, etc.; service shops – are positioned between professional services and mass services; usually with medium levels of volume and customization; mass services – have a high number of transactions, often involving limited customization – e.g. mass transportation services, call centers, etc.)

Process performance in terms of throughput time, work-in-progress and cycle time are related by a formula known as *Little’s Law* – the mathematical relationship between throughput time (the time for a unit to move through the process), work-in-process (WIP, the number of units within a process waiting to be processes further) and cycle time (the average time between units of output emerging from a process): throughout time equals work-in-process x cycle time. Variability has a significant effect on the performance of processes, particularly the relationship between waiting time and utilization.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 90-112

147. What are the elements of good product and service design?

All products and services are considered as having three aspects: a *concept* (understanding of the nature, use and value of the service or product); a *package* of 'component' products and services that provide those benefits defines in the concept; the *process* (the way in which the component products and services will be created and delivered). Producing designs for products, services is itself a process which conforms to the input-transformation-output idea of operations management. Good product and service design is important because: good design makes good business sense because it translates customer needs into the shape and form of the product or service and so enhances profitability; design includes formalizing three particularly important issues – the concept, package and process implied by the design; design is a process that itself must be designed according to the process design principles.

The major stages of product and service design are:

- *Concept generation* transforms an idea for a product or service into a concept which captures the rapture of the product or service and provides an overall specification for its design;
- *Screening* the concept involves examining its feasibility, acceptability and vulnerability in broad terms to ensure that it is a sensible addition to the company's product or service portfolio;
- *Preliminary design* involves the identification of all component parts of the product or service and the way they fit together, typical tools include component structures (diagrams that show the constituent component parts of a product or service package and the order in which the component parts are brought together) and flow charts;
- *Design evaluation and improvement* involve re-examining the design to see whether it can be done in a better way, more cheaply or more easily, typical techniques include quality function deployment (QFD, a technique used to ensure that the eventual design of a product or service actually meets the needs of its customers), value engineering (VE, an approach to cost reduction in product design that examines the purpose of a product or service, its basic functions and its secondary functions) and Taguchi methods (a design techniques that uses design combinations to test the robustness of a design);
- *Prototyping and final design* involve providing the final details which allow the product or service to be produced, the outcome of this stage is a fully developed specification for the package of products and services, as well as a specification for the processes that will make and deliver them to customers.

Product and service design and process design should be considered interactively, as looking at them together can improve quality of both. It helps a design 'break even' on its investment earlier than would otherwise have been the case. Interactive design must be managed in the following way:

- Employ *simultaneous development* where design decisions are taken as early as they can be without necessarily waiting for a whole design phase to be completed.
- Ensure early *conflict resolution* which allows continuous decisions to be resolved early in the design process, thereby not allowing them to cause far more delay and confusion if they emerge later in the process.

- Use a *project-based organizational structure* which can ensure that a focused and coherent team of designers is dedicated to a single design or group of design projects.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007;pp. 120-141

148. What is supply network perspective, what is involved in configuring a supply network? Explain where should an operation be located and how much capacity should an operation plan to have

Supply network perspective refers to setting an operation in the context of all other operations with which it interacts, some of which are its suppliers and its customers. *Supply network* – the network of supplier and customer operations that have relationships with an operation. Supply network has its supply side and demand side: *supply side* – the chains of suppliers, suppliers; suppliers, etc. that provide parts, information or services to an operation; *demand side* – the chains of customers, customers' customers etc. that receive the products and services produced by an operation.

The main advantage of organization taking a total supply network perspective is that it helps any operation to understand how it can compete effectively within the network. This is because a supply network approach requires operations managers to think about their suppliers and their customers as operations. It can also help to identify particularly significant links within the network and hence identify long-term strategic changes which will affect the operation.

Configuring a supply network involves two main issues: 1) concerning the overall *shape* of the supply network; 2) concerning the nature and extent of *outsourcing or vertical integration*.

- changing the shape of the supply network may involve reducing the number of suppliers, to the operation so as to develop closer relationships, any bypassing or disintermediating operations in the network;
- outsourcing or vertical integration concerns the nature of the ownership of the operations within a supply network. The direction of vertical integration refers to whether an organization wants to own operations on its supply side or demand side (backwards or forwards integration).

The extent of vertical integration relates to whether an organization wants to own a wide span of the stage in the supply network. The balance of vertical integration refers to whether operations can trade with only their vertically integrated partners or with any other organizations.

The stimuli which act on an organization during the location decision can be divided into supply-side and demand-side influences. Supply-side influences are the factors such as labour, land and utility costs which change as location changes. Demand-side influences include such things as the image of the location, its convenience for customers and the suitability of the site itself.

The amount of capacity an organization will have depends on its view of current and future demand. It is when its view of future demand is different from current demand that this issue becomes important. When an organization has to cope with changing demand, a number of capacity decisions need to be taken. These include choosing the optimum capacity for each site, balancing the various capacity levels of the operation in the network and timing the changes in the capacity of each part of the network. Important influences on these decisions include the concepts of economy and diseconomy of scale, supply flexibility if demand is different from that forecast, and the profitability and cash flow implications of capacity timing changes.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 148-169

149. What are job design, its key elements and how do we go designing jobs and organizing work?

Job design is the way in which we structure the content and environment of individual staff member's job within the workplace and the interface with the technology or facilities that they use. The six key elements of job design are: 1) what are the environmental conditions of the workplace? 2) What technology is available and how it will be used? 3) What tasks are to be allocated to each person? 4) What is the best method of performing each job? 5) How long will tasks take and how many people will be needed? 6) How do we maintain commitment? Job design involves deciding what tasks to allocate to each person in the organization, the best method of performing them and how long they should take. Job design is also concerned with how people should interact with their workplace, the technology and the immediate work environment. It is also concerned with trying to ensure a committed and motivated workforce through autonomy, skill development and team-working, for example.

Ergonomics is concerned primarily with the physiological aspects of job design. This includes the study of how the human body fits into its workplace and of how humans react to the immediate environment, especially its heating, lighting and noise characteristics.

The concept of division of labor involves taking a total task and dividing it into separate pan; each of which can be allocated to a different individual to perform. The advantages of this are largely concerned with reducing costs. However, highly divided jobs are monotonous and. In their extreme form, contribute to physical injury.

Scientific management took some of the ideas of division of labor and applied them more systematically. Method study is the systematic recording and examination of methods of doing work and work measurement is about establishing the time to do a job.

Behavioral models of job design are more concerned with individuals' reactions to, and attitudes to, their job. It is argued that jobs which are designed to fulfill people's need for self-esteem and personal development are more likely to achieve satisfactory work performance. The empowerment principle of job design has concentrated on increasing the autonomy which individuals have to shape the nature of their own jobs. Team working can both put together a required mixture of skills and allow decisions to be made by the people who have to manage the results. Flexible working involves individuals in being able to change the nature of their jobs, the time which they spend at their jobs and the location in which jobs are performed. While applicable only to certain jobs, flexible working may have a significant impact.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 254-279

150. What is TQM? Describe where the idea comes from, and distinguish the main differences between traditional quality management and TQM

TQM – **Total Quality Management** – is a holistic approach to the management of quality that emphasizes the role of all parts of an organization and all people within an organization to influence and improve quality; heavily influenced by various quality ‘gurus’, it reached its peak of popularity in the 1980s and 1990s.

The term TQM first was formally used in 1957 by A. Feigenbaum. Many authorities have contributed to the development of the idea: W.E. Deming (underlined control methods, participation, education, openness and purposeful improvement, elaborated *14 points of equal improvement*), J.M. Juran(‘fitness to use’ – was concerned about management responsibility for quality and impact of individual workers as motivated and involved in quality improvement activities), K. Ishikawa (considered worker participation as a key to the successful TQM implementation), G. Taguchi (was concerned with engineering-in quality through the optimization of the product design combined with statistical methods of quality control, he suggested quality loss function (QLF) which includes such factors as warranty costs, customer complaints and loss of customer goodwill) and P.B. Crosby (worked on cost of quality, he tried to highlight the costs and benefits of implementing quality programs). The emphasis placed on different aspects of TQM varies among these authorities but the general idea is similar.

TQM can be seen as being an extension of the traditional approach to quality – inspection based quality control being replaced by the concept of quality assurance with in turn has been suppressed by TQM. The major differences between traditional quality management and TQM are:

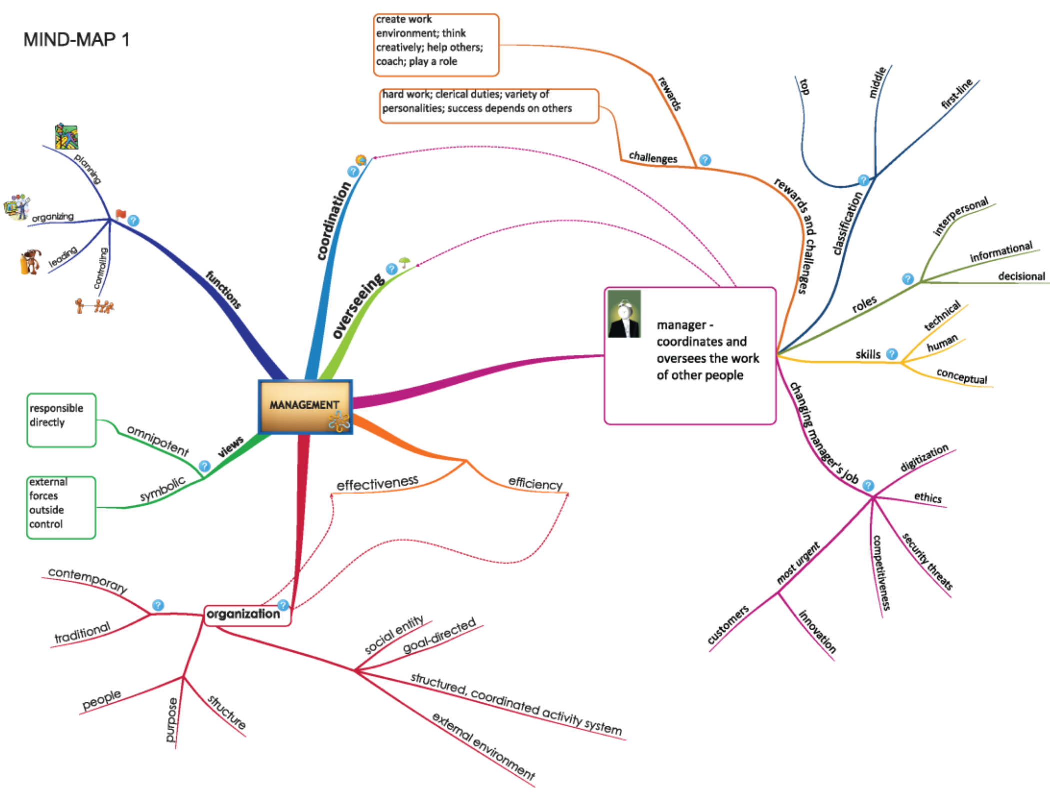
- TQM puts customers at the forefront of quality decision making. Customers’ needs and expectations are always considered first in measuring achieved quality.
- TQM takes an organization-wide perspective. It holds that all parts of the organization have the potential to make a positive contribution to quality. Central to this idea is the concept of the internal customer-supplier chain.

- TQM places emphasis on the role and responsibilities of every member of staff within an organization to influence quality. It encourages the idea of empowering individuals to improve their own part of the operation.
- Traditionally, the emphasis was placed on finding an optimum amount of quality effort which minimized the costs associated with quality. By contrast, TQM emphasizes the balance between different types of quality cost. It argues that increasing the expenditure and effort on prevention will give a more-than-equivalent reduction in other costs. This idea is often summarized in the phrase ‘right first time’.

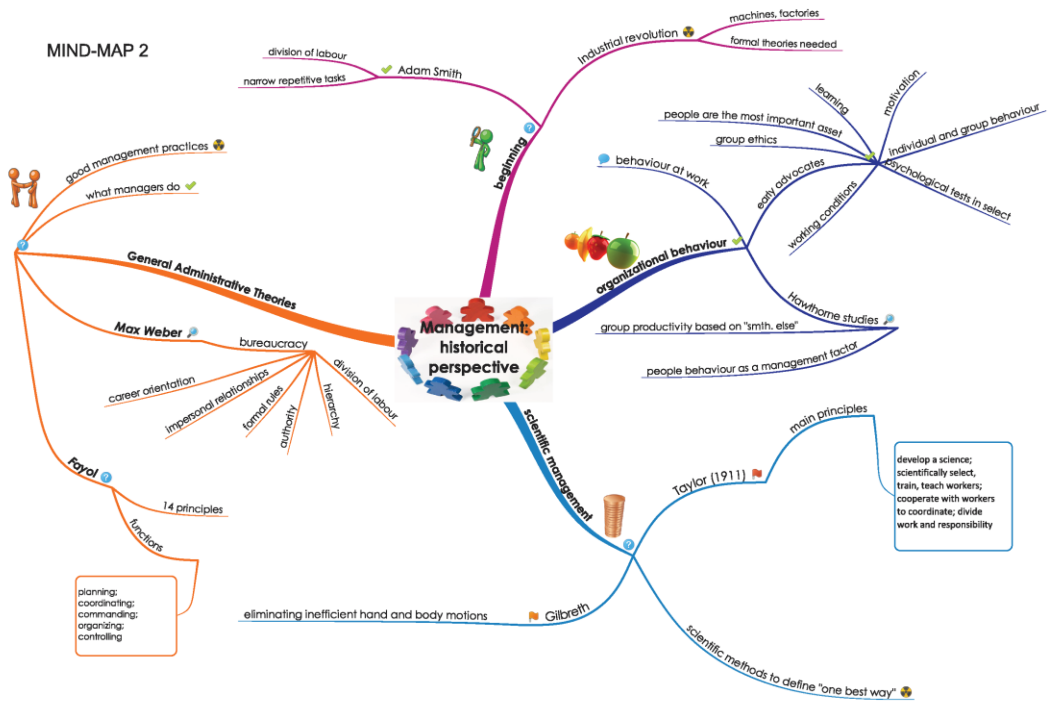
Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 651-661

APPENDIX
(MIND-MAPS)

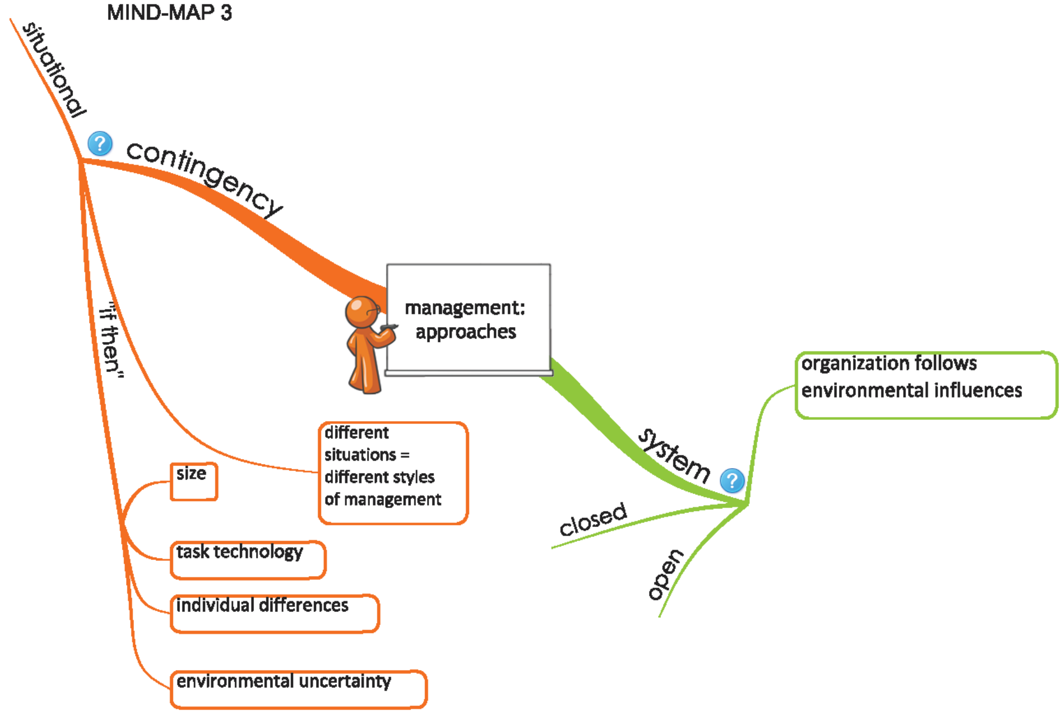
MIND-MAP 1

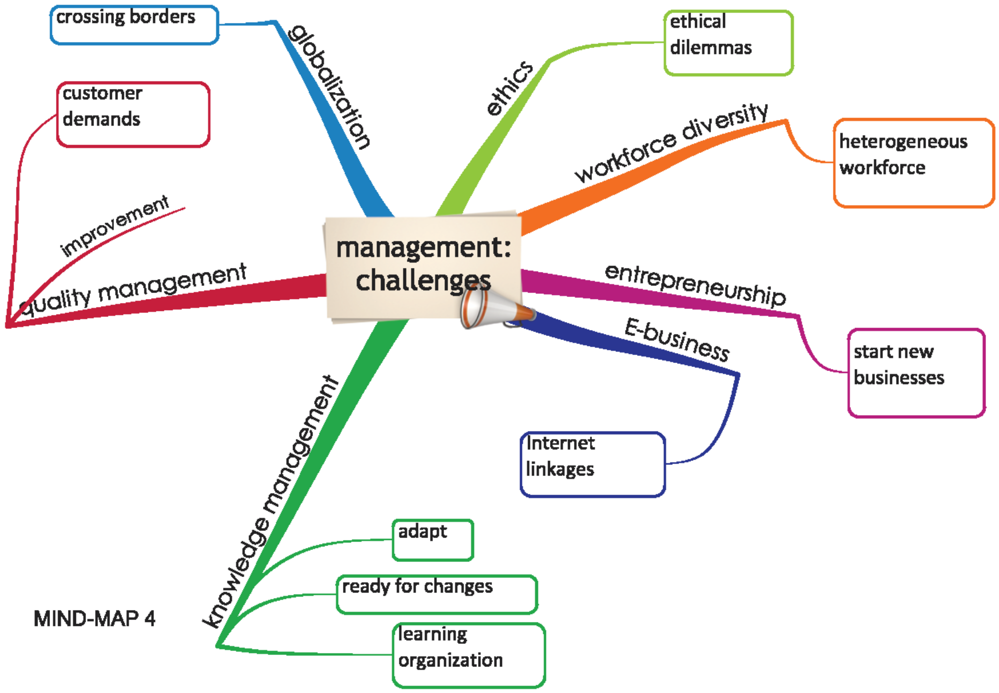


MIND-MAP 2



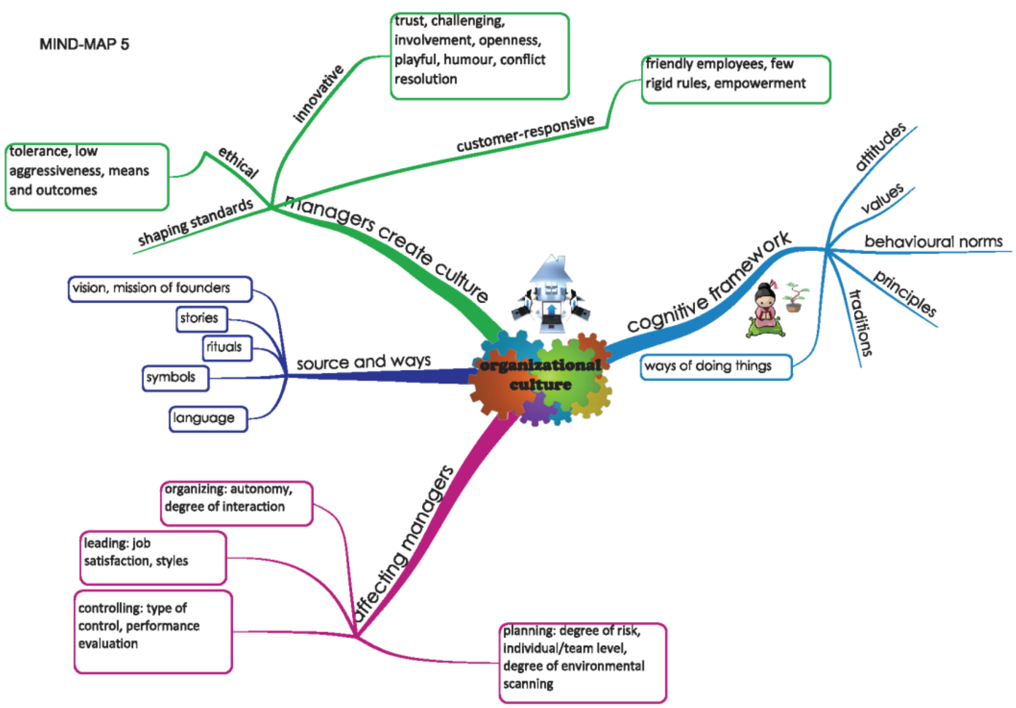
MIND-MAP 3

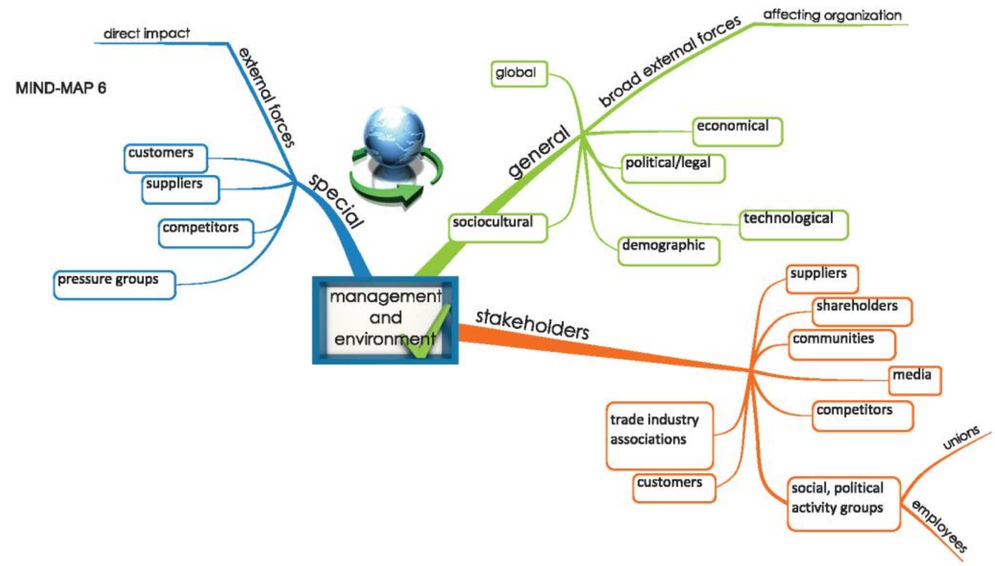


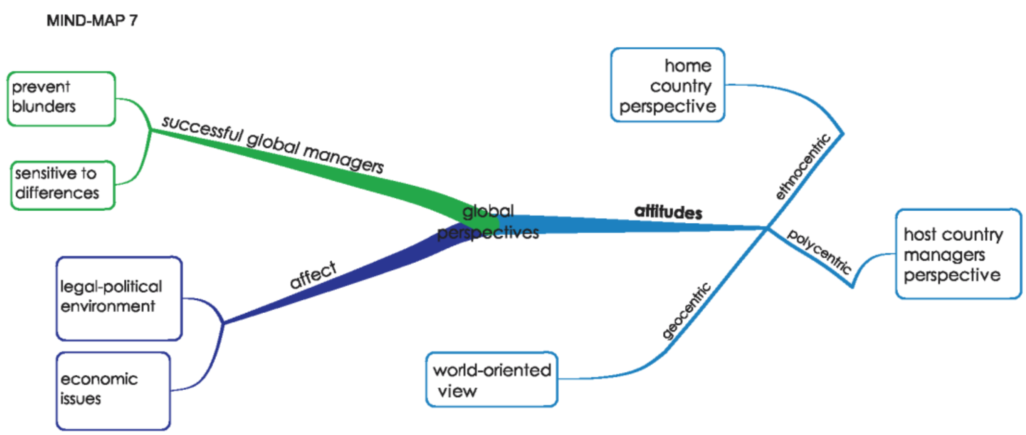


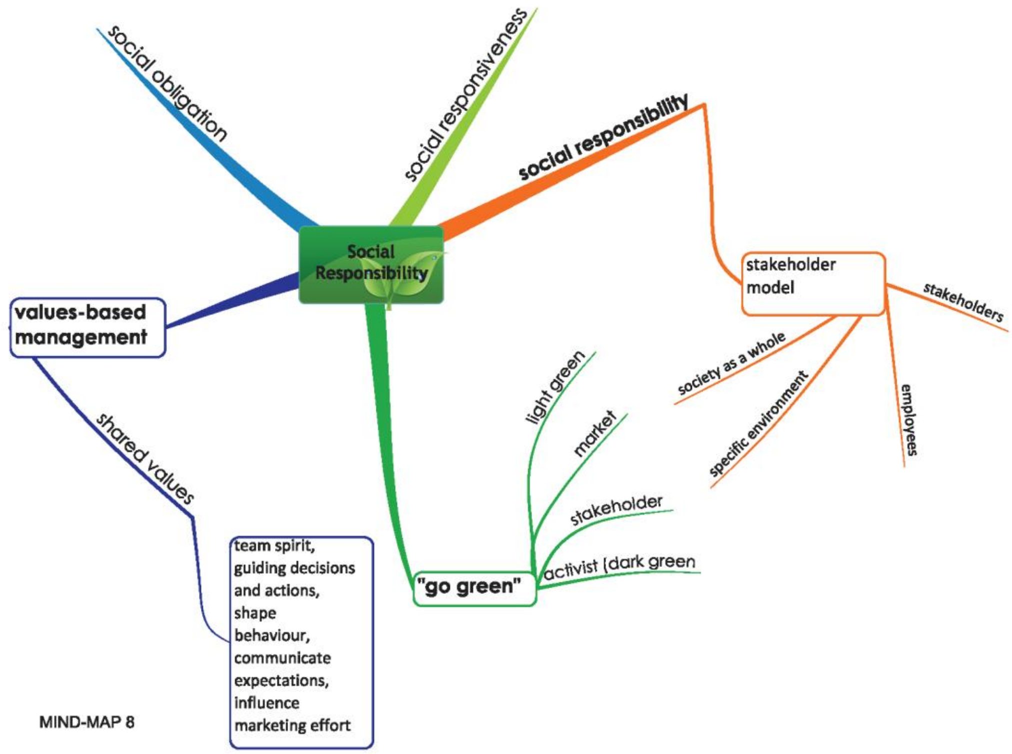
MIND-MAP 4

MIND-MAP 5

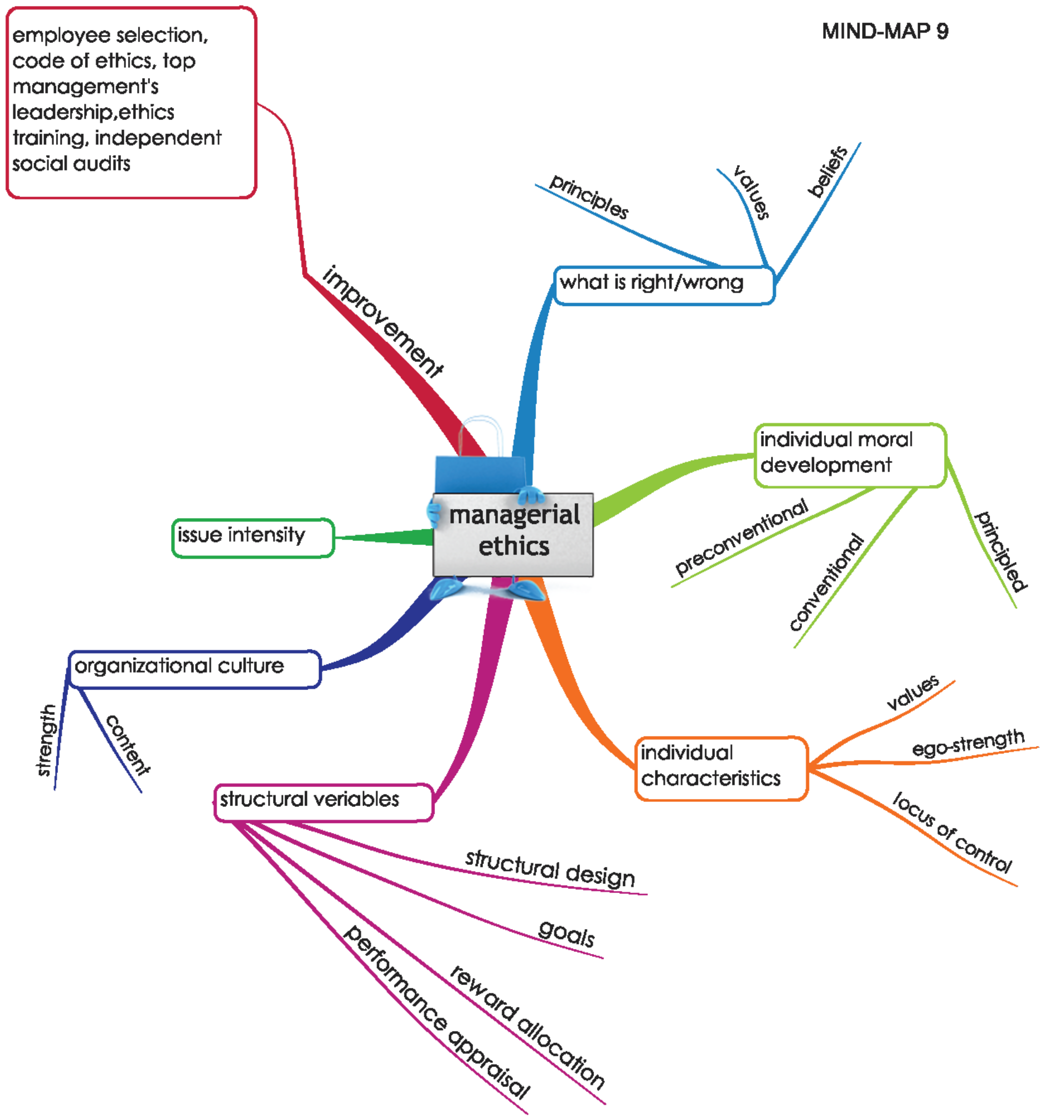



MIND-MAP 6
management and environment
special
external forces
direct impact
customers
suppliers
competitors
pressure groups
general
broad external forces
affecting organization
global
economical
political/legal
technological
demographic
sociocultural
stakeholders
suppliers
shareholders
communities
media
competitors
trade industry associations
customers
social, political activity groups
unions
employees

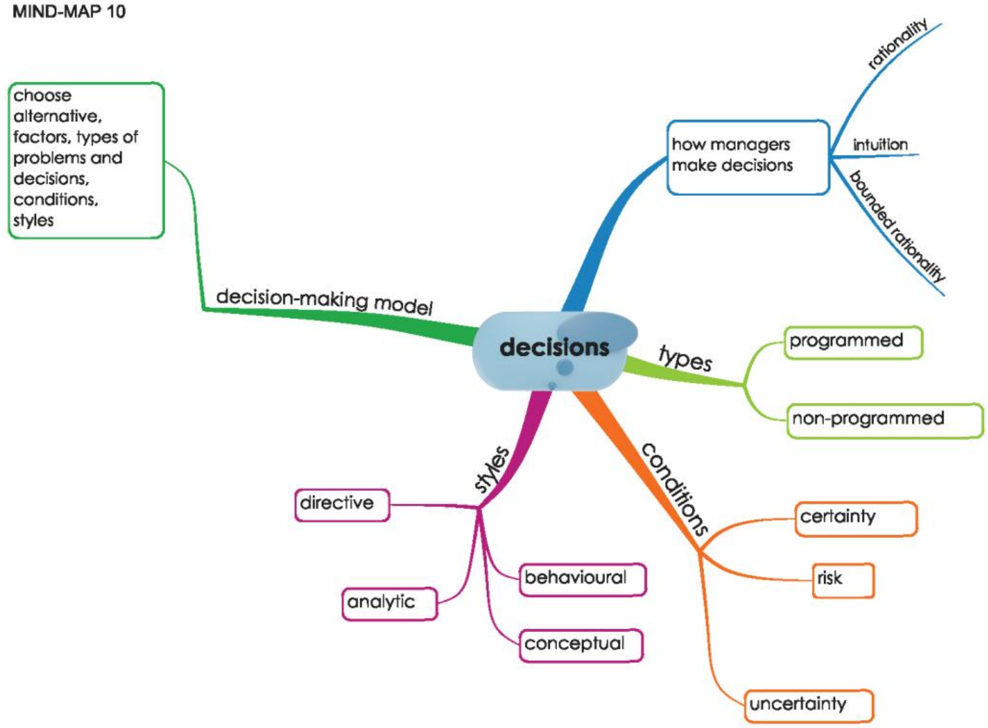

MIND-MAP 7
global perspectives
successful global managers
prevent blunders
sensitive to differences
affect
legal-political environment
economic issues
attitudes
ethnocentric
home country perspective
polycentric
host country managers perspective
geocentric
world-oriented view


Social Responsibility
social obligation
social responsiveness
social responsibility
stakeholder model
stakeholders
society as a whole
specific environment
employees
values-based management
shared values
team spirit, guiding decisions and actions, shape behaviour, communicate expectations, influence marketing effort
"go green"
light green
market
stakeholder
activist (dark green

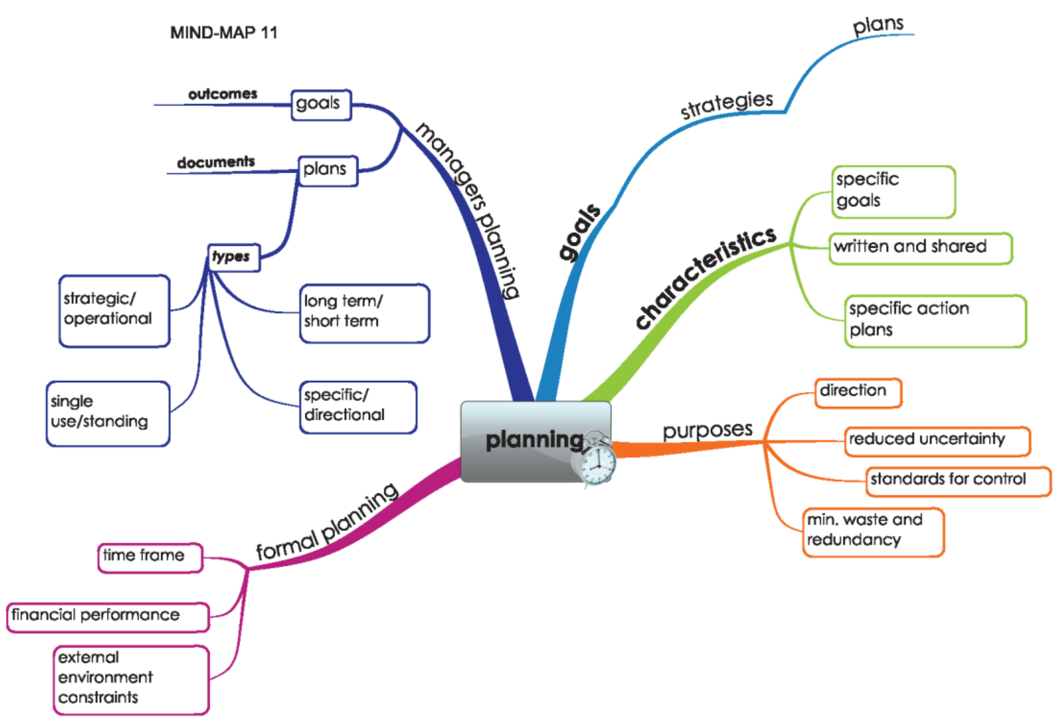
MIND-MAP 8

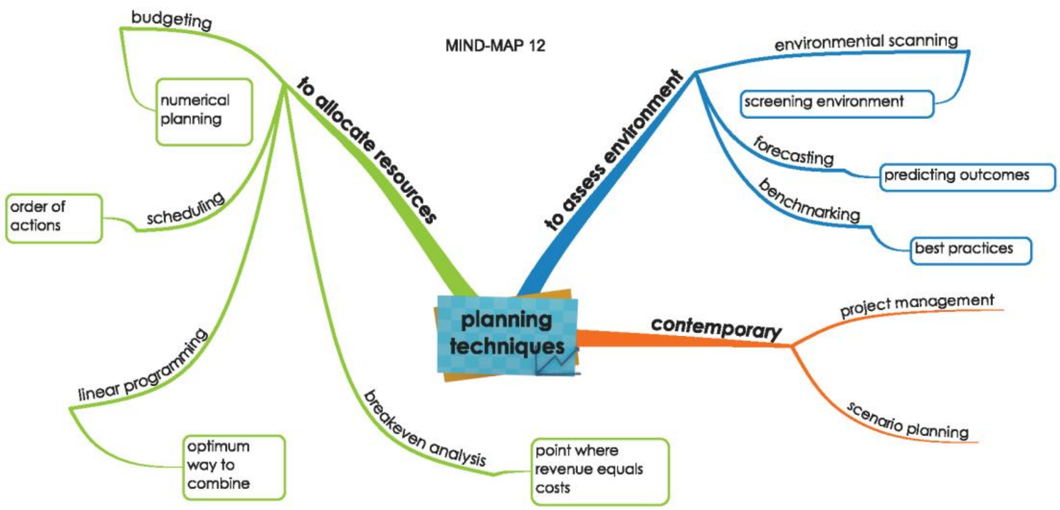

MIND-MAP 9
managerial ethics
improvement
employee selection, code of ethics, top management's leadership,ethics training, independent social audits
what is right/wrong
principles
values
beliefs
individual moral development
preconventional
conventional
principled
individual characteristics
values
ego-strength
locus of control
structural veriables
structural design
goals
reward allocation
performance appraisal
organizational culture
strength
content
issue intensity

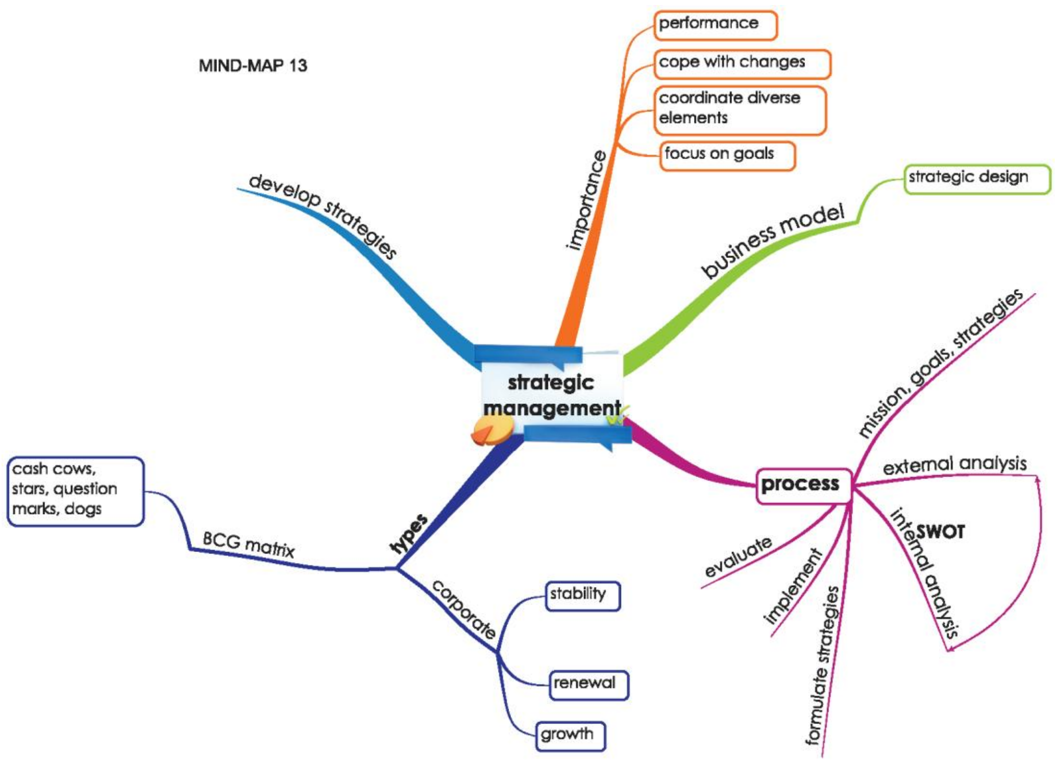
MIND-MAP 10

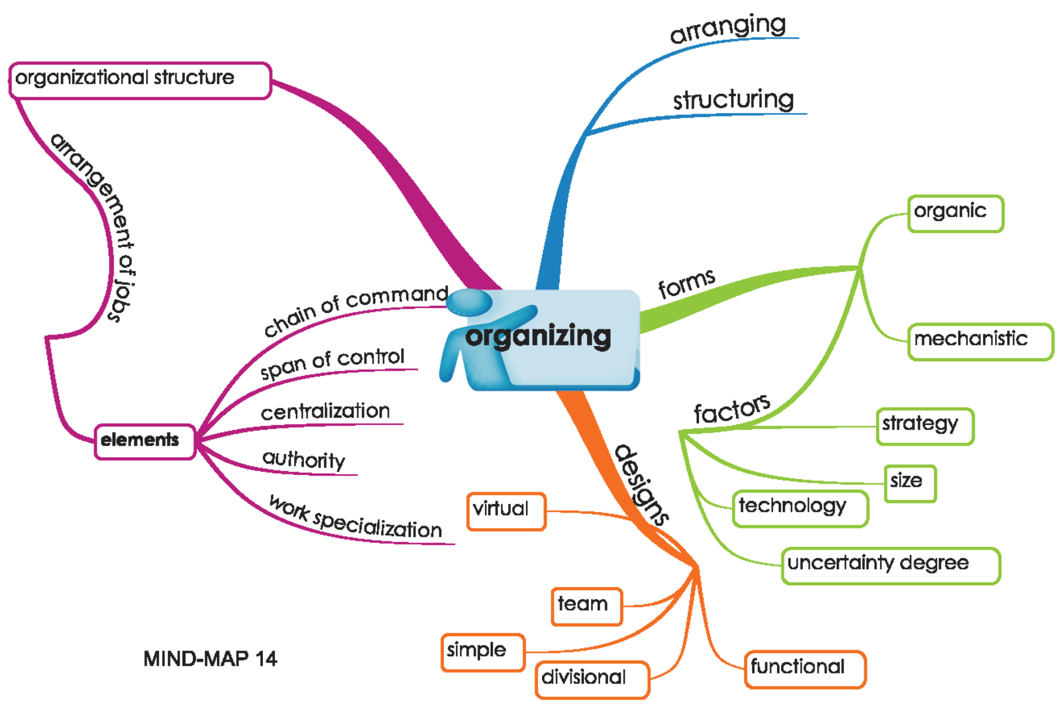


MIND-MAP 11

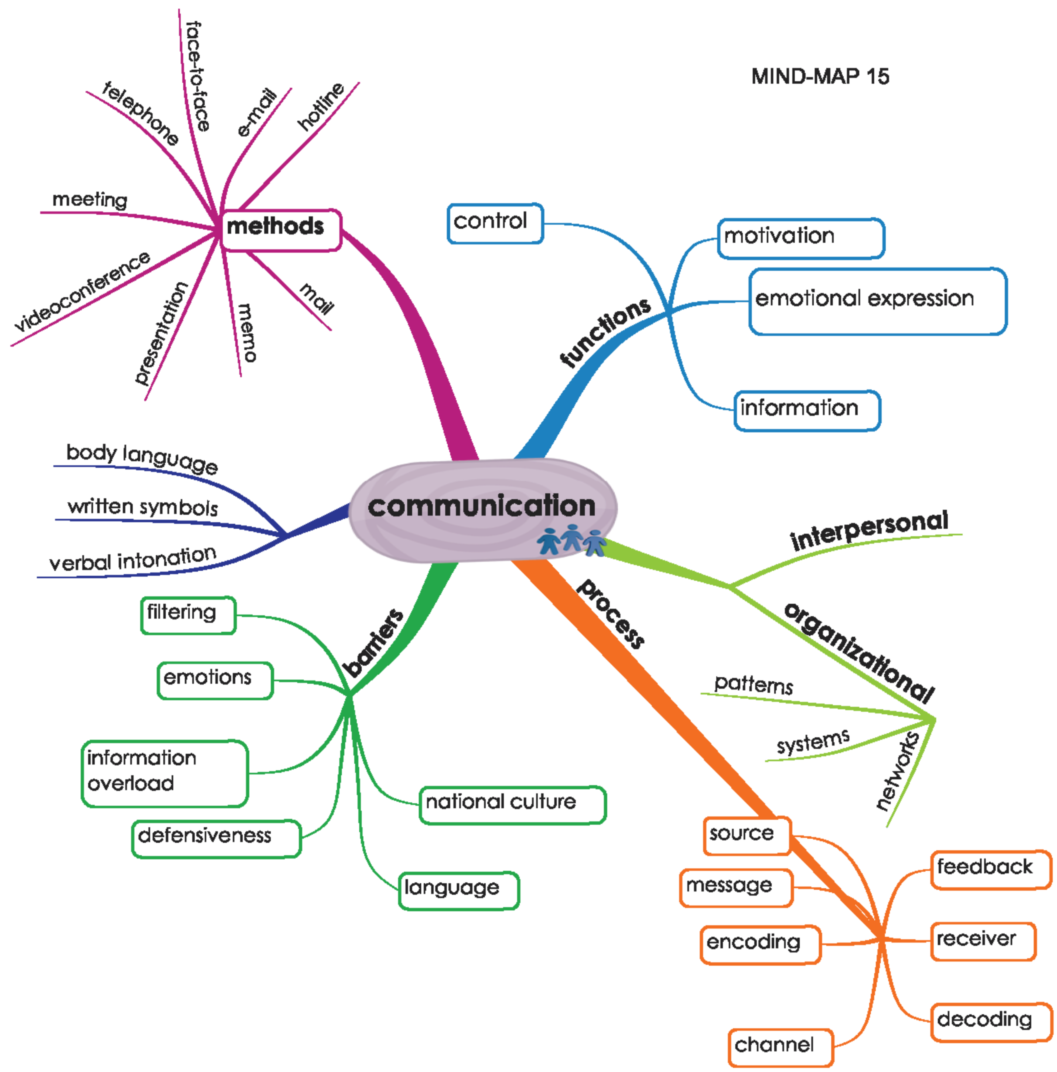



MIND-MAP 12
planning techniques
to allocate resources
budgeting
numerical planning
scheduling
order of actions
linear programming
optimum way to combine
breakeven analysis
point where revenue equals costs
to assess environment
environmental scanning
screening environment
forecasting
predicting outcomes
benchmarking
best practices
contemporary
project management
scenario planning

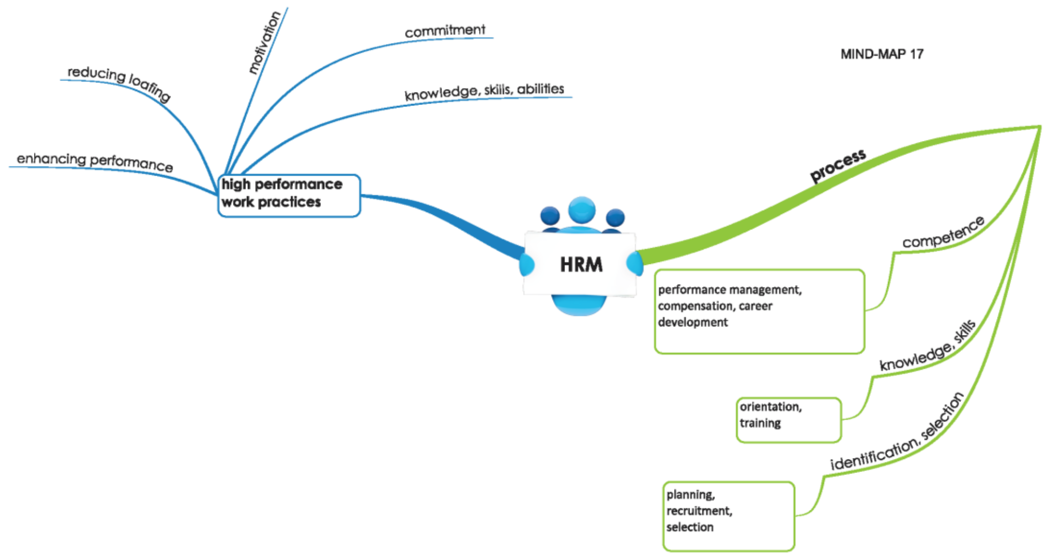

MIND-MAP 13
strategic management
importance
performance
cope with changes
coordinate diverse elements
focus on goals
develop strategies
business model
strategic design
process
mission, goals, strategies
external analysis
SWOT
internal analysis
formulate strategies
implement
evaluate
types
BCG matrix
cash cows, stars, question marks, dogs
corporate
stability
renewal
growth

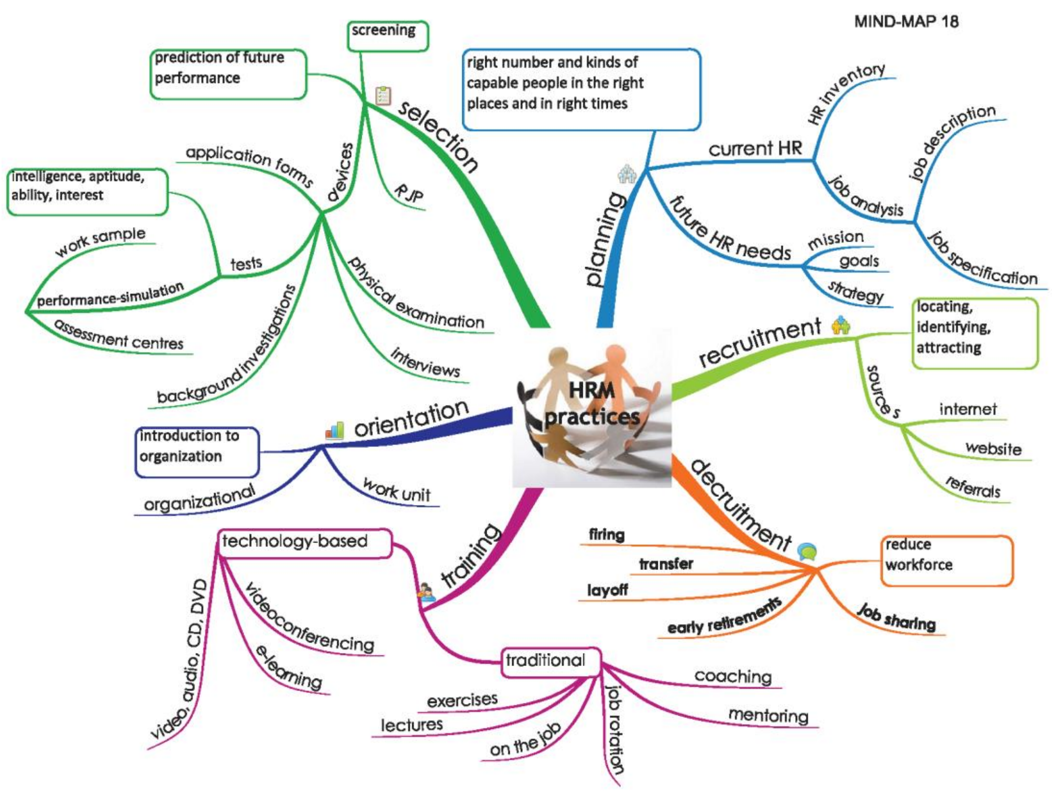

organizing
organizational structure
arrangement of jobs
elements
chain of command
span of control
centralization
authority
work specialization
arranging
structuring
forms
organic
mechanistic
factors
strategy
size
technology
uncertainty degree
designs
virtual
team
simple
divisional
functional

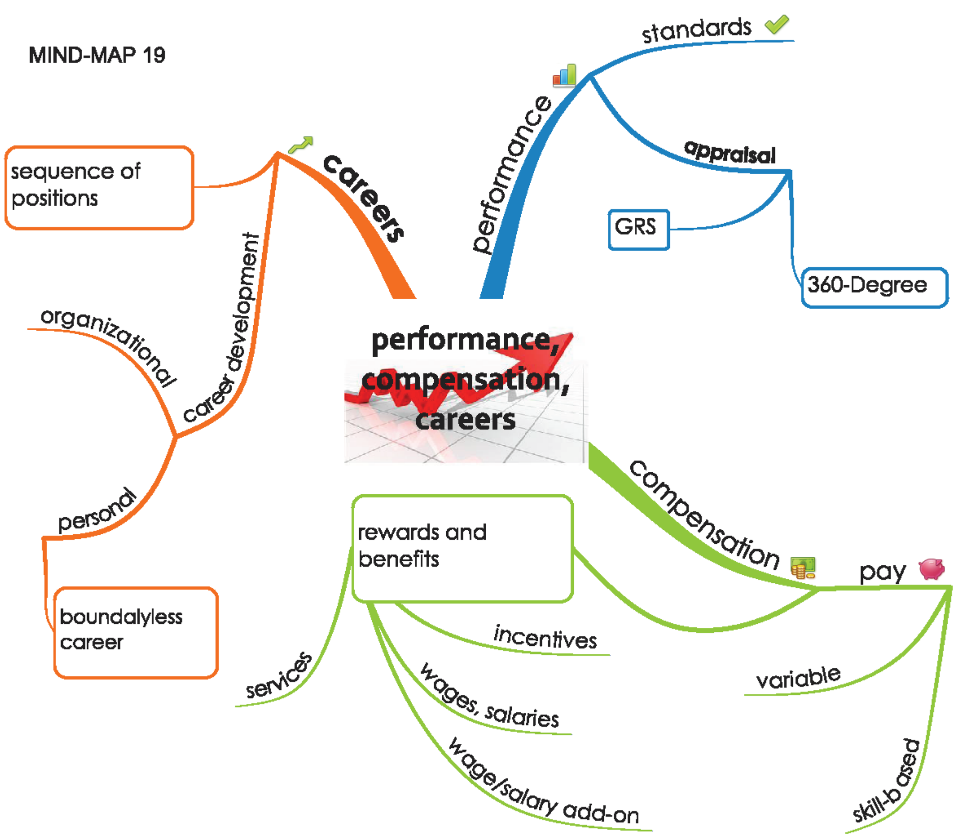
MIND-MAP 14


MIND-MAP 15
communication
methods
face-to-face
telephone
e-mail
hotline
meeting
videoconference
presentation
memo
mail
functions
control
motivation
emotional expression
information
body language
written symbols
verbal intonation
interpersonal
organizational
patterns
systems
networks
process
source
message
encoding
channel
feedback
receiver
decoding
barriers
filtering
emotions
information overload
defensiveness
national culture
language

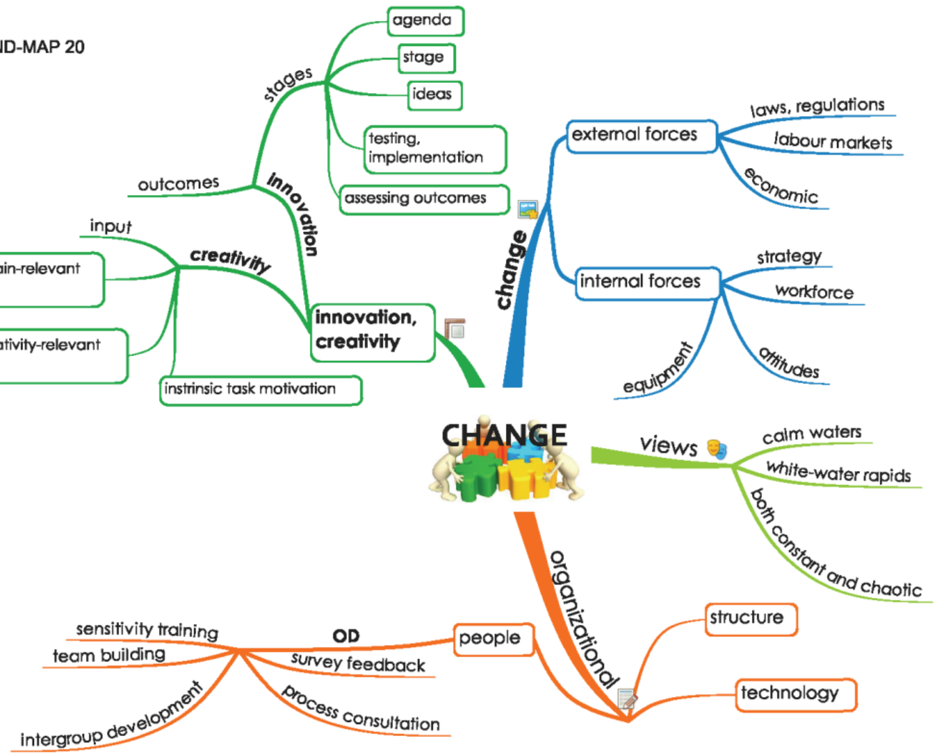

informal
formal
flow
organizational communication
directions
downward
upward
lateral
diagonal
MIND-MAP 16


MIND-MAP 17
HRM
high performance work practices
enhancing performance
reducing loafing
motivation
commitment
knowledge, skills, abilities
process
competence
performance management, compensation, career development
knowledge, skills
orientation, training
identification, selection
planning, recruitment, selection

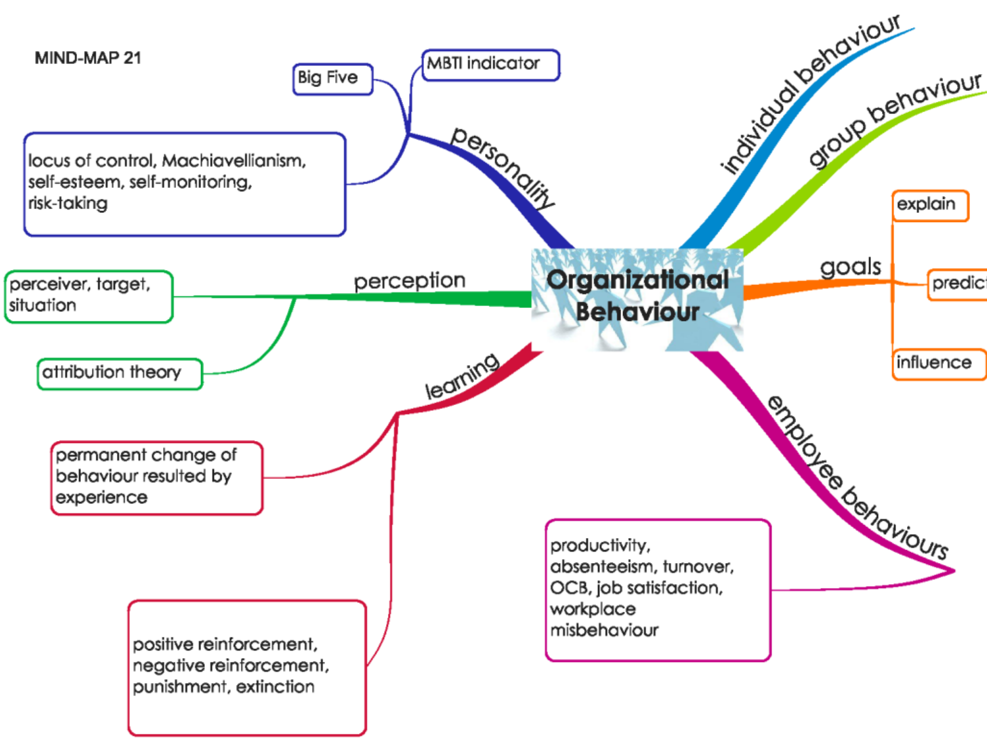

MIND-MAP 18
HRM practices
selection
screening
prediction of future performance
devices
application forms
tests
intelligence, aptitude, ability, interest
work sample
performance-simulation
assessment centres
background investigations
physical examination
interviews
RJP
planning
right number and kinds of capable people in the right places and in right times
current HR
HR inventory
job analysis
job description
job specification
future HR needs
mission
goals
strategy
recruitment
locating, identifying, attracting
sources
internet
website
referrals
decruitment
reduce workforce
firing
transfer
layoff
early retirements
job sharing
training
technology-based
video, audio, CD, DVD
videoconferencing
e-learning
traditional
exercises
lectures
on the job
job rotation
coaching
mentoring
orientation
introduction to organization
organizational
work unit

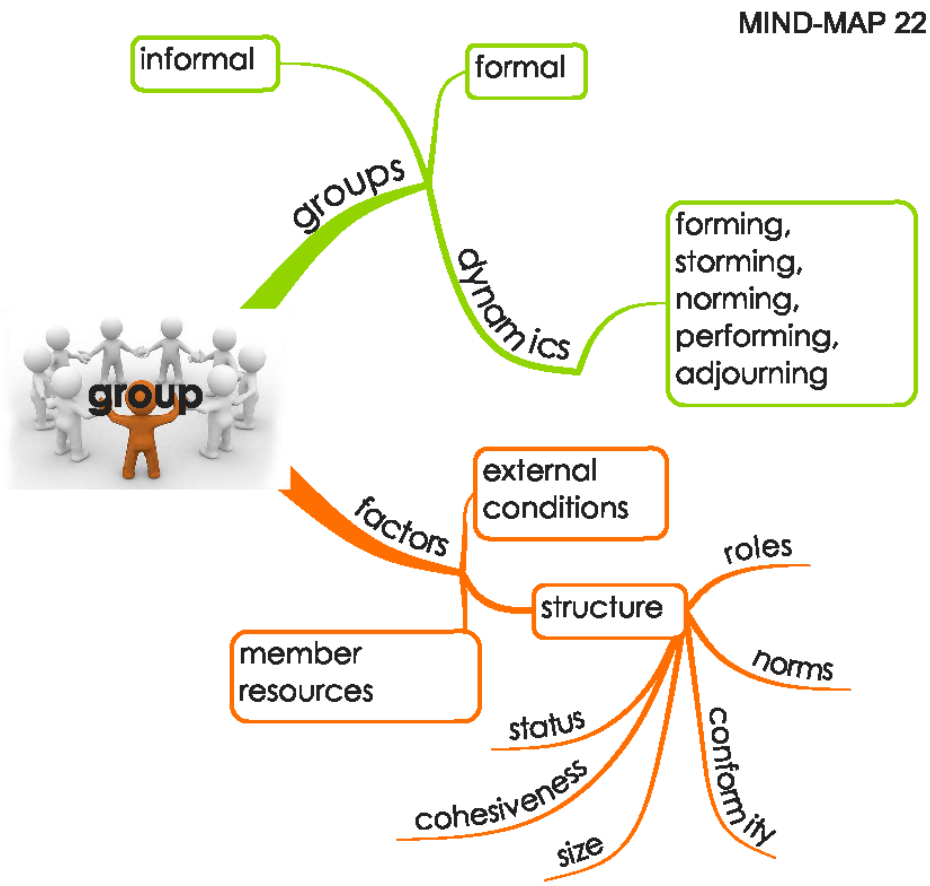

MIND-MAP 19
performance, compensation, careers
careers
sequence of positions
career development
organizational
personal
boundalyless career
performance
standards
appraisal
GRS
360-Degree
compensation
pay
rewards and benefits
incentives
wages, salaries
wage/salary add-on
services
variable
skill-b ased

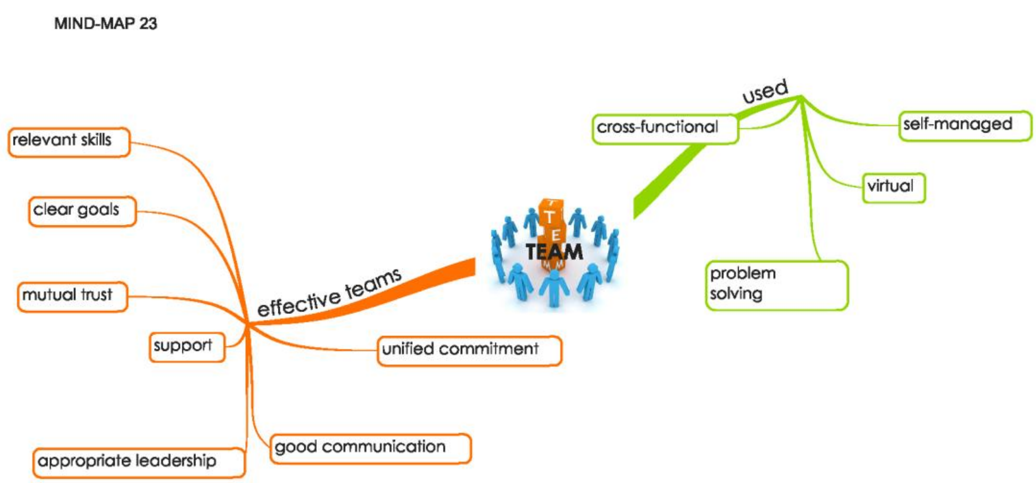
MIND-MAP 20

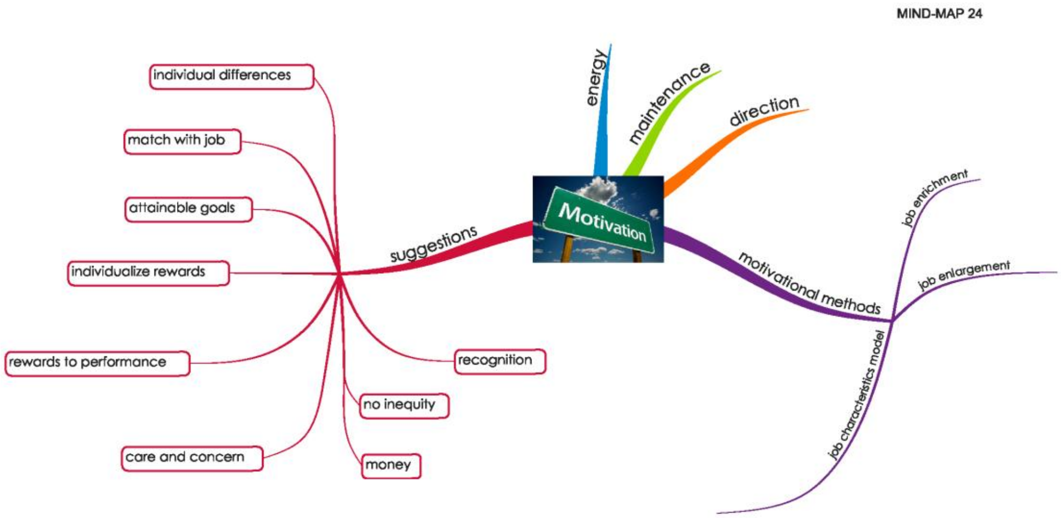


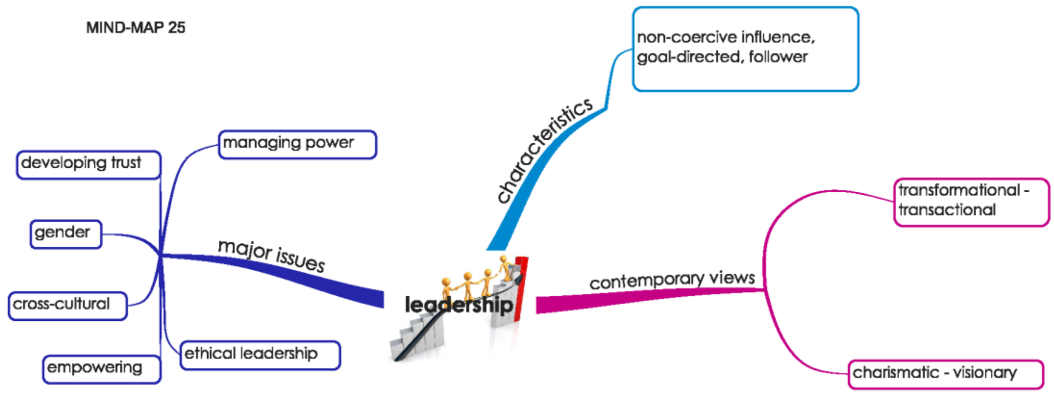
MIND-MAP 21

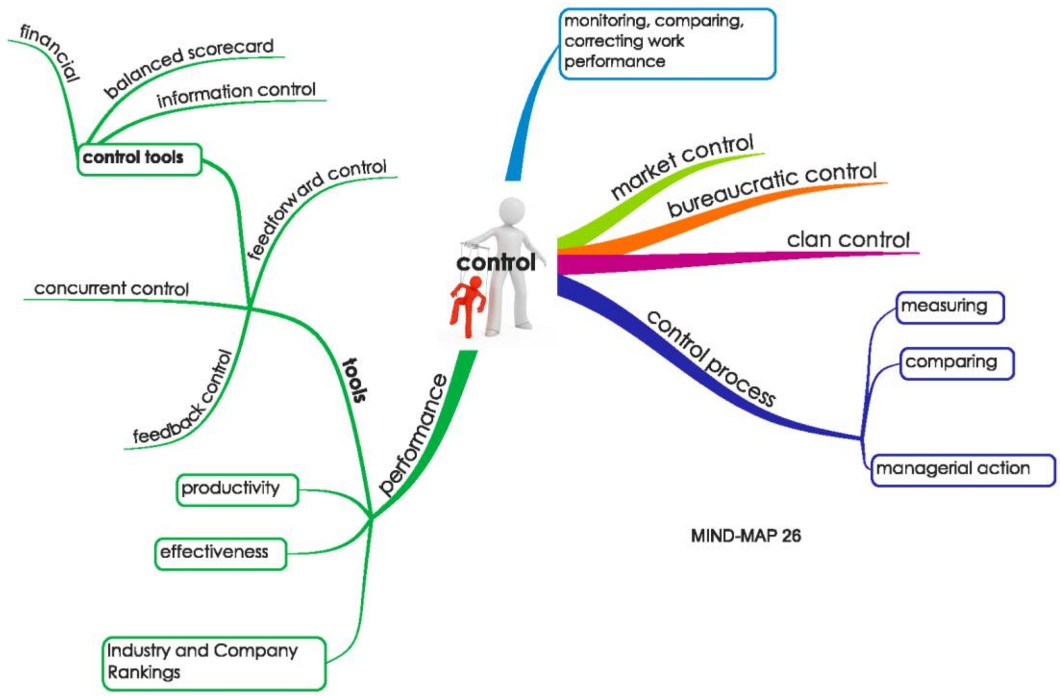



MIND-MAP 22
informal
formal
groups
dynamics
forming, storming, norming, performing, adjourning
group
factors
external conditions
structure
roles
norms
member resources
status
cohesiveness
size
conformity


MIND-MAP 23
relevant skills
clear goals
mutual trust
support
appropriate leadership
effective teams
unified commitment
good communication
TEAM
used
cross-functional
self-managed
virtual
problem solving

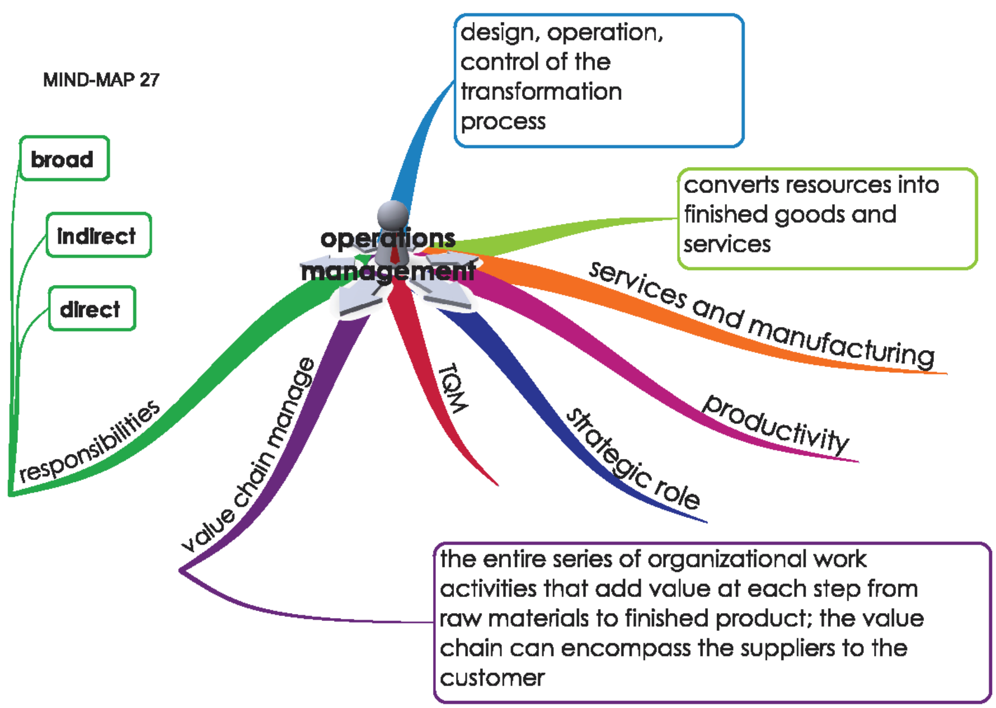

MIND-MAP 24
Motivation
energy
maintenance
direction
suggestions
individual differences
match with job
attainable goals
individualize rewards
rewards to performance
care and concern
recognition
no inequity
money
motivational methods
job enrichment
job enlargement
job characteristics model


MIND-MAP 25
leadership
characteristics
non-coercive influence,
goal-directed, follower
major issues
managing power
developing trust
gender
cross-cultural
empowering
ethical leadership
contemporary views
transformational -
transactional
charismatic - visionary



MIND-MAP 26

MIND-MAP 27



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