



# **Modern Business Administration**

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## **PREFACE**

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

The purpose of current books is to introduce to the students, academicians, field professionals and others. The book has been written in a question-answer form and can be used to review and refresh knowledge in Business Administration, present the facts and methods based on the most recent scientific achievements.

The book is written based on the Business Research Centre's extended seminars.





# 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 layoff 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, EhsanNikbakht; Barron's Inc 2006, Chapter 1, p. 1*

## **2. 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, EhsanNikbakht; Barron's Inc 2006, Chapter 1, pp. 2-3*

## **3. 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).

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

#### **4. 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, 6th ed, Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, p. 13*

## **5. 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, EhsanNikbakht; Barron's Inc 2006, Chapter 2, pp. 1-3*

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## TIME VALUE OF MONEY

### 6. 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 the U.S. 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 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, 5th ed.; Gropelli, EhsanNikbakht; Barron's Inc 2006, Chapter 3, pp. 1-2*

## 7. 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:

$$\begin{aligned} \text{Original deposit} &+ \text{Interest on deposit} &= \text{FV} \\ \$100 &+ (10\%) (\$100) &= \$110 \end{aligned}$$

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
$FV = P (1+R)^t$	$FV = P (1+R)^2$
$FV = \$100 (1 + .10)$	$FV = \$100 (1 + .10)^2$
$FV = \$100 (1.10)$	$FV = \$100 (1.10) (1.10)$
$FV = \$110$	$FV = \$121$

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:

$$\begin{array}{l}
 \text{Original } \$100 \times 1.10 = \$110 \text{ future value (FV) after 1 year} \\
 \$100 \times 1.10 = \$121 \text{ FV after 2 years} \\
 \$121 \times 1.10 = \$133 \text{ FV after 3 years}
 \end{array}$$

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:

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

Where  $C_N$  is cash flow at date  $N$  and  $r$  is the appropriate interest rate.

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

## 8. 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, EhsanNikbakht; Barron's Inc 2006, Chapter 3*

## 9. 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 ( $1.10 \times 1.10 \times 1.10 = 1.33$ ), 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, EhsanNikbakht; Barron's Inc 2006, Chapter 3, pp. 6-8*

### **10. 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.

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

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:

$$PV = \frac{C_N}{(1 + r)^N}$$

Where  $C_N$  is cash flow at date  $N$  and  $r$  is the appropriate interest rate.

## 11. 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:

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

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

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

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:

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

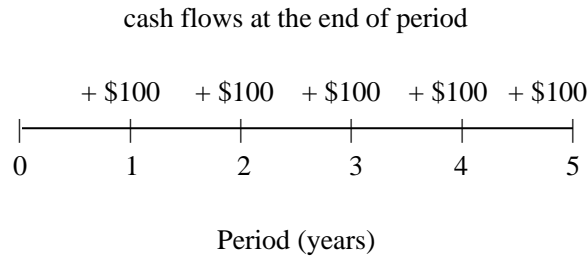
*Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 4, pp. 83-84*

## 12. 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

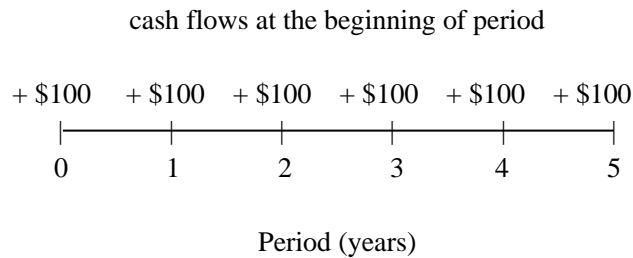
quarter, or each month. Not surprisingly, annuities are among the most common kinds of financial instruments. The pensions that people receive when they retire are often in the form of an annuity. Other examples are the monthly mortgage payments on a house, quarterly investments in a trust account for a child's future education, and periodic loan payments.

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



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.



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

### 13. 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 starting at some time  $N$
3. Subtract the results

So, we have:

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

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.

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

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:

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

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

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

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

#### 14. How do you calculate the present value of:

- perpetuity
- annuity

- growing perpetuity
- growing annuity

$$PV \text{ of perpetuity} = \frac{C}{(1+r)} + \frac{C}{(1+r)^2} + \frac{C}{(1+r)^3} + \dots = \frac{C}{r}$$

$$PV \text{ of growing perpetuity} = \frac{C}{r-g}$$

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

$$PV \text{ of growing annuity} = \frac{c}{r-g} \left[ 1 - \left( \frac{1+g}{1+r} \right)^N \right] \text{ where } r > g$$

*Corporate Finance, 6th ed, Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 4, pp. 83-98*

## RISK AND RETURN

### 15. Define holding period return (HPR) and Expected Return

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:

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

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.

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

HPR can be rewritten in a more convenient form:

$$HPR_{[0,1]} = \frac{P_1 - P_0 + Div_1}{P_0}$$

where  $P_0$  is the beginning price at time 0. For the moment we assume that  $Div_1 = 0$ .  $P_1$  is a random variable taking values at *time 1* according to the economic scenarios.

$$\left\{ \begin{array}{cccc} s_1 & s_2 & s_3 & s_4 \\ \text{prob}_1 & \text{prob}_2 & \text{prob}_3 & \text{prob}_4 \end{array} \right\}$$

where  $s_1$  is the depression state of the economy,  $s_2$  - recession,  $s_3$  - normal, and  $s_4$  - boom. It appears from this  $P_1$  is a discrete random variable with a probability distribution

$$P_1 = \left\{ \begin{array}{cccc} a_1 & a_2 & a_3 & a_4 \\ \text{prob}_1 & \text{prob}_2 & \text{prob}_3 & \text{prob}_4 \end{array} \right\}$$

Therefore  $HPR_{[0,1]}$  is also random with a probability distribution:

$$HPR_{[0,1]} = \left\{ \begin{array}{cccc} HPR_1 & HPR_2 & HPR_3 & HPR_4 \\ \text{prob}_1 & \text{prob}_2 & \text{prob}_3 & \text{prob}_4 \end{array} \right\}$$

with

$$HPR_i = \frac{a_i - P_0}{P_0}$$

A random variable  $HPR_{[0,1]}$  can be characterized by mathematical expectation and variance. Let us denote  $R = HPR_{[0,1]}$  and the realizations of HPR are also denoted as  $R_i = HPR_i$  for simplicity. Expected return and variance are defined as

$$E(R) = \sum_{i=1}^s prob_i \times R_i$$

$$Var(R) = E[R - E(R)]^2 = \sum_{i=1}^s prob_i [R_i - E(R)]^2$$

where

$s$  is the number of scenarios (in this case  $s=4$ );

$Prob_i$  is the probability of  $i^{th}$  scenario;

$R_i$  is the rate of return of the stock in  $i^{th}$  scenario.

*Expected Return.* This is the return that an individual expects a stock to earn over the next period. Of course, because this is only an expectation, the actual return may be either higher or lower. An individual's expectation may simply be the average return per period a security has earned in the past. Alternatively, it may be based on a detailed analysis of a firm's prospects, on some computer-based model, or on special (or inside) information.

Suppose financial analysts believe that there are four different likely states (probability each scenarios) of the economy: depression, recession, normal, and boom times. The returns on the Supertech Company (price at time 0 is  $P_0 = \$100$ ) are expected to follow the economy closely. The return predictions for *time 1* are as follows:

Scenario (s)	Probability (prob.)	Price ( $P_1$ )	Rate of return % ( $R$ )
Depression	0.15	\$80	-0.20
Recession	0.15	\$95	-0.05
Normal	0.5	\$105	0.05
Boom	0.2	\$115	0.15

Expected return and variance in our example is  $E(R) = 0.0175$  and  $Var(R) = 0.0118$

*Corporate Finance, 6<sup>th</sup> ed, Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 9, pp. 225-231*

*Corporate Finance, 6<sup>th</sup> ed, Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 10, pp. 243-244*



**16. 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 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:

$$\text{Effective Annual Rate: } \text{EAR} = \left(1 + \frac{\text{APR}}{n}\right)^n - 1$$

$$\text{Semi-Annual Rate (n = 2), } \text{EAR} = \left(1 + \frac{0.1}{2}\right)^2 - 1 = 10.25\%$$

$$\text{Monthly Rate (n = 12), } \text{EAR} = \left(1 + \frac{0.1}{12}\right)^{12} - 1 = 10.47\%$$

*Investments, 8<sup>th</sup> ed; Bodie, Kane, Marcus, McGraw-Hill2009, Chapter 5*

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

$$\text{APR} = \text{Per} - \text{period rate} \times \text{Periods per year}$$

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

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

Rearranging,

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

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  $(1 + APR/n)^n$ . 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

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

Or equivalently

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

*Investments, 8th ed; Bodie, Kane, Marcus, McGraw-Hill 2009, Chapter 5, p. 119*

*Finance, 5th ed; Groppelli, Ehsan Nikbakht; Barron's Inc 2006, Chapter 3, pp. 12-13*

### 18. 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.

$$\text{Simple Interest} = p \times i \times n$$

Where

$p$  = principal (original amount borrowed or loaned)

$i$  = interest rate for one period

$n$  = number of periods

Therefore,

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

By “Days/Year” we mean “Number of days in Period / Number of days in a Year”

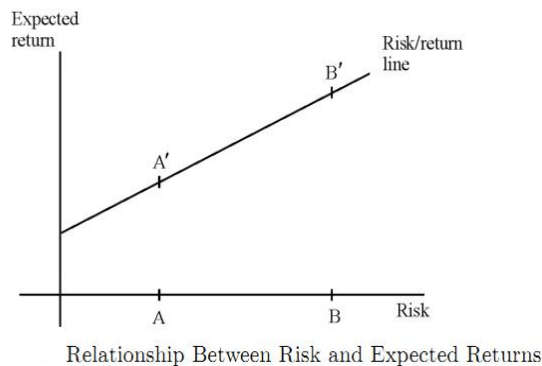
*Mastering Financial Calculations, Robert Steiner, Prentis Hall, Chapter 1, p. 5*

## 19. 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.



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.

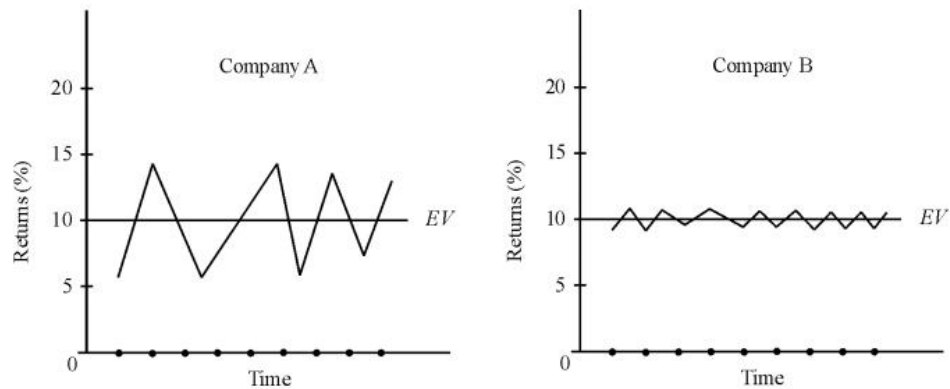
*Finance, 5th ed; Groppelli, EhsanNikbakht; Barron's Inc 2006, Chapter 1, pp. 3-4*

## 20. Define risk. How can risk be measured?

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**.

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

Where

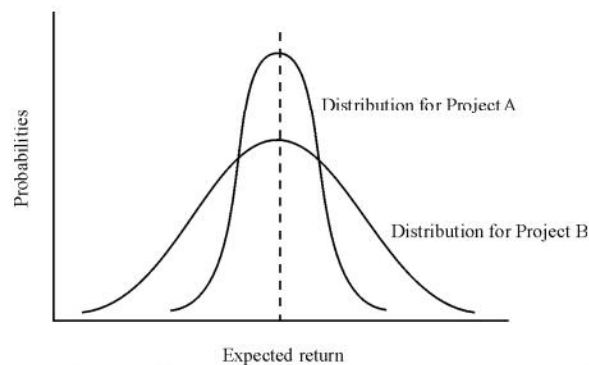
$N$  = number of observations

$t$  = time periods

$ER$  = 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.

## 21. 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, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter7; pp. 197-199*

## 22. What is Arbitrage and Speculation?

In economics and finance, arbitrage is the practice of taking advantage of a price difference between two or more markets: Simultaneously buying on one market and selling on another generates riskless profit with zero investment. 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.

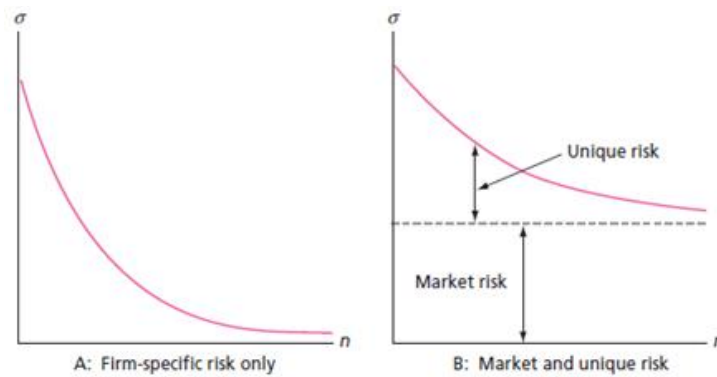
Speculation is purchase (or sale) of goods with a view to resale (repurchase) at a later date, where the motive behind such action is the expectation of a change in the relevant prices relatively to the ruling price and not a gain accruing through their use or any kind of transformation effected in them.

*Investments, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter10; p.319*

*Investments, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter 6; p. 157*

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

Diversification is the process of investing a portfolio across different asset classes in varying proportions depending on an investor's time horizon, risk tolerance, and goals. While diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses, this disciplined approach does help alleviate some of the speculation that is often involved with investing. Primary asset classes include domestic equity, foreign equity, and fixed income.



When common sources of risk affect all firms, however, even extensive diversification cannot eliminate risk. In 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, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter7; pp. 195-196*

## VALUATION AND CAPITAL BUDGETING

### 24. What is the general definition of the value of an asset? List the steps of calculating value of an 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 Expected after tax incremental cash flows*

*Finance, 5<sup>th</sup> ed., Groppelli, EhsanNikbakht; Barron's Inc 2006, Chapter 5, p. 1*

### 25. 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 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 and the straight-line, sum-of-the-years'-digits, 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:



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

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, 5<sup>th</sup> ed., Groppelli, EhsanNikbakht; Barron's Inc 2006, Chapter 2, pp. 9-12*

## 26. Define NPV

The Net Present Value of a project is the difference between the discounted future cash flows and the initial investment. 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 is defined as

$$NPV = -C_0 + \frac{C_1}{(1+r)} + \frac{C_2}{(1+r)^2} + \dots + \frac{C_T}{(1+r)^T} = -C_0 + \sum_{i=1}^T \frac{C_i}{(1+r)^i}$$

where

$C_0$  is the initial investment;

$C_i$  -is after-tax incremental cash flow at time  $i$ ;

$r$  -is a one period interest rate and is assumed to be constant.

$T$ - is investment horizon.

Traditional definition of NPV assumes that after-tax incremental cash flows are constants. However, cash flows are never constants and a more realistic method would imply that they are random variables. So, we would rewrite the NPV definition above as follows

$$NPV = -C_0 + E \sum_{i=1}^T \frac{C_i}{(1+r)^i}$$

where  $C_i$  is random for  $i = 1, 2, \dots, T$  and has some probability distribution.

In order to introduce the project valuation technique using traditional method, we are considering the case with gasoline station which require import of gasoline.

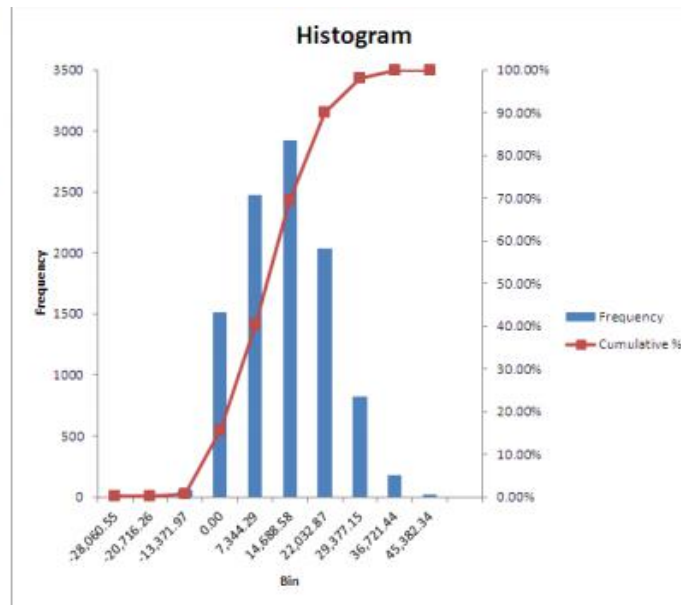
Time	0	1	2	3	4	5	6	7	8	9	10	11	12
After-tax incremental cash flows		8,153	8,153	8,153	8,153	8,153	8,153	8,153	8,153	8,153	8,153	8,153	8,153

Traditional valuation technique - NPV (net present value)- with ( $C_0$ ) investment \$80,000, monthly cash flows ( $C_i$ ) \$8,153 during the 12 months ( $T=12$ ), and discount rate ( $r$ ) recalculated for monthly data 0.8 %, shows us

$$NPV = -C_0 + \sum_{i=1}^T \frac{C_i}{(1+r)^i} = \$12,493$$

which is slightly positive NPV. But cash flows  $C_i$  in the project are random variables with some volatility. Adjusting the project for randomness of cash flows can be done via Monte Carlo simulation. Monte Carlo simulation in the case is done based on uniform distribution - uniformly simulating monthly quantity of gasoline sales between 9,510 and 19020 gallons. Data is collecting via market research - measurement done on different gasoline stations. Constructing the histogram on simulated data (10000 of iterations) we can find that up to 15.71% of the iterations the project gives negative NPV. The following graph illustrates the NPV histogram.

Bin	Frequency	Cumulative %
-28,060.55	1	0.01%
-20,716.26	3	0.04%
-13,371.97	59	0.63%
0.00	1508	15.71%
7,344.29	2471	40.42%
14,688.58	2918	69.60%
22,032.87	2032	89.92%
29,377.15	818	98.10%
36,721.44	175	99.85%
45,382.34	15	100.00%



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

*PhD Thesis; Real Option Valuation of the Project with Robust Mean-variance Hedging;  
T. Uzunashvili; Georgian American University 2013; pp. 26-27.*

## 27. 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. According to the definition, NPV is a function of interest rate  $r$ . In simple terms, the IRR is an interest rate that makes the NPV equal to zero. So, IRR is the solution to the following equation for  $r$

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

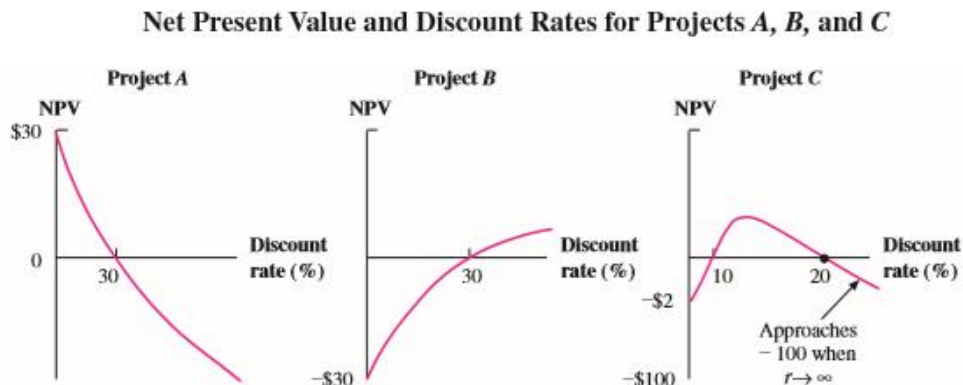
An *independent project* is one whose acceptance or rejection is independent of the acceptance or rejection of other projects. Consider three project scenarios: investing project A, financing project B and mixture project C.

Project A:  $C_0 < 0, C_i > 0, i = 1, 2, \dots, T$  (first cash flow is negative and all remaining cash flows are positive);

Project B:  $C_0 > 0, C_i < 0, i = 1, 2, \dots, T$  (first cash flow is positive and all remaining cash flows are negative);

Project C:  $C_0 < 0, C_i > 0, C_j < 0, i \neq j, i, j = 1, 2, \dots, T$  (some cash flows after first are positive and some cash flows after first are negative).

These three cases can be visualized graphically as follows



Note that on the first two graphs (project A and B) the IRR equals 30 percent while on the third graph (project C) there are two intersection points, 10 and 20 percent.

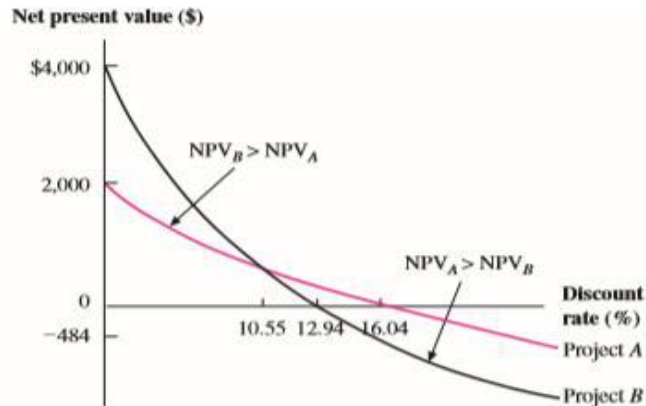
*Mutually exclusive investments* mean that for two projects, A and B, you accept A or B, or you reject both of them, but you cannot accept both of them. For example, the Kaufold Corporation has two alternative uses for a warehouse. It can store toxic waste containers (investment A) or electronic equipment (investment B). The cash flows are as follows:

Year:	0	1	2	3	NPV			
					@0%	@10%	@15%	IRR
Investment A	-\$10,000	\$10,000	\$1,000	\$ 1,000	\$2,000	\$669	\$ 109	16.04%
Investment B	-10,000	1,000	1,000	12,000	4,000	751	-484	12.94

As with example presented above, we can select the better project with one of three different methods:

- 1) *Compare NPVs of the Two Projects.* Graph below aids our decision. If the discount rate is below 10.55 percent, one should choose project B because B has a higher NPV. If the rate is above 10.55 percent, one should choose project A because A has a higher NPV.

### Net Present Value and the Internal Rate of Return for Mutually Exclusive Projects



- 2) *Compare Incremental IRR to Discount Rate.* The above method employed NPV. Another way of determining that B is a better project is to subtract the cash flows of A from the cash flows of B and then to calculate the IRR.

The incremental cash flows are

Year:	NPV of Incremental Cash Flows				Incremental IRR	@0%	@10%	@15%
	0	1	2	3				
B - A	0	-\$9,000	0	\$11,000	10.55%	\$2,000	\$83	-\$593

- 3) *Calculate NPV on Incremental Cash Flows.* Finally, one could calculate the NPV on the incremental cash flows. We find that the incremental NPV is positive when the discount rate is either 0 percent or 10 percent. The incremental NPV is negative if the

discount rate is 15 percent. If the NPV is positive on the incremental flows, one should choose B. If the NPV is negative, one should choose A.

*Finance, 5<sup>th</sup> ed., Groppelli, EhsanNikbakht; Barron's Inc., 2006; Chapter 7, pp. 7-9*  
*Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 6, pp. 149-159*

**28. 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 an 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.

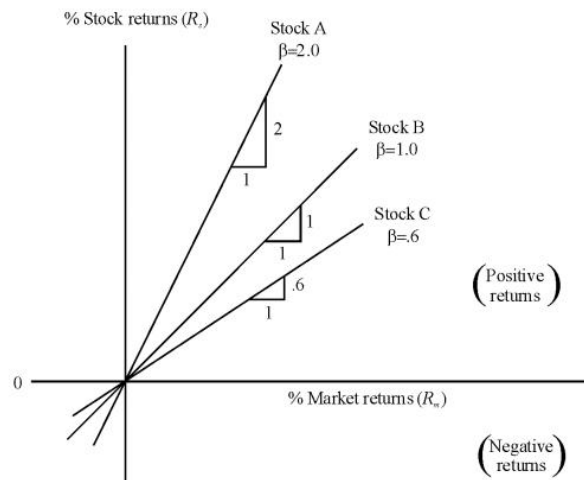
*Finance, 5<sup>th</sup> ed., Groppelli, EhsanNikbakht; Barron's Inc., 2006; Chapter 3, pp. 2-4*

## 29. 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 ( $\beta$ ), 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 ( $\beta_s$ ) 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

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

where

$R_S$  = required rate of return

$R_f$  = risk-free rate (such as the return on U.S. treasury bills)

$\beta$  = beta risk coefficient of the company  
 $R_M$  = return on a market portfolio

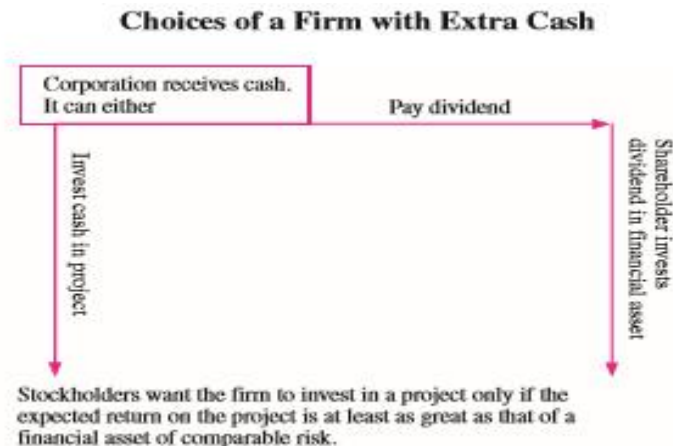
Once  $R_S$  (required rate of returns) is computed, the future income is discounted at that rate and, thus, can be used in every valuation method.

*Finance, 5<sup>th</sup> ed; Groppelli, EhsanNikbakht; Barron's Inc., 2006; Chapter 4, pp. 13-16*

### 30. What is the opportunity cost of capital?

The appropriate discount rate on a new project is the minimum expected rate of return an investment must offer to be attractive. This minimum required return is often called the *cost of capital* associated with the investment. It is called this because the required return is what the firm must earn on its capital investment in a project just to break even. It can thus be interpreted as the opportunity cost associated with the firm's capital investment.

Whenever a firm has extra cash, it can take one of two actions. On the one hand, it can pay out the cash immediately as a dividend. On the other hand, the firm can invest extra cash in a project, paying out the future cash flows of the project as dividends. Which procedure would the stockholders prefer? If a stockholder can reinvest the dividend in a financial asset (a stock or bond) with the same risk as that of the project, the stockholders would desire the alternative with the highest expected return. In other words, the project should be undertaken only if its expected return is greater than that of a financial asset of comparable risk. This is illustrated in chart.



This discussion implies a very simple capital-budgeting rule:

*The discount rate of a project should be the expected return on a financial asset of comparable risk.*

From the firm's perspective, the expected return is the cost of equity capital if firm is all equity financing. Under the CAPM, the expected return on the stock is

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

where

$R_S$  -required rate of return

$R_f$  - risk-free rate (such as the return on U.S. treasury bills)

$\beta$  -beta risk coefficient of the company

$R_M$  - return on a market portfolio

If a firm uses both debt and equity, the cost of capital is a weighted average of each. it is usually referred to as the weighted average cost of capital  $R_{WACC}$

$$R_{WACC} = \frac{S}{S+B} R_S + \frac{B}{S+B} R_B(1 - T_c)$$

where

$S$  - is the value of equity;

$B$  -is the value of debt;

$R_S$ -is the cost of equity;

$R_B$ -is the cost of debt;

$T_c$ -is the corporation's tax rate.

*Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 12, pp. 307-310*

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

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

Rearranging terms, we have:

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

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  $\approx$  indicates that the equation is approximately true. This approximation is reasonably accurate for low rates of interest and inflation

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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 7, pp. 177-183*

### **32. What information do you need to determine the value of the following assets?**

- Bonds
- Preferred stock
- Common stock

The information required to value bonds, preferred stock, and common stock is as follows:

- (a) Bonds: coupon rate, face value (redemption value, maturity value, par value), maturity, discount rate (Yield), and time between interest payments.
- (b) Preferred stock: dividends paid in each period, discount rate.
- (c) Common stock: expected dividend next year, required rate of return, and rate of growth of dividends.

*Finance, 5<sup>th</sup> ed; Groppelli, EhsanNikbakht; Barron's Inc., 2006; Chapter 5, pp. 2-6*

### **33. 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:

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

Here it is assumed that  $Div_1 = Div_2 = \dots = Div$ . 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:

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

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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003;  
Chapter 27, pp.108-112*

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## ASSET TYPES AND CLASSES

### **34. 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 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.

*Investments, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter1, pp.1-2*

### **35. 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. Equity markets and equity valuation are the topics of later questions. 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, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter1, pp.3-4*

### **36. 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.

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.

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, and 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, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter2, pp.24-28*

### **37. 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 semiannual 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, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter2, pp.29-35*

### **38. 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.

**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.

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, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter2, pp.35-38*

### 39. 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 (divisor).

$$DJIA_t = \frac{\sum_{i=1}^{30} P_{it}}{d}$$

where

$P_{it}$  = prices of the component stocks at time  $t$   
 $d$  = Dow Divisor.

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.

$$DJIA_t = \frac{\sum_{i=1}^{30} P_{it} (old)}{d(old)} = \frac{\sum_{i=1}^{30} P_{it} (new)}{d(new)}$$

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. 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. The formula to calculate the S&P 500 index value is:

$$S\&P\ index_t = \frac{\sum_{i=1}^N p_{it} \cdot Q_{it}}{\sum_{i=1}^N p_{ib} \cdot Q_{ib}}$$

Where

$S\&P\ index_t$  = index value at time  $t$ ;

$t$  = close time;

$b$  = current time;

$p_i$  = the price of  $i$  stock in the index;

$Q_i$  = the number of shares available publicly for  $i$  stock;

$N$  = number of stocks.

*Investments, 8<sup>th</sup> ed., Bodie, Kane, Marcus; McGraw-Hill, 2009; Chapter2, pp.38-45*

#### 40. 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*



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## FINANCIAL INSTITUTIONS AND THEIR RISKS

### 41. 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.

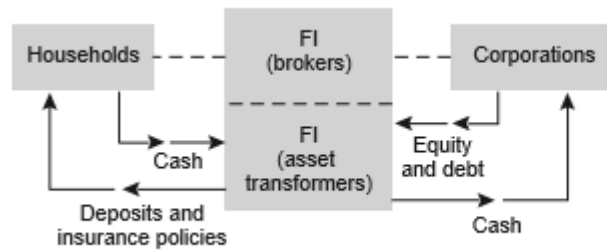
Because of (1) monitoring costs, (2) liquidity costs, and (3) price risk, the average household saver may view direct investment in corporate securities as an unattractive proposition and prefer either not to save or to save in the form of cash.

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.

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. Graphically, this could be illustrated as follows:



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

## 42. Risks of Financial Intermediation

A major objective of Financial Institutions (FI) management is to increase the FI's returns for its owners. This often comes, however, at the cost of increased risk. This introduces the various risks facing FIs: interest rate risk, market risk, credit risk, off balance-sheet risk, technology and operational risk, foreign exchange risk, country or sovereign risk, liquidity risk, and insolvency risk.

*Interest rate risk:* The risk incurred by an FI when the maturities of its assets and liabilities are mismatched.

*Market risk:* The risk incurred from assets and liabilities in an FI's trading book due to changes in interest rates, exchange rates, and other prices.

*Off-balance-sheet risk:* The risk incurred by an FI as the result of activities related to its contingent assets and liabilities held off the balance sheet.

*Foreign exchange risk:* The risk that exchange rate changes can affect the value of an FI's assets and liabilities denominated in nondomestic currencies.

*Country or sovereign risk:* The risk that repayments to foreign lenders or investors may be interrupted because of restrictions, intervention, or interference from foreign governments.

*Technology risk:* The risk incurred by an FI when its technological investments do not produce anticipated cost savings.

*Operational risk:* The risk that existing technology, auditing, monitoring, and other support systems may malfunction or break down.

*Liquidity risk:* The risk that a sudden surge in liability withdrawals may require an FI to liquidate assets in a very short period of time and at less than fair market prices.

*Insolvency risk:* The risk that an FI may not have enough capital to offset a sudden decline in the value of its assets.

*Financial Institutions Management, 6<sup>th</sup> ed., Anthony Saunders, Marcia Millon Cornett; McGraw-Hill, 2008; Chapter 9, pp. 168-170*

## BOND TYPES, PRICING AND RETURN

### 43. 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, 5<sup>th</sup> ed.; Groppelli, EhsanNikbakht; Barron's Inc. 2006; Chapter 5, p. 2*

### 44. 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:

$$\text{Bond value} = \text{Present value of coupons} + \text{Present value of par value}$$

If we call the maturity date  $N$  and call the discount rate (yield)  $y$ , the bond value can be written as:

$$\text{Bond Value} = \sum_{n=1}^N \frac{\text{Coupon}_n}{(1+y)^n} + \frac{\text{Par Value}_N}{(1+y)^N}$$

Where *Coupon* is the coupon payment at time  $n$ .

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

### 45. 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, 3 months and 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; Chapter 2, pp. 24-28*

#### 46. 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:

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

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

Where

$n$  – number of periods until the cash flow will be received;

$c$  – expected cash flow

$I$  – number of periods

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

*Fixed Income Mathematics 4<sup>th</sup> ed., Frank J. Fabozz, McGraw-Hill; Chapter 5, pp. 58-59*

#### 47. 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:

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

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.

Since the semi-annual coupon payments are equivalent to an ordinary annuity, the present value of the coupon payments, that is, the present value of:

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

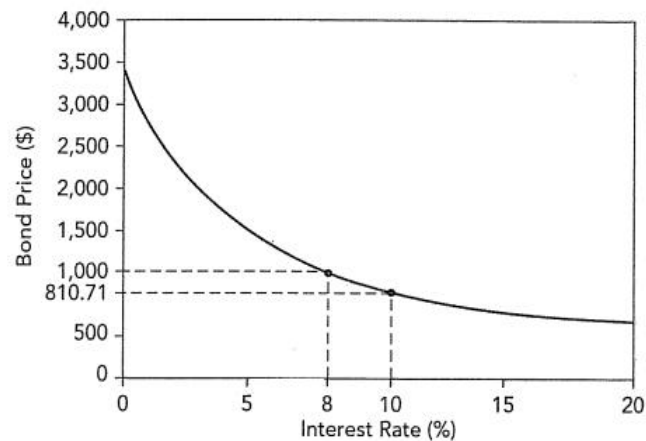
Can be expressed as:

$$c \left[ \frac{1 - \left[ \frac{1}{(1+y)^n} \right]}{y} \right]$$

*Fixed Income Mathematics, 4<sup>th</sup> ed., Frank J. Fabozz, McGraw-Hill; Chapter 6, pp. 66-67*

#### 48. Graph and explain the relationship between Bond Price and Required Yield

To demonstrate this method, we first need to review the relationship between a bond's price and its 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<sup>th</sup> ed., Frank J. Fabozz, McGraw-Hill; Chapter 6, pp. 71-72*

#### 49. 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). For a semi-annual-pay bond whose next coupon payment will be received 6 months from now, the yield to maturity is computed by solving the following relationship for  $y$ :

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

Where

- P = Price (\$);
- c = Semiannual coupon interest (\$);
- y = One-half the yield to maturity;
- n = Number of periods (number of years  $\times$  2);
- M = Maturity value (\$).

For a semiannual-pay bond, doubling the interest rate or discount rate ( $y$ ) gives the yield to maturity.

We can express this relationship as follows:

$$P = \sum_{t=1}^n \frac{c}{(1+y)^t} + \frac{M}{(1+y)^n}$$

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<sup>th</sup> ed., Frank J. Fabozz, McGraw-Hill; Chapter 7, p. 94*

#### 50. 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;

Pay particular attention to the number of periods used in the pricing of a zero coupon bond. Although an issue may mature in  $N$  years, the number of 6-month periods is used in the exponent, and the periodic interest rate is the required yield divided by 2. The reason is that the pricing of a zero-coupon bond must be made consistent with the pricing of a coupon bond. Recall that with a coupon bond the present value of the maturity value is computed using twice the number of year to maturity. Therefore, we handle the maturity value for the zero-coupon bond the same way.

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:

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

Where

$y$  = One-half the yield to maturity;  
 and future value per dollar invested is given by:

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

Once again, doubling  $y$  gives the yield to maturity. Remember that the number of periods used in the formula is double the number of years.

*Fixed Income Mathematics, 4<sup>th</sup> ed., Frank J. Fabozz, McGraw-Hill; Chapter 7, pp. 96-97*

## 51. What is Yield Curve?

The graphical depiction of the relationship between the yield to maturity on securities of the same credit risk and different maturity is called the *yield curve*. The yield curve is constructed from the maturity and observed yield of Treasury securities because Treasuries reflect the pure effect of maturity alone on yield, given that market participants do not perceive government securities to have any credit risk. When market participants refer to the “yield curve,” they usually mean the Treasury yield curve.

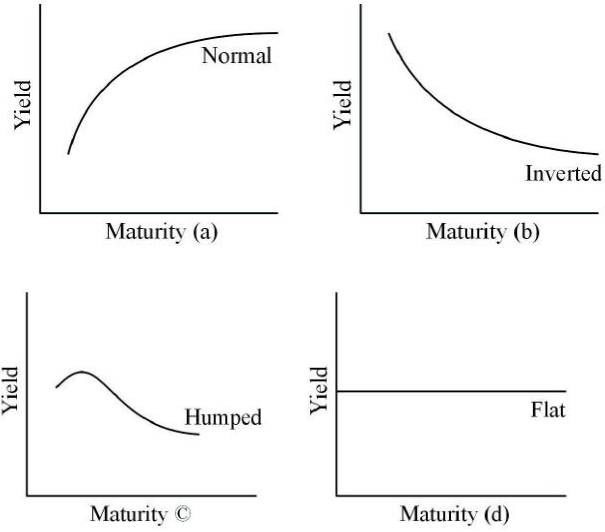
There are four Hypothetical Yield Curves:

- *Upward sloping or normal yield curve* – When the yield increases with maturity.
- *Downward sloping or an inverted yield curve* – When yield decreases with maturity.
- *Humped yield curve* – When the yield curve initially is upward sloping, but after a certain maturity it becomes downward sloping.



- *Flat yield curve*– When yield curve is one where the yield is the same regardless of the maturity.

Four Hypothetical Yield Curves:

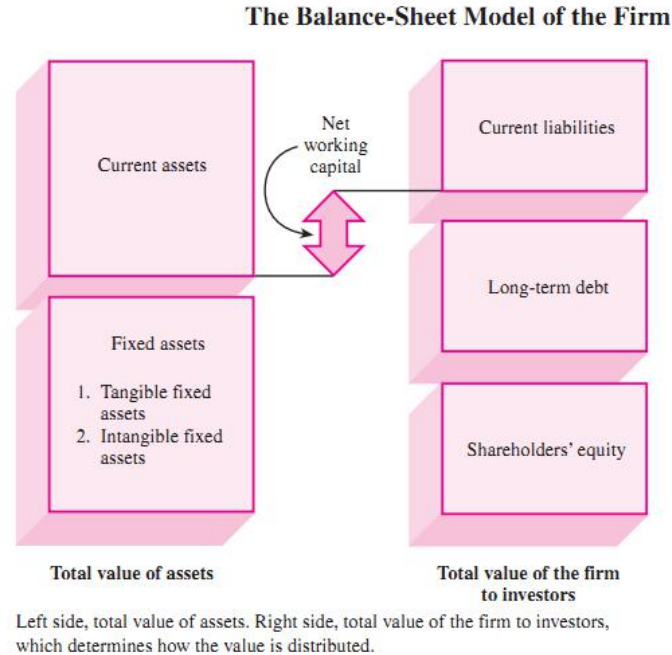


*Fixed Income Mathematics, 4<sup>th</sup> ed., Frank J. Fabozz, McGraw-Hill; Chapter 8, pp. 116-117*

## CAPITAL STRUCTURE AND MANAGEMENT

### 52. 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:



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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp. 2-9*

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

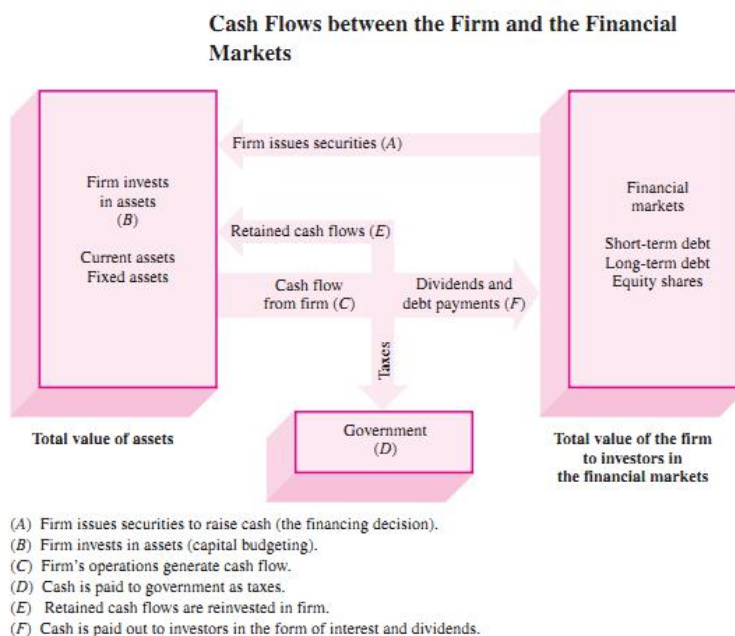
The most important job of a financial manager is to create value from the firm's capital budgeting, financing, and liquidity activities. How do financial managers create value?

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.

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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp. 5-9*

#### 54. 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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp. 19-20*

### **55. What are the main financial ratios used for analysis? Divide them into categories**

Another way of avoiding the problems involved in comparing companies of different sizes is to calculate and compare financial ratios. Such ratios are ways of comparing and investigating the relationships between different pieces of financial information. Using ratios eliminates the size problem because the size effectively divides out. We're then left with percentages, multiples, or time periods. Financial ratios are traditionally grouped into the following categories:

1. Short-term solvency, or liquidity, ratios – current ratio, the quick (or acid-test) ratio, cash ratio
2. Long-term solvency, or financial leverage, ratios – total debt ratio, debt-equity ratio, equity multiplier, long-term debt ratio, times earned ratio, cash coverage ratio
3. Asset management, or turnover, ratios – inventory turnover, day's sales in inventory, receivables turnover, day's sales in receivables, total asset turnover
4. Profitability ratios - profit margin, return on assets (ROA), return on equity (ROE),
5. Market value ratios – earnings per share (EPS), price-earnings ratio (PE), market-to-book ratio

As the name suggests, short-term solvency ratios as a group are intended to provide information about a firm's liquidity, and these ratios are sometimes called liquidity measures. The primary concern is the firm's ability to pay its bills over the short run without undue stress. Consequently, these ratios focus on current assets and current liabilities.

Long-term solvency ratios are intended to address the firm's long-run ability to meet its obligations, or, more generally, its financial leverage. These are sometimes called financial leverage ratios or just leverage ratios.

Asset management measures are intended to describe how efficiently or intensively a firm uses its assets to generate sales. These measures are sometimes called asset utilization ratios.

Profitability ratios are probably the best known and most widely used of all financial ratios. In one form or another, they are intended to measure how efficiently the firm uses its assets and how efficiently the firm manages its operations. The focus in this group is on the bottom line, net income.

Final group of measures is based, in part, on information not necessarily contained in financial statements – the market price per share of the stock. Obviously, these measures can only be calculated directly for publicly traded companies.

*Fundamentals of Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jordan; McGraw-Hill, 2003; Chapter 3, pp. 62-73*

### 56. Write Modified Du Pont Identity. Explain how it is used?

The famous decomposition of return on equity (ROE), called Du Pont Identity, after Du Pont Corporation, who popularized its use, is as follows:

$$\begin{aligned} ROE &= \frac{Net\ Income}{Total\ Equity} = \frac{Net\ Income}{Total\ Equity} \times \frac{Assets}{Assets} = \frac{Net\ Income}{Assets} \times \frac{Assets}{Total\ Equity} \\ &= \frac{Sales}{Sales} \times \frac{Net\ Income}{Assets} \times \frac{Assets}{Total\ Equity} \\ &= \frac{Net\ Income}{Sales} \times \frac{Sales}{Assets} \times \frac{Assets}{Total\ Equity} \end{aligned}$$

Remind that  $Net\ Income/Sales$  is profit margin,  $Sales/Assets$  is total asset turnover and  $Assets/Total\ Equity$  is equity multiplier. Thus, Du Pont Identity becomes:

$$ROE = Profit\ Margin \times Total\ Asset\ Turnover \times Equity\ Multiplier$$

The Du Pont identity tells us that ROE is affected by three things:

1. Operating efficiency (as measured by profit margin)
2. Asset use efficiency (as measured by total asset turnover)
3. Financial leverage (as measured by the equity multiplier)

The decomposition of ROE is a convenient way of systematically approaching financial statement analysis. If ROE is unsatisfactory by some measure, then the Du Pont identity tells you where to start looking for the reasons.

*Fundamentals of Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jordan; McGraw-Hill, 2003; Chapter 3, pp. 73-75*

### 57. 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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 1, pp.4-5*

### 58. 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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003;  
Chapter 29, pp. 390-393*

### 59. Define MM Propositions II with Taxes. Show the results graphically

Modigliani-Miller propositions with taxes are as follows:  
Assumptions:

- Corporations are taxed at the rate  $T_C$ , on earnings after interest
- No transaction costs
- Individuals and corporations borrow at same rate

Results:

MM Proposition I (with taxes):  $V_L = V_U + T_C B$  (for a firm with perpetual debt)

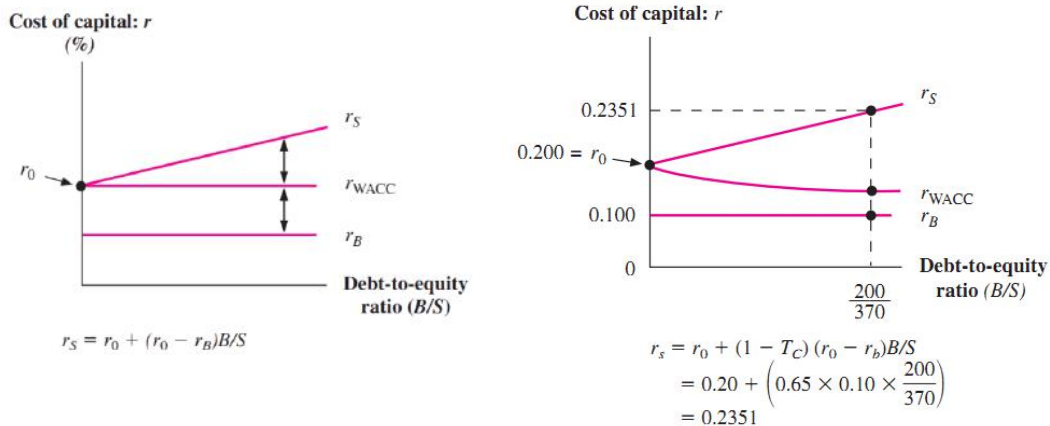
MM Proposition I (with taxes):  $r_S = r_0 + \frac{B}{S}(1 - T_C)(r_0 + r_B)$

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:



*Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003;  
Chapter 15, pp.393-407*

## 60. What costs are associated with the financial distress?

Debt provides tax benefits to the firm. However, debt puts pressure on the firm, because interest and principal payments are obligations. 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.

Direct costs of financial distress are legal and administrative costs of liquidation or reorganization. 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. 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.

Indirect costs of financial distress are reflected in 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.

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.

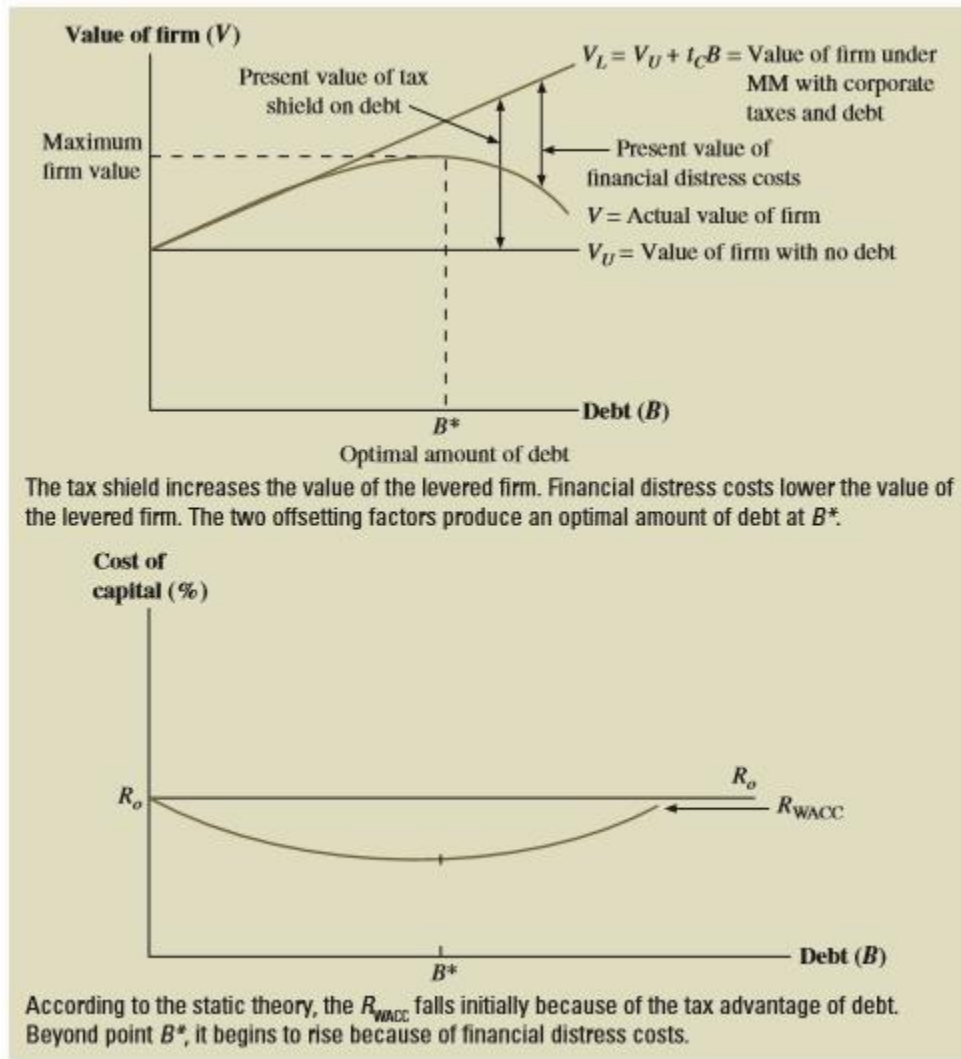
It's worth mentioning that strategies 2 and 3 are very similar. In strategy 2, the firm chooses not to raise new equity. Strategy 3 goes one step further, because equity is actually withdrawn through the dividend.

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

## **61. Explain the limits to the use of debt**

A frequently asked question is, "Does the MM theory with taxes predict the capital structure of typical firms?" The typical answer is, 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:



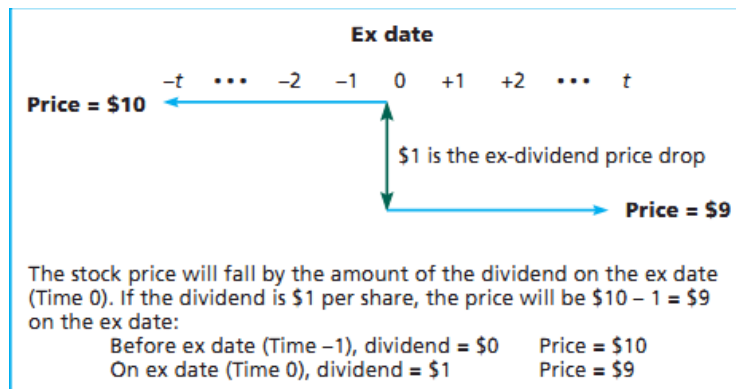
## 62. Explain the importance of dividend policy and what effect it has on a stock price

The dividend decision is important because it determines the payout received by shareholders and the funds retained by the firm for investment. Dividend policy is usually reflected by the current dividend-to-earnings ratio. This is referred to as the payout ratio. Unfortunately, the optimal payout ratio cannot be determined quantitatively. Rather, one can only indicate qualitatively what factors lead to low – or high – dividend policies.

The mechanics of a cash dividend payment are divided into four dates:

1. Declaration date – the board of directors passes a resolution to pay a dividend
2. Ex – dividend date – two business days before the date of record
3. Date of record – preparation of a list of all individuals believed to be stockholders
4. Date of payment – dividend checks are mailed

Interesting to note, that the stock price will fall by the amount of the dividend on the ex – dividend date as illustrated below:



Dividend policy is strategic decision that hugely determines the price of the firm's stock. According to Gordon model, investors price a security by forecasting and discounting future dividends. So, once dividend policy is declared, it is expected to be committed and drive the stock price. Thus, changes in dividend policy will be followed by changes in current stock price.

*Fundamentals of Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jordan; McGraw-Hill, 2003; Chapter 4, pp. 606-616*

## 63. Name the reasons for issuing preferred stock

Preferred stock represents equity of a corporation, but it is different from common stock because it has preference over common stock in the payment of dividends and in the assets of

the corporation in the event of bankruptcy. Preference means only that the holder of the preferred share must receive a dividend (in the case of an ongoing firm) before holders of common shares are entitled to anything.

A preferred dividend is not like interest on a bond. The board of directors may decide not to pay the dividends on preferred shares, and their decision may not have anything to do with current net income of the corporation. Dividends payable on preferred stock are either cumulative or noncumulative. If preferred dividends are cumulative and are not paid in a particular year, they will be carried forward. Usually both the cumulated (past) preferred dividends plus the current preferred dividends must be paid before the common shareholders can receive anything. Unpaid preferred dividends are not debts of the firm. Directors elected by the common shareholders can defer preferred dividends indefinitely. However, if so:

- Common shareholders must forgo dividends.
- Though holders of preferred shares do not always have voting rights, they will typically be granted these rights if preferred dividends have not been paid for some time.

A good case can be made that preferred stock is really debt in disguise. Preferred shareholders receive a stated dividend only, and if the corporation is liquidated, preferred shareholders get a stated value. In recent years, many new issues of preferred stock have had obligatory sinking funds.

For all these reasons, preferred stock seems like debt, but, unlike debt, preferred stock dividends cannot be deducted as interest expense when determining taxable corporate income. From the individual investor's point of view, preferred dividends are ordinary income for tax purposes. For corporate investors, however, 70 percent of the amounts they receive as dividends from preferred stock are exempt from income taxes.

Corporate investors have an incentive to hold the preferred stock issued by other corporations over holding their debt because of the 70-percent income tax exemption they receive on preferred stock dividends.

Let us summarize two offsetting tax effects to consider in evaluating preferred stock:

- Dividends are not deducted from corporate income in computing the tax liability of the issuing corporation. This is the bad news.
- When a corporation purchases preferred stock, 70 percent of the dividends received is exempt from the corporate taxation. This is the good news.

First effect (1) just listed represents a clear tax disadvantage to the issuance of preferred stock. Although the second effect (2) represents a tax advantage, both academics and practitioners generally agree that (2) does not fully offset (1).

*Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003;  
Chapter 14, pp. 379-381*

**64. 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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003;  
Chapter 2, p. 24*

**65. Explain the market and book 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.

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

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.

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

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

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

The P/E ratio is defined as:

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

For example, if stock A is trading at \$24 and the earnings per share for the most recent 12 months 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.

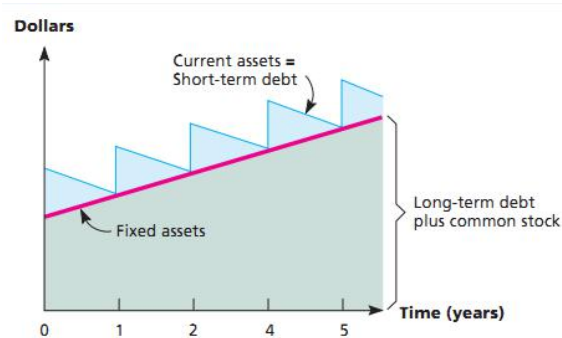
*Finance, 5<sup>th</sup> ed., Groppelli, EhsanNikbakht; Barron's Inc., 2006; Chapter 18, p. 18*

## 67. In an ideal company, NWC is always zero. Why might NWC be positive in a real company?

In an ideal economy the firm could perfectly predict its short-term uses and sources of cash, and net working capital could be kept at zero. In the real world, cash and net working capital provides a buffer that lets the firm meet its ongoing obligations. The financial manager seeks the optimal level of each of the current assets.

The situation is shown on a graph below. Long-term assets are assumed to grow over time, whereas current assets increase at the end of the harvest and then decline during the year. Short-

term assets end up at zero just before the next harvest. Current (short-term) assets are financed by short-term debt, and long-term assets are financed with long-term debt and equity. Net working capital – current assets minus current liabilities – is always zero.



In an ideal world, net working capital is always zero because short-term assets are financed by short-term debt.

In the real world, it is not likely that current assets will ever drop to zero. For example, a long-term rising level of sales will result in some permanent investment in current assets. Moreover, the firm's investments in long-term assets may show a great deal of variation. A growing firm can be thought of as having a total asset requirement consisting of the current assets and long-term assets needed to run the business efficiently. The total asset requirement may exhibit change over time for many reasons, including (1) a general growth trend, (2) seasonal variation around the trend, and (3) unpredictable day-to-day and month-to-month fluctuations.

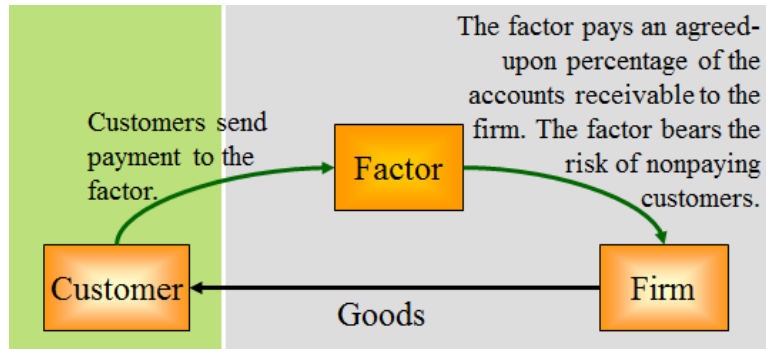
*Corporate Finance, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003;  
Chapter 27, pp. 651-654*

## 68. 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, 6<sup>th</sup> ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 29, p. 810*

## BASICS OF DERIVATIVES

### 69. 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 you 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, 2<sup>nd</sup> ed., Robert L. McDonald; Pearson, 2006; Chapter 1, pp. 1-2*

### 70. 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, 2<sup>nd</sup> ed., Robert L. McDonald; Pearson, 2006; Chapter 2, p. 21*

## **71. 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, 2<sup>nd</sup> ed., Robert L. McDonald; Pearson, 2006; Chapter 5, p. 142*

**72. 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 exercised 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:

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

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:

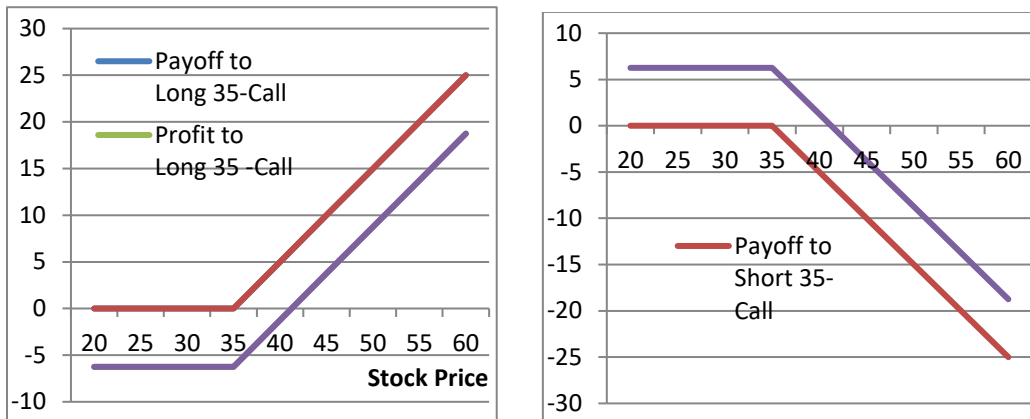
$$\text{Long call profit} = \max[0, S_T - K] - \text{future value of option premium}$$

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:

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

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

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:

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

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:

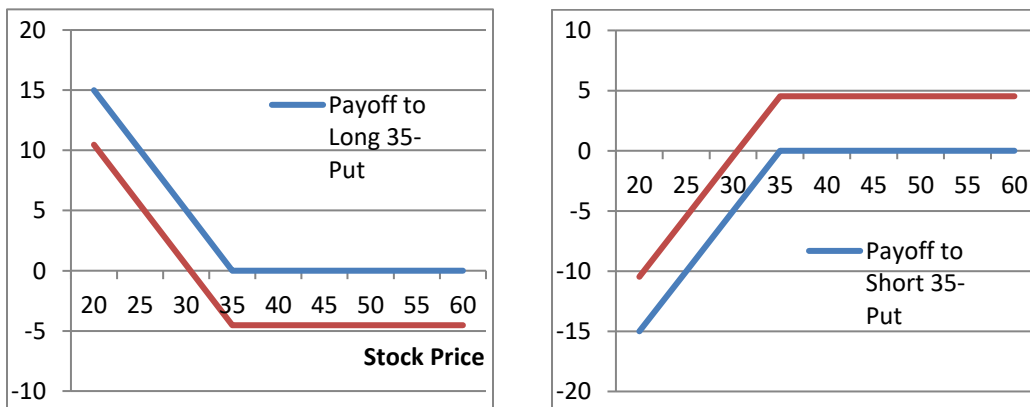
$$\text{Long put profit} = \max[0, K - S_T] - \text{future value of option premium}$$

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

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

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

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





# 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, 7/8<sup>th</sup> ed., 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:

$$\begin{array}{rcl}
 \textit{Economic} & & \\
 \textit{Resources} & & \textit{Claims to Economic Resources} \\
 \text{Assets} & = & \text{Liabilities} + \text{Owners' Equity}
 \end{array}$$

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.

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$



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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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 its

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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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	
<b>Debit</b> entries  (left side)	<b>Credit</b> entries  (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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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.

## 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. This 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: 
$$\text{Current ratio} = \frac{\text{Total current assets}}{\text{Total current liabilities}}$$
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: 
$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

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, 7/8<sup>th</sup> ed., 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.

### 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	<u>XX</u>
<b>Accounts receivable, net</b>	<b>XX</b>

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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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**.

- Both purchases and sales of inventory items are recorded directly to the **Inventory** account.
- 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.
- 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.
- 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:

$$\begin{array}{r}
 \text{Net purchases} = \text{Purchases} \\
 \quad + \text{Freight-in} \\
 \quad - \text{Purchase returns and allowances} \\
 \quad - \text{Purchase discounts} \\
 \hline
 = \text{Net purchases}
 \end{array}$$

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, 7/8<sup>th</sup> ed., 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:

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

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

$$\begin{array}{r}
 \text{Beginning inventory} \\
 + \text{Purchases} \\
 \hline
 = \text{Cost of goods available for sale} \\
 - \text{Ending inventory} \\
 \hline
 = \text{Cost of goods sold}
 \end{array}$$

*Financial Accounting, 7/8<sup>th</sup> ed., 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.

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:

$$\frac{\text{Cost - residual value}}{\text{Useful life in years}} = \text{Annual depreciation expense}$$

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:

$$\frac{\text{Cost - residual value}}{\text{Useful life in units}} = \text{Depreciation per unit} \times \text{Units produced} = \text{Annual depreciation expense}$$

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.

$$\text{SL rate} = \frac{1}{\text{useful life}}$$

Step 2: multiply the SL rate by 2. This is the DDB rate.

$$\text{DDB rate} = \text{SL rate} \times 2$$

Step 3: multiply the book value (cost - accumulated depreciation) by the DDB rate. This is depreciation expense.

$$\text{Depreciation expense} = \text{Book value} \times \text{DDB rate}$$

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 revised any time a change in the useful life or residual value occurs. To revise depreciation:

1. Determine the remaining depreciable book value.

$$\text{Remaining depreciable book value} = \text{Remaining book value} - \text{Residual value}$$

2. Then, revise the SL depreciation as follows:

$$\text{New annual depreciation expense} = \frac{\text{Remaining depreciable book value}}{\text{Remaining useful life}}$$

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:

$$\frac{\text{Cost} - \text{residual value}}{\text{Estimated units of resource}} = \text{Depletion per unit} \times \text{Units extracted} = \text{Annual depletion expense}$$

The depletion entry is as follows:

Depletion Expense	XX	
Accumulated Depletion		XX

**Accumulated Depletion** is a contra account similar to Accumulated Depreciation.

*Financial Accounting, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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 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.

The 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, 7/8<sup>th</sup> ed., 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 **disadvantages** 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.

## 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 nonpublicly traded companies.

*Financial Accounting, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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:

$$\text{Return on assets} = \frac{\text{Net income} + \text{Interest expense}}{\text{Average total assets}}$$

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:

$$\text{Return on equity} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common stockholders' equity}}$$

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, 7/8<sup>th</sup> ed., Walter T. Harrison, Jr.; Charles T. Horngren /  
Pearson Edition, p. 500*

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## 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, 7/8<sup>th</sup> ed., 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, 7/8<sup>th</sup> ed., 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.





# 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 summary 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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 customers 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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 one time 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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, pp. 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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

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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<sup>th</sup> ed., 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 through 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 Market 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 earn less than the leaders

*Kotler, P.& Keller, K. "A framework for Marketing Management", 3<sup>rd</sup> edition, Prentice Hall, 2007, p. 172*

### **58. Discuss the Market 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 under performing, 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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.

#### Marketing communication mix consist of 6 major models of communication

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", 3<sup>rd</sup> 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 its 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", 3<sup>rd</sup> 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>*

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## 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<sup>th</sup> ed., 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<sup>th</sup> ed., 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.

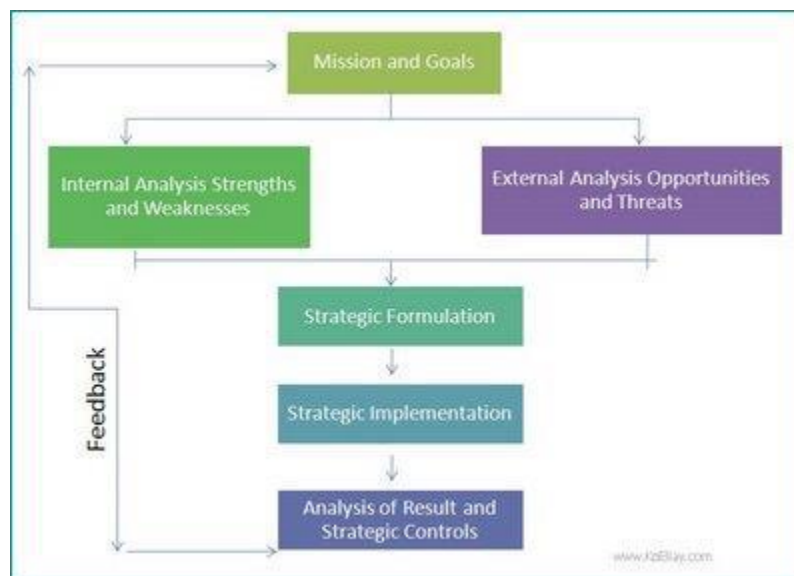
1. Successful differentiation sends a signal to a new entrant that the costs of overcoming the incumbent company's differentiation will be too costly and may easily prevent the new entrant decision to join the market.
2. Successful differentiations reduce threat from rivalry, by carving out unique product 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:](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 through 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 copy cat 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 multibuiness 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 multibusiess 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 managers 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 creates 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 than 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", 3<sup>rd</sup> 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 effect the decisions of the managers of any organisation. Tax changes, new laws, trade barriers, demographic change and government policy changes are all examples of macro change. To help analyse these factors managers can categorise 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 organisations 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](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.

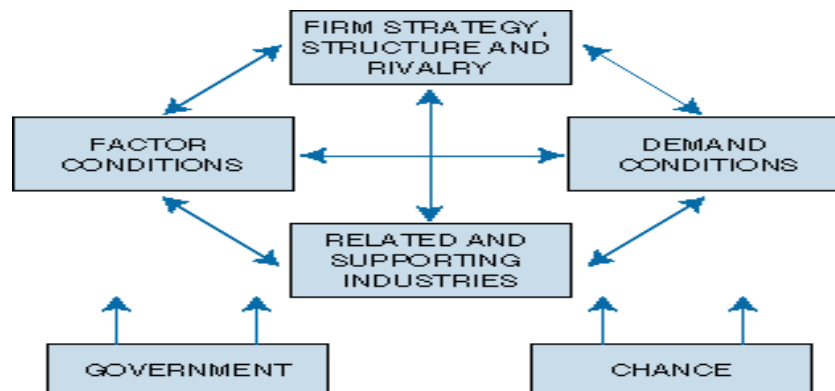
Present economic downturn impact is beyond our current assessment, but whatever the length of current recession, few general features of prevailing business environment can still be identified.

- 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 organisation in relation to the "best practice" and to identify weak areas in need of perfection

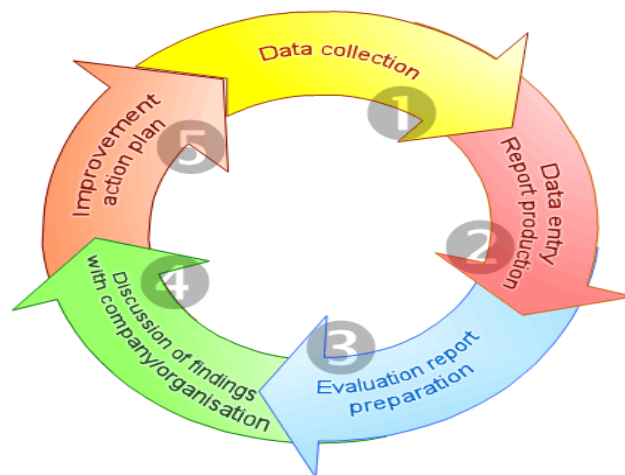
The evaluation is carried in the following fields:

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 words 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 countries 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, ExxonMobile, 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 through 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

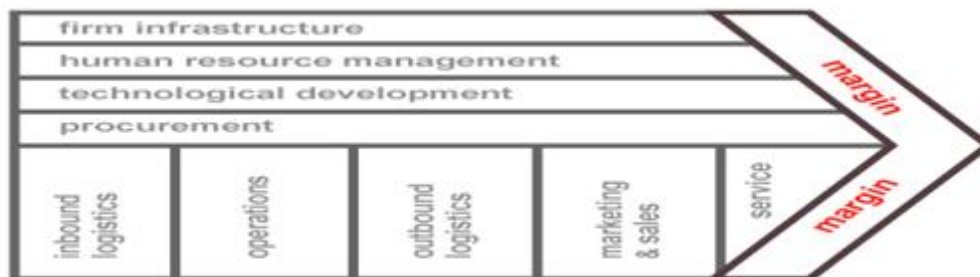
human needs are arranged in a hierarchy, from the most pressing to the least pressing. Maslow's hierarchy of needs are: 1 physiological needs, 2 safety needs, 3 social needs, 4 esteem needs and 5 self-actualization needs.

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'.



#### Primary activities:

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](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 others 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 through 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*



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## 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> 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", 3<sup>rd</sup> edition, Prentice Hall, 2007, p. 227 and <http://www.answers.com/topic/edlp>*

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## BRANDING AND ADVERTIZING/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?

A brand is a name, term, sign, symbol, design or a combination of them that identifies the 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, trade marks 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 trademarkable 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 advertizing, 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 through 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", 3<sup>rd</sup> 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 public 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 DOMAIN (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 its 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. First-line managers – managers at the lowest level of the organization that manage the work of nonmanagerial employees. Middle managers – managers between the first level and the top level of the organization who manage the work of first-line managers. Top managers – 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?

Planning – defining goals, establishing strategies, and developing plans.

Organizing – arranging and structuring work.

Leading – working with and through people.

Controlling – 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, restructuring 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 newest 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. 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*

## 9. 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*

## 10. 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*

## 11. 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*

## **12. 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*

## **13. 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*

#### 14. 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*

#### 15. 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*

#### 16. 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*

### **17. 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*

### **18. 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*

### **19. 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*

### **20. 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*

### **21. 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*

## 22. 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.

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*

### **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. Define possible global perspectives in business**

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*

### **25. 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*

## 26. 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*

## 27. 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*

## 28. 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*

## 29. 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*

## 30. 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). Nonprogrammed 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*

## 31. 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,



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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*

## PLANNING

### 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*

## ORGANIZING

### 37. 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.

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.

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).

*Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; p. 266*

*Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western:*

*Thomson, 2007; pp. 191-199*

*See Mind-Map 14*

### 38. 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*

### 39. 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*

### 40. 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). **Interpersonal communication** is the exchange of meanings within one system of symbols 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. 292-296*

*See Mind-Map 15*

### 41. 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*

#### **42. 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*

#### **43. 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*

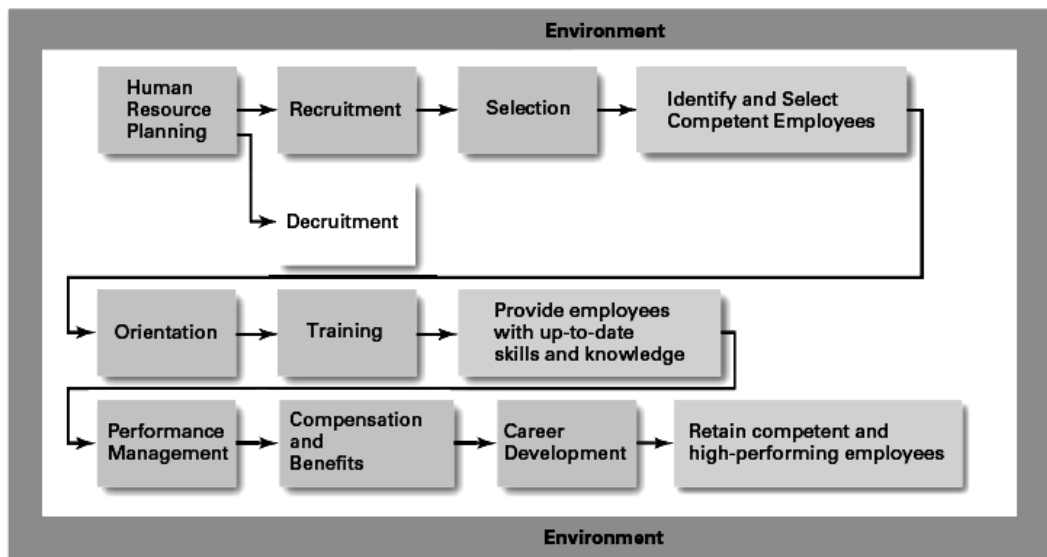
**44. Explain how an organization's human resources can be a significant source of competitive advantage.**

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*

**45. 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*

#### **46. 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*

#### **47. 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*

#### **48. 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*

#### **49. 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*

#### **50. 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*

### 51. 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 additions, 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*

### 52. 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*

### 53. 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*

#### 54. Explain the two views 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*

#### 55. 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*

#### 56. 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

### 57. 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*

### 58. What are the levels of analysis in organizations?

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*  
*See Mind-Map 21*

### **59. 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*

### **60. 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*

### 61. 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*

### 62. 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*

### 63. 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** 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.

Personality can be accessed through different approaches. One of the most popular in organizations is MBTI (Myers-Briggs Type Indicator). 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 (the way people believe that they control their own destiny (internal locus of control) or believe that their lives are controlled by outside forces (external locus of control)), Machiavellianism (an individual who is high in Machiavellianism is pragmatic, maintains emotional distance, and believes that ends can justify means), self-esteem (the degree to which they like or dislike themselves), self-monitoring (an individual's ability to adjust his or her behavior to external, situational factors), and risk-taking (willingness to take chances, differences in the propensity to assume or to avoid risk).

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.

*Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 134-147*

*Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 397-405*  
*See Mind-Map 21*

#### **64. Differentiate among cognitive intelligence, practical intelligence, emotional intelligence, and social skills**

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. 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)).

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*

### **65. 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*

### **66. 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*

### **67. 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*

### **68. 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*

**69. 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*

**70. 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*

**71. 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*

**72. 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*

**73. 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*

**74. 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*

## 75. 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*

## 76. 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.

**Forming:** High dependence on leader for guidance and direction. Little agreement on group aims other than received from leader. Individual roles and responsibilities are unclear. Processes are often ignored. Members test tolerance of system and leader.

**Storming:** Decisions don't come easily within group. Group members attempt to establish themselves in relation to other group members and the leader, who might receive challenges. Clarity of purpose increases but plenty of uncertainties persist. Compromises may be required to enable progress.

**Norming:** Agreement and consensus is largely forms among group, who respond well to facilitation by leader. Roles and responsibilities are clear and accepted. Big decisions are made by group agreement. Smaller decisions may be delegated to individuals or small teams within group. Commitment and unity is strong.

**Performing:** The group is more strategically aware; the group knows clearly why it is doing what it is doing. The group has a shared vision and is able to stand on its own feet with no interference or participation from the leader. There is a focus on over-achieving goals, and the team makes most of the decisions against criteria agreed with the leader.

**Adjourning,** is the break-up of the group, hopefully when the task is completed successfully, its purpose fulfilled; everyone can move on to new things, feeling good about what's been achieved.

*Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 424-427*

*See Mind-Map 22*

*Tuckman B.W., 'Developmental Sequence in Small Groups', Psychological Bulletin 63, 1965*

*Tuckman B.W. and Jensen M.A.C., 'Stages of small group development revisited', Group and Organization Studies, vol.2, no.4, 1977, pp.419-27*

## **77. 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*

## 78. 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*

## 79. 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*

## 80. 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*

### **81. 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*

### **82. 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 size 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*



### 83. Distinguish between various forms of individual power in organizations

**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) information power, 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) rational persuasion, using logical arguments and factual evidence to convince others that an idea is acceptable, (2) expert power, the power an individual has because he or she is recognized as having some superior knowledge, skill, or expertise, (3) referent power, influence based on the fact that an individual is admired by others, and (4) charisma, having an engaging and magnetic personality.

*Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 471-474*

### 84. 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*

### 85. 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*

## 86. 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.

<b>Managers</b>	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
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<b>Leaders</b>	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
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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*

## CONTROLLING

### 87. 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*

### 88. 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).

Measuring: four sources of information frequently used by managers to measure actual performance are personal observation, statistical reports, oral reports, and written reports. Comparing: determines the degree of variation between actual performance and the standard. Making Managerial Action: 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*

### 89. 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*

### **90. What are the tools for controlling organizational performance?**

Managers can implement controls *before* an activity begins (*feedforward 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*

### **91. 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*

### **92. 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*

### **93. 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.

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*

#### 94. What is 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.

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.

*Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 90-112*

#### 95. 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.

*Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 120-141*

**96. What is supply network perspective, what is involved in configuring a supply network?**

**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*.

*Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 148-169*

**97. What is 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.

*Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 254-279*

## 98. 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*

## 99. 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*

## 100. Contemporary issues in managerial research: knowledge management, symbolic management, talent management

### Knowledge Management

Knowledge Management is the ability to selectively capture, archive, and access the best practices of work-related knowledge and decision making from employees and managers for



both individual and group behaviors. Knowledge Management is fundamentally about a systematic approach to managing intellectual assets and other information in a way that provides the company with a competitive advantage.

*Essentials of Knowledge Management, Bryan Bergeron, John Wiley & Sons, Inc., Hoboken, New Jersey, 2003*

### Symbolic Management

Jeffrey Pfeffer in 1981 in his article “Management as symbolic action: The creation and maintenance of organizational paradigms” (Pfeffer, 1981) shared a new direction in management vision - symbolic management (managers are symbols, they cannot be fully responsible for what happens in an organization) opposed to omnipotent view (managers are fully responsible for success or failure of the organization). Symbolic management in this perspective underlines a new managerial function (along with classical four of planning, organizing, leading and control) – a symbolic one, which intervenes and determines all others. Symbolic management is the set of not direct instruments of overseeing and coordinating activities in organization, based on metaphors, signs and images, created and lead within the human interactions and cognitive system. Symbolic actions play a significant role, for example, in contemporary planning tools as project management and scenario planning, in organizing working with organizational design and shaping human behavior, in leading by symbolic figure of a leader and managing people, in control by managing organization as a system and dealing with operations. P. Drucker (Drucker, 1993) puts management in symbolic category calling manager a person who is responsible for knowledge application and effectiveness.

Symbolic management can be seen in different perspectives of interacting effectively with people – out of organization (external stakeholders) and in organization (employees): as brands, logos, PR (images), communication mechanisms (signs) and organizational culture’s values, artifacts, behaviors (metaphors). Contemporary organization is the field for *manus symbolicus* (symbolic hand, embodiment of A. Smith’s “invisible hand” symbolizes a symbolic manager) dramatically different from manager of the First and Second Waves modes of production, different in abilities to heuristic symbolic, i.e. abstract and metaphoric thinking, Symbolic management is transformation of arguments into symbols as in a new symbolic organization of the information society managers speak the symbolic language. Significant part of data, information, and knowledge is reflected in ‘symbolic forms’ – signs, images, and metaphors.

### Talent Management

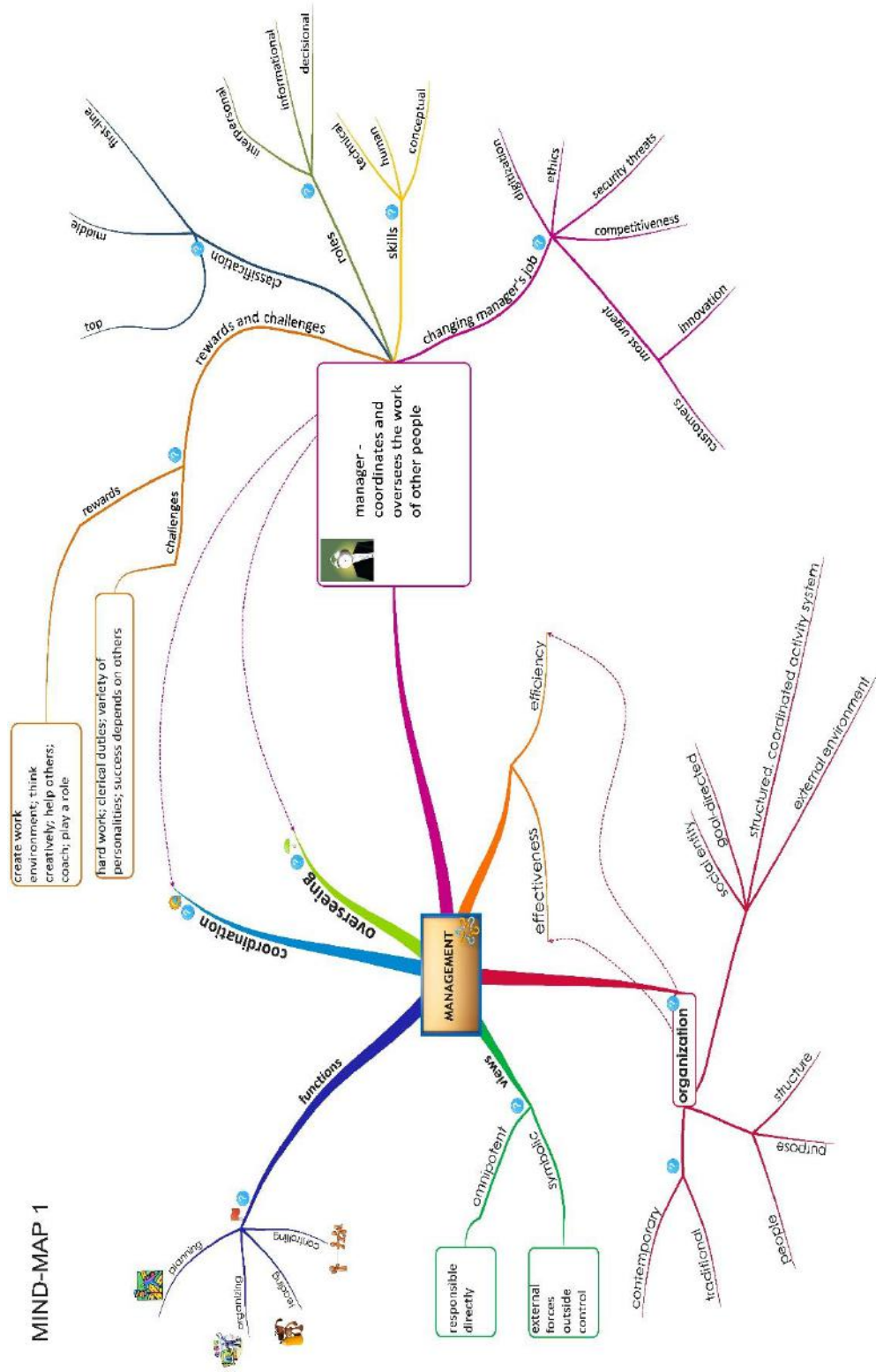
A new term of talent management has been introduced in last decade. Schon and Ian, 2009 (Schon & Ian, 2009) worked on the issue titled as “The global war for talent”. They stated that the last decade witnessed global changes that intensified the competition in pooling the talent internationally and talent management becomes challenging aspect of organizational development. Managing talent is a challenge to all organizations in the context of globalization irrespective of the country (Gardner, 2002). Moreover, the concern about the scarcity of talent is almost universal. Organizations around the world are competing for the same pool of talents. This is seen as a global labor market for talents. Trend of global integration shows organizations’ standardizations in talent recruitment, development and management, to ensure their competitive position and consistency. In order to increase the effectiveness of a firm

several resources can be used to achieve this, which includes money, men and machines. Of these resources, the most important of them all is the people (Kehinde, 2012).

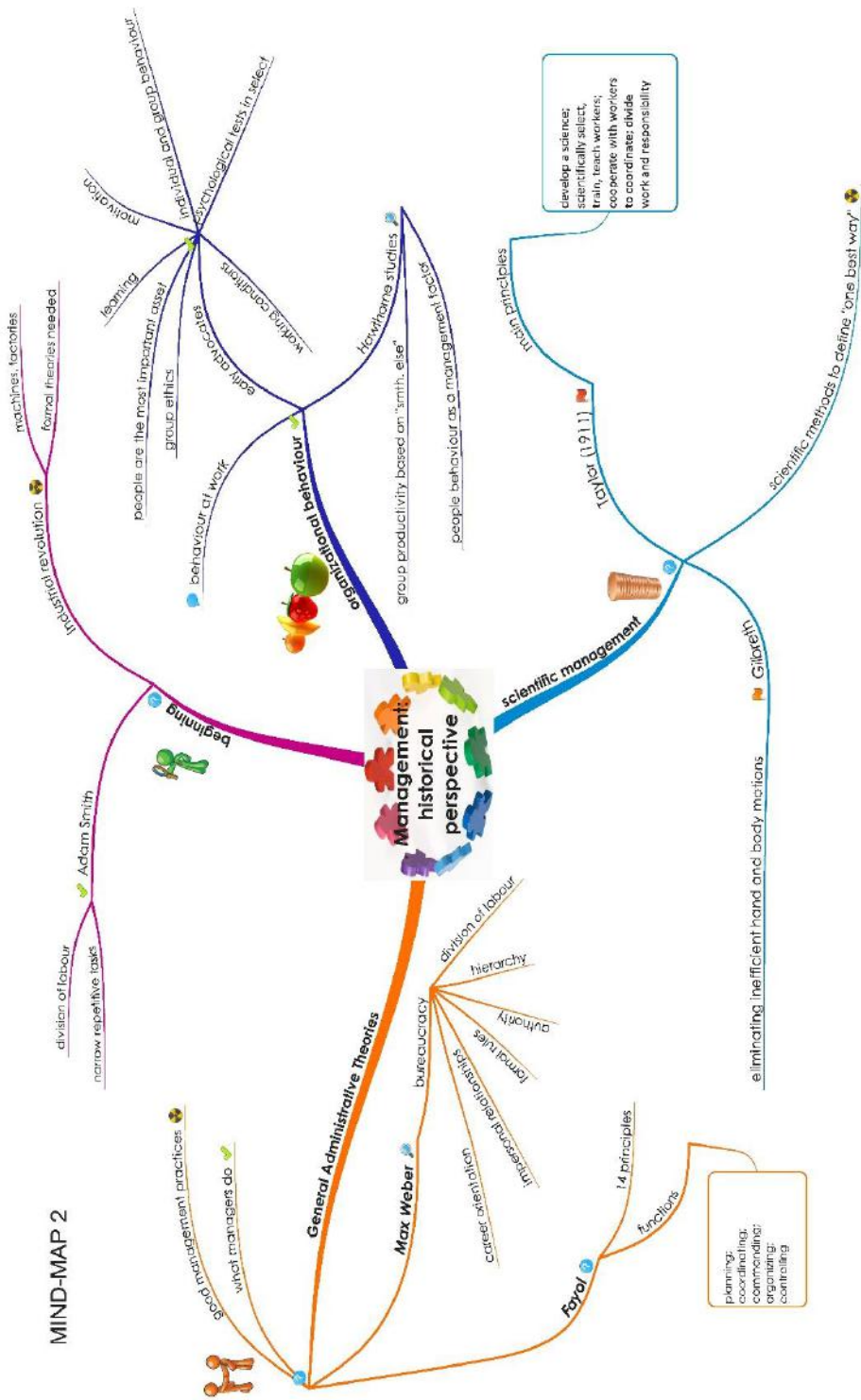
Talent management involves positioning the right people in the right jobs (Devine, 2008). This ensures that the employees maximize their talent for optimal success of the organization. As talent management is a relatively new area for both public and private sector organizations, most organizations have prioritized it to ensure they acquire the right staff. This is because talent management has been linked to successful attraction, retention and developments of employees (Beheshtifar, M. & Nekoie-Moghadam, M. , 2011).

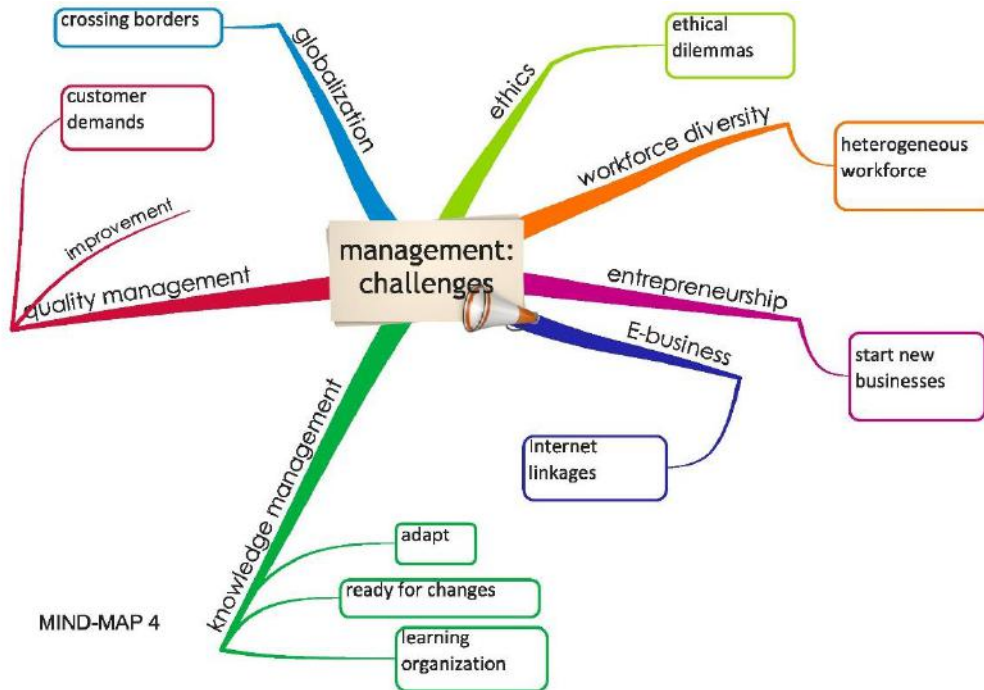
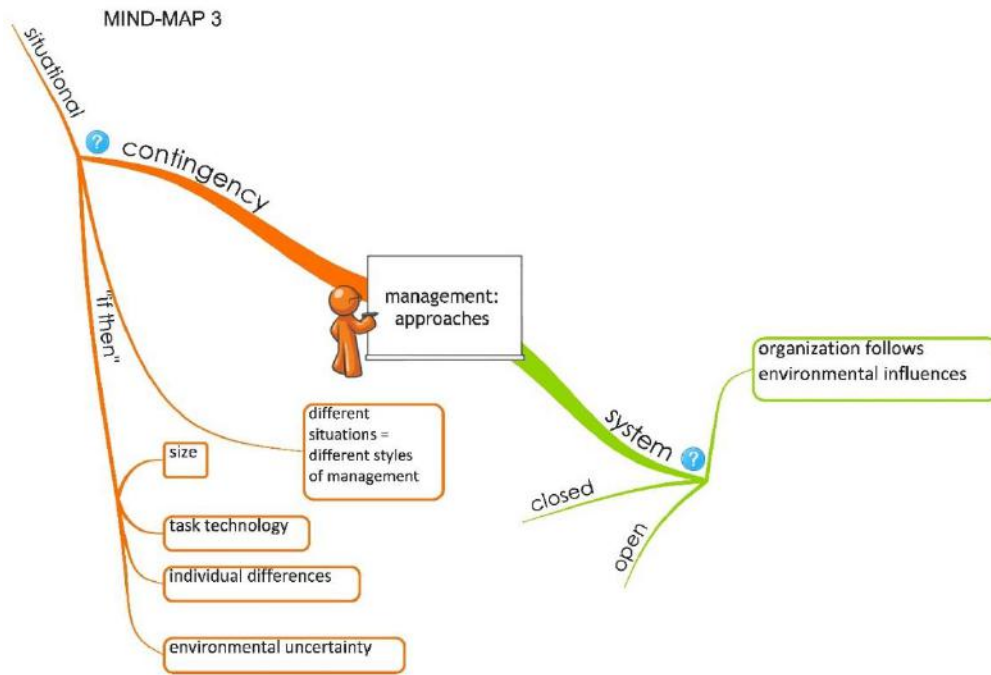
**Talent management** is the systematic attraction, identification, development, engagement/ retention and deployment of those individuals who are of particular value to an organization, either in view of their 'high potential' for the future or because they are fulfilling business/operation-critical roles.

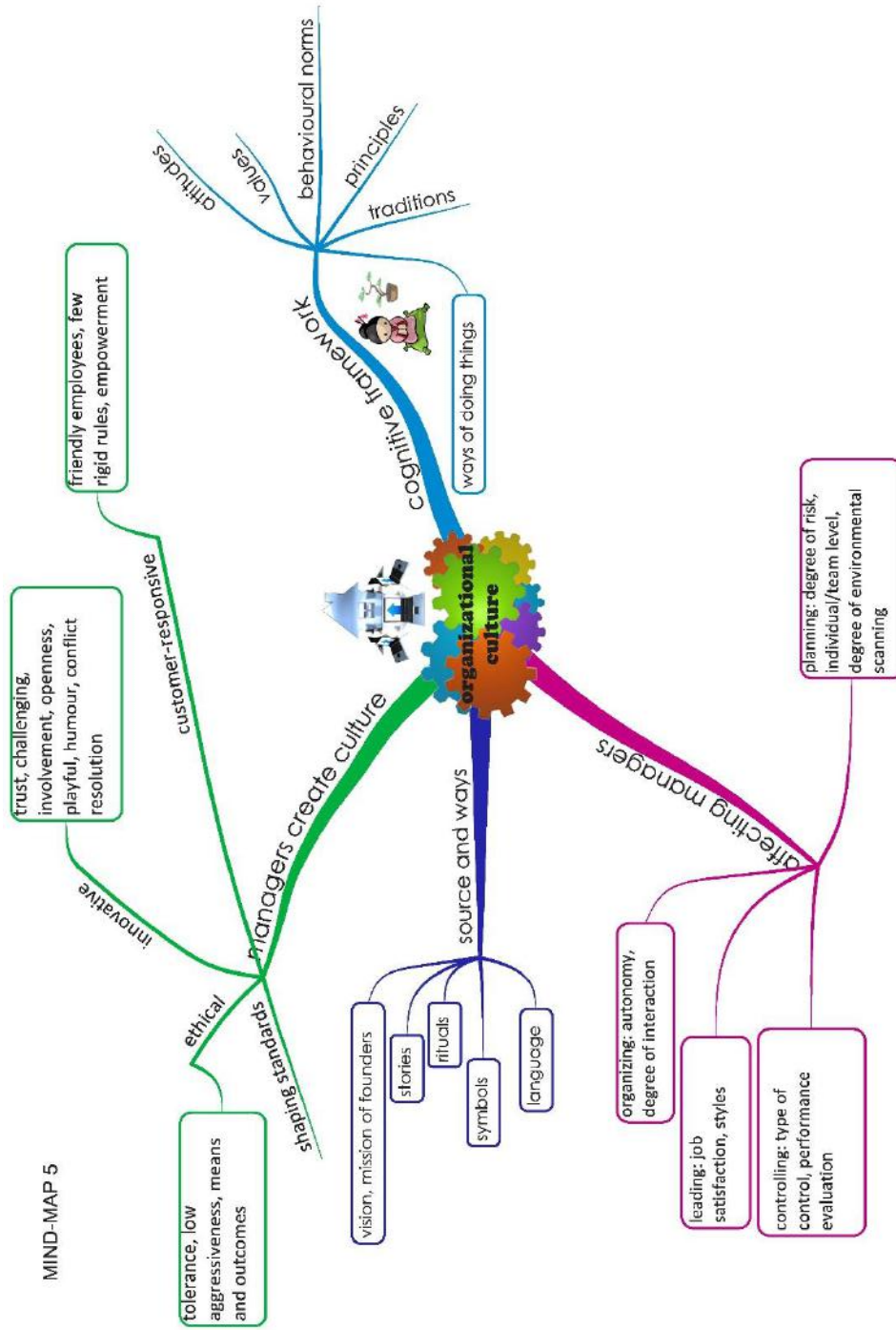
## **APPENDIX: MANAGEMENT MIND-MAPS**

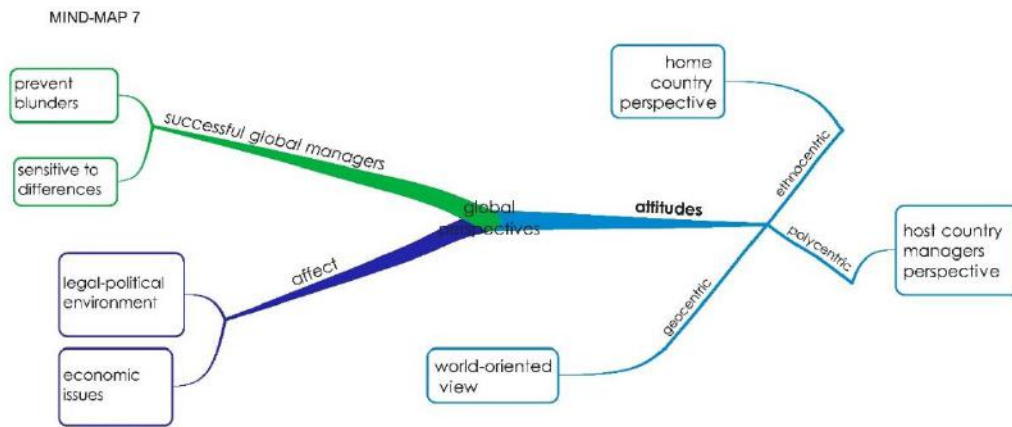
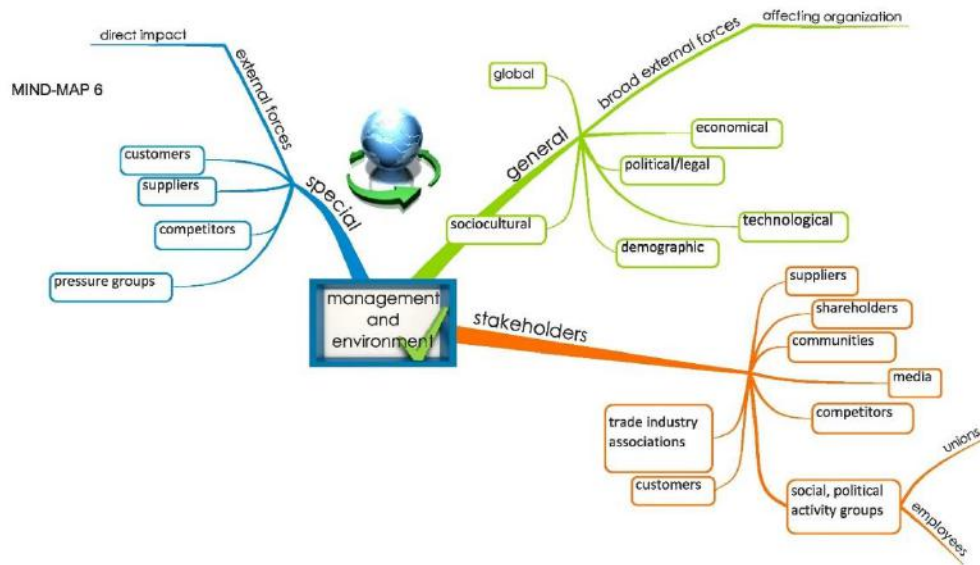


MIND-MAP 2

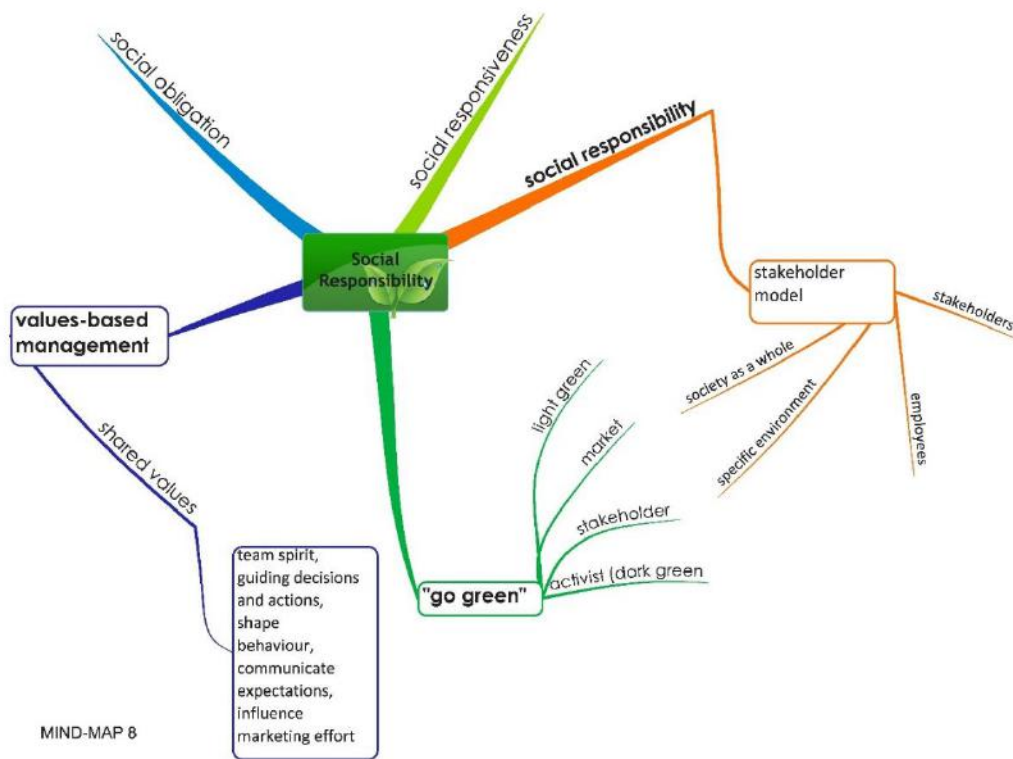




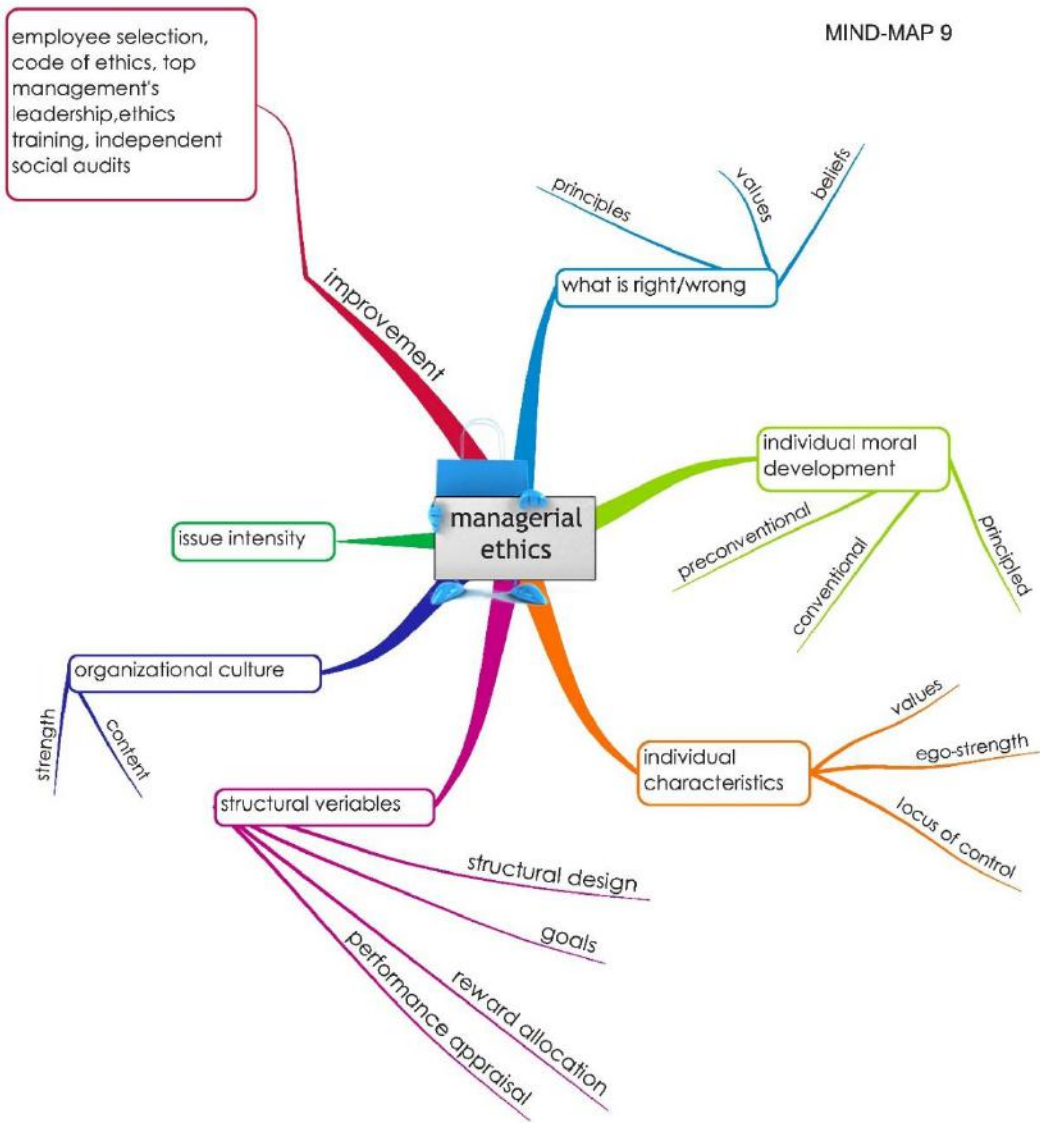




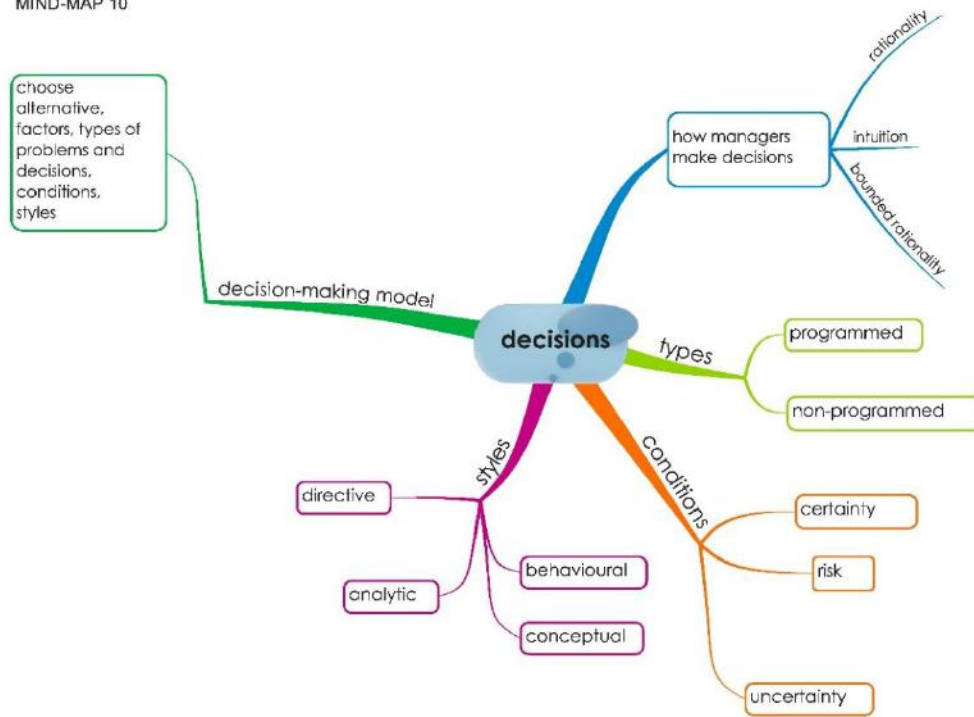




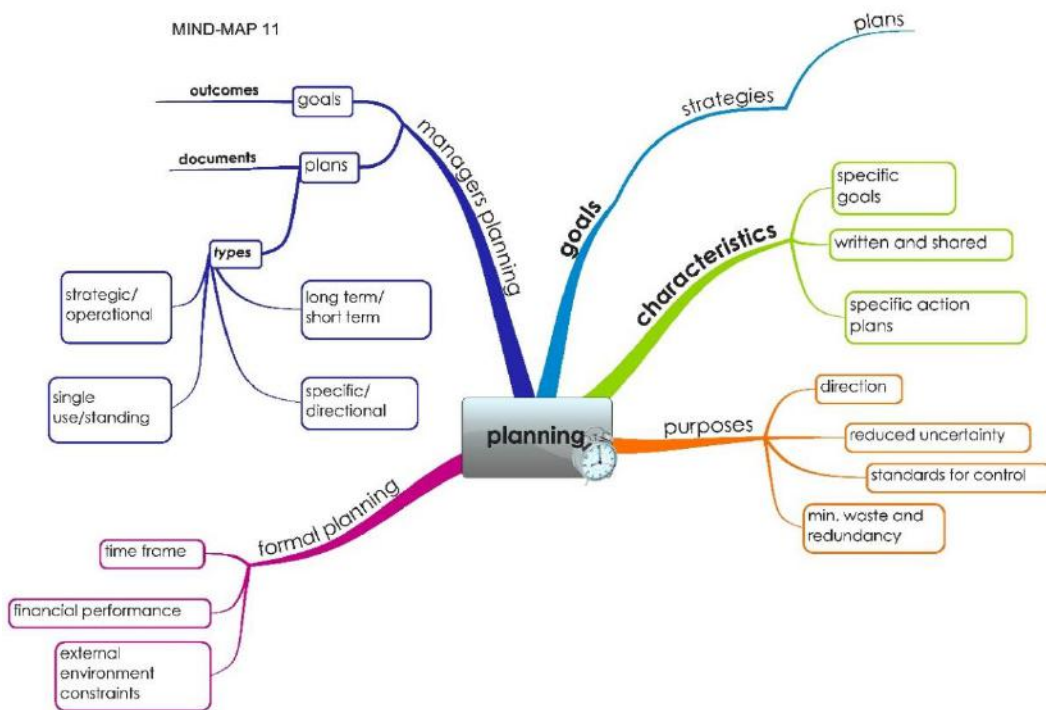
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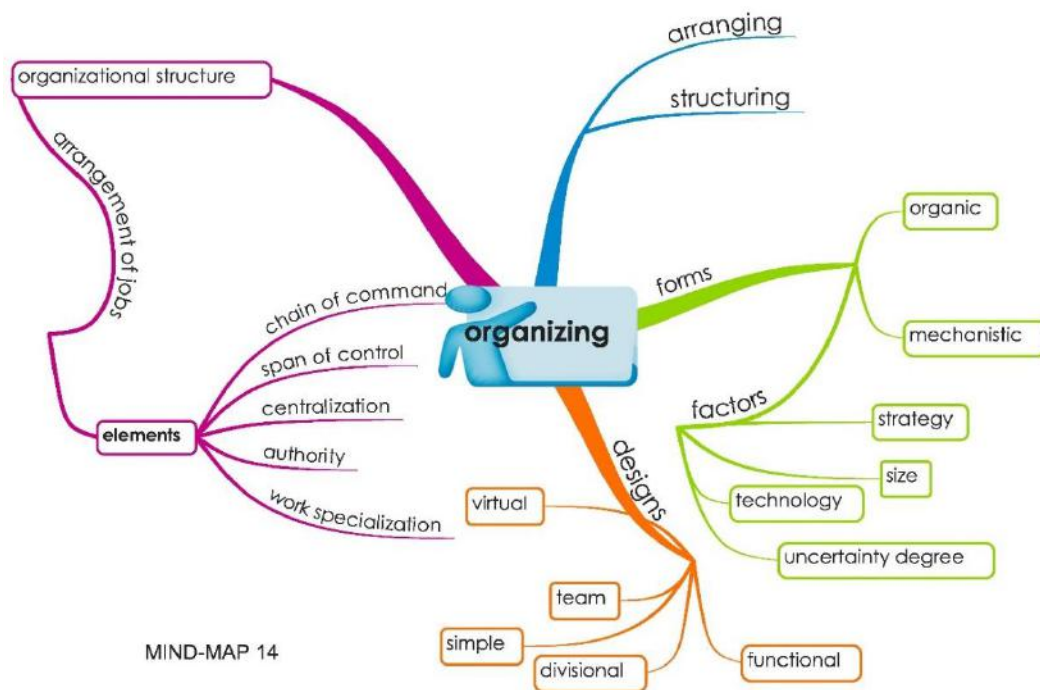
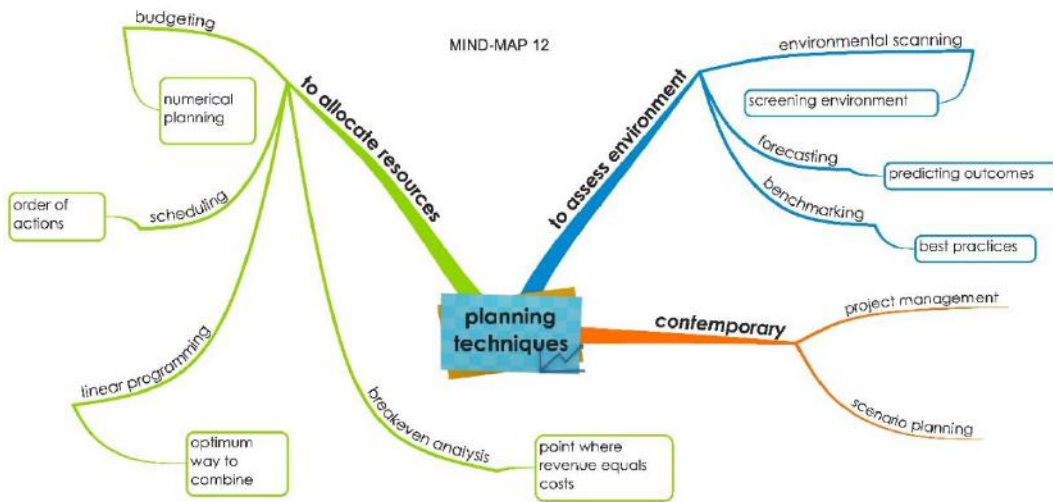


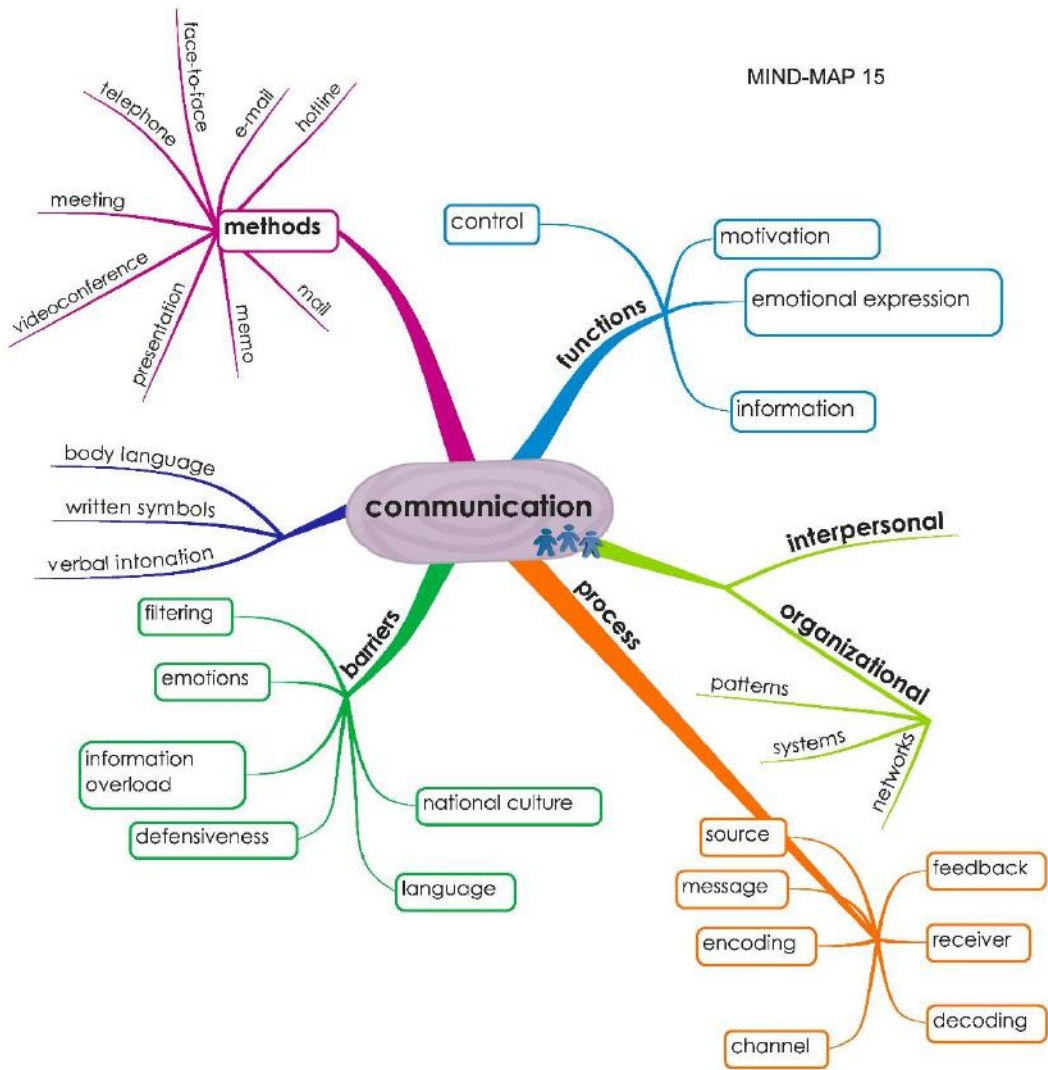
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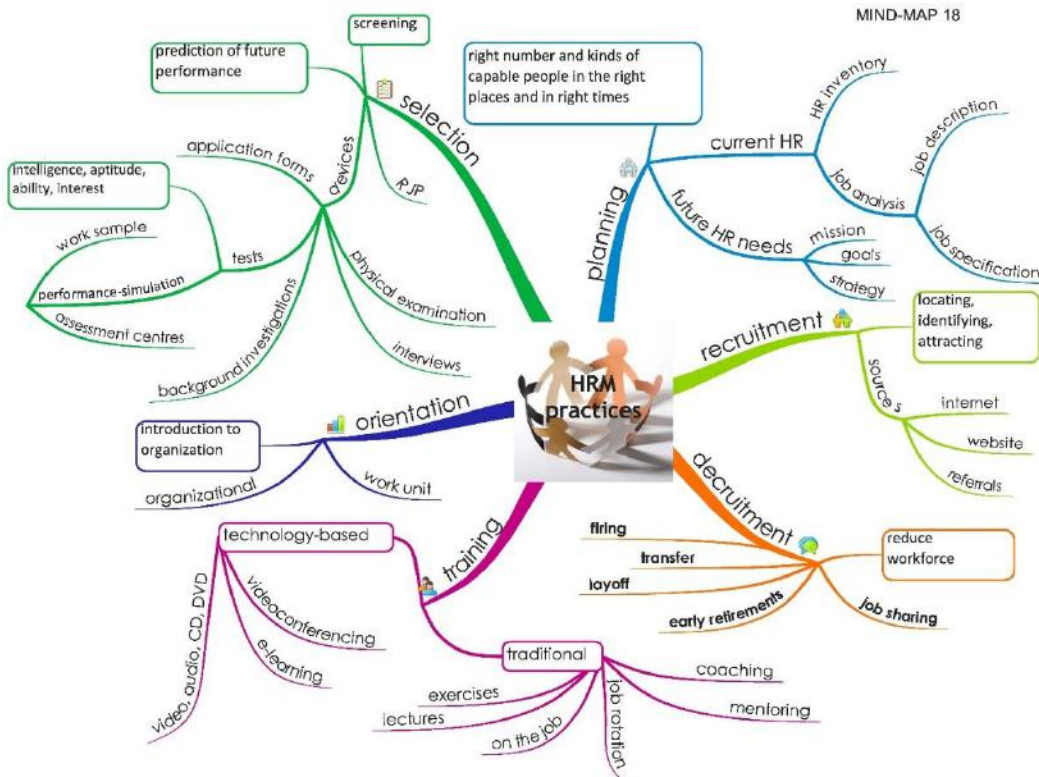
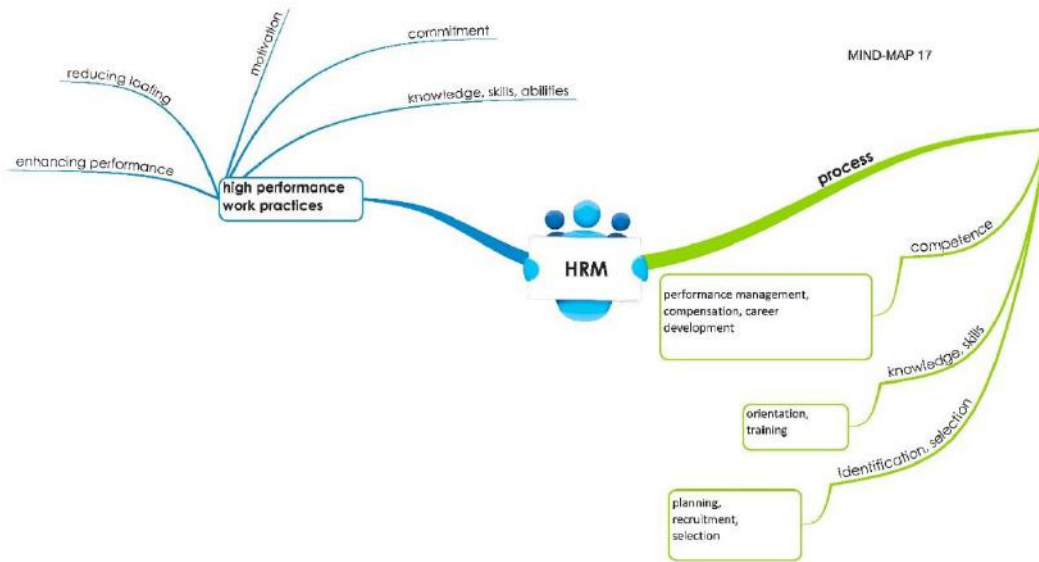


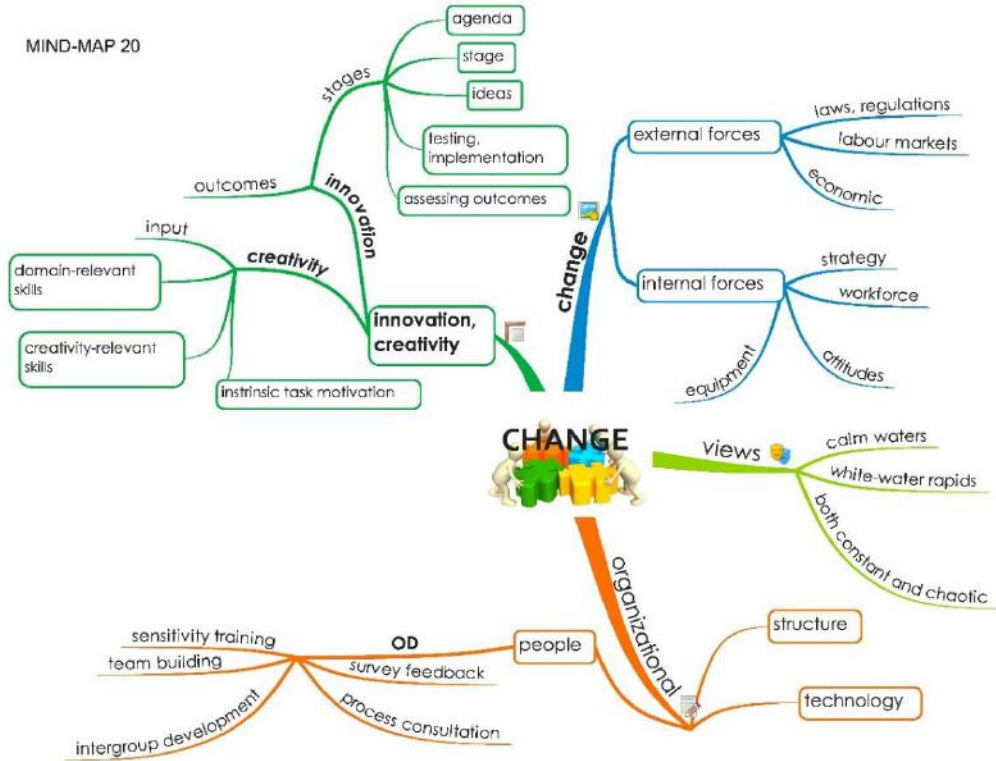
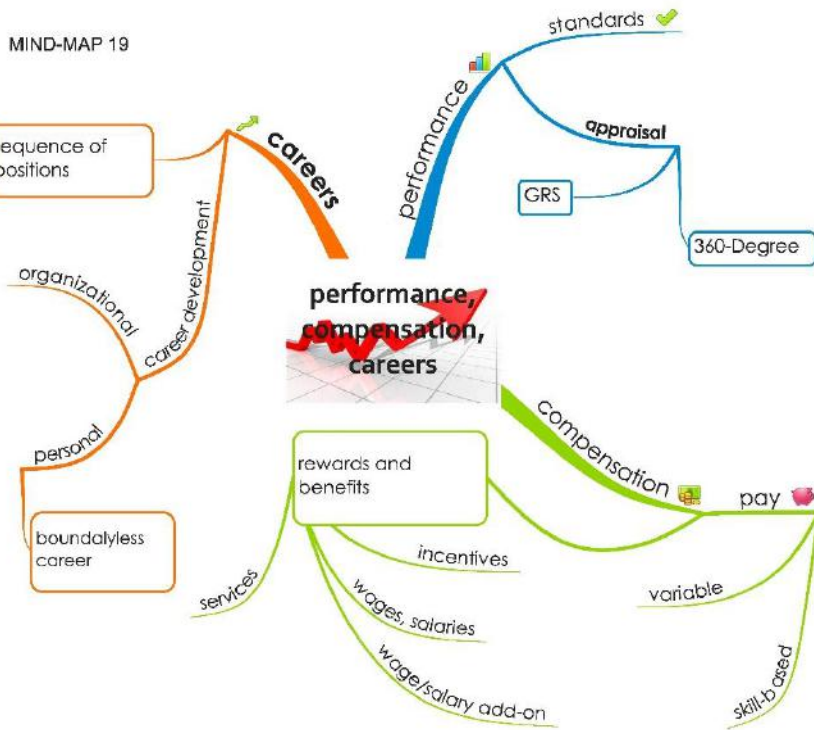
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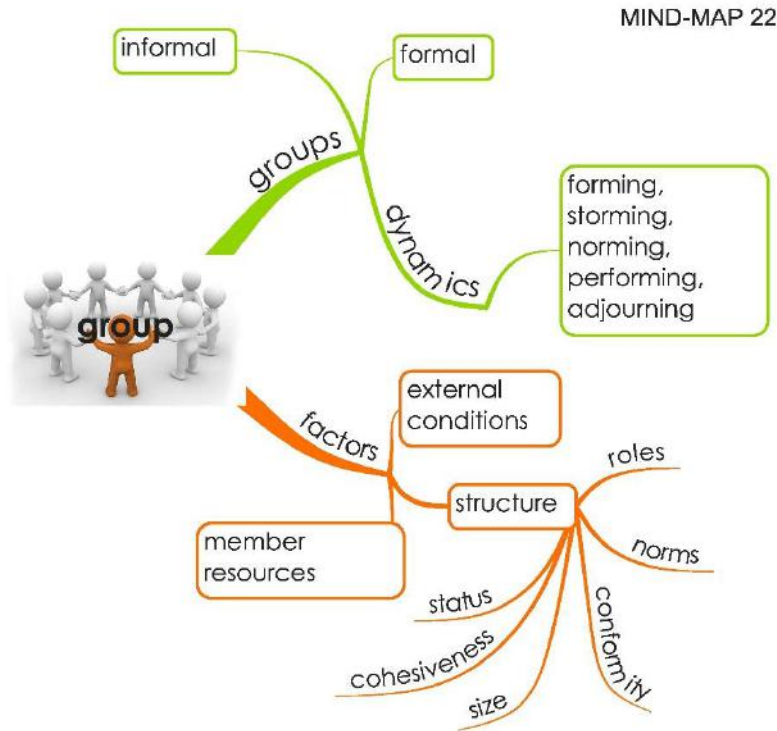
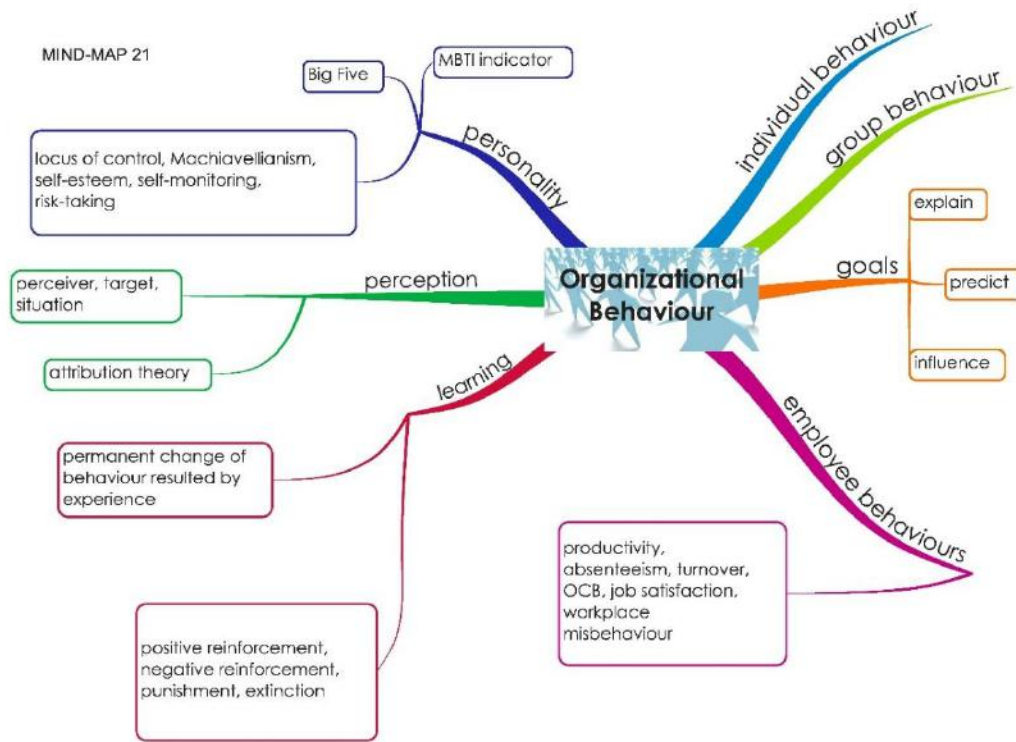






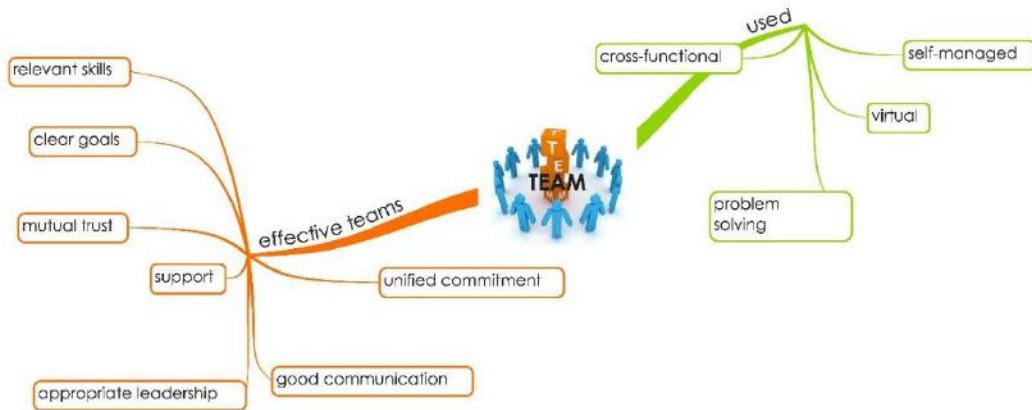




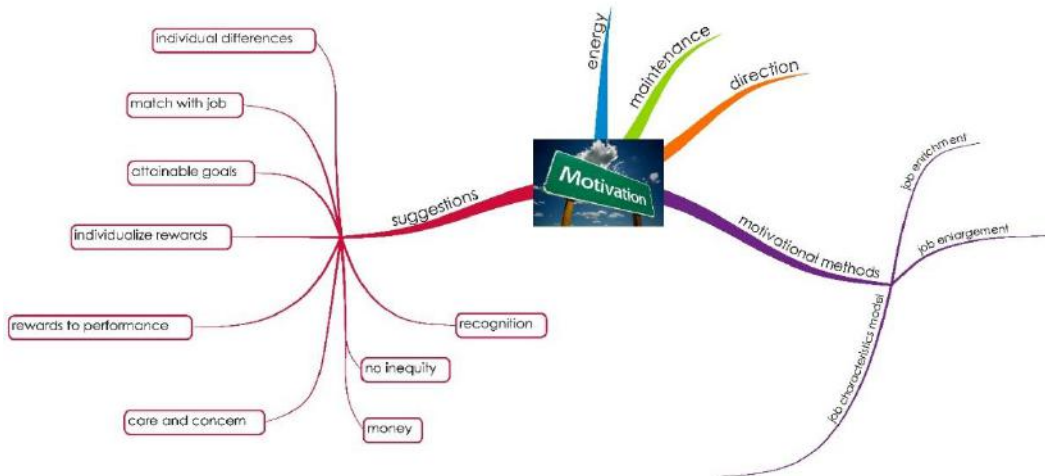




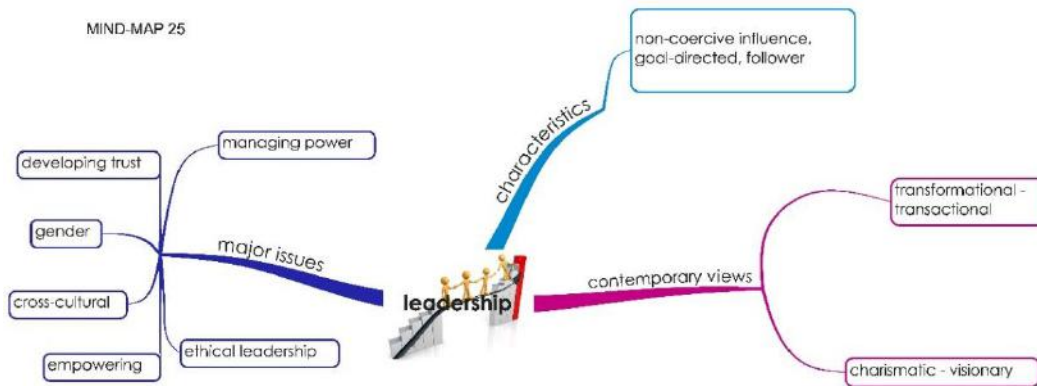
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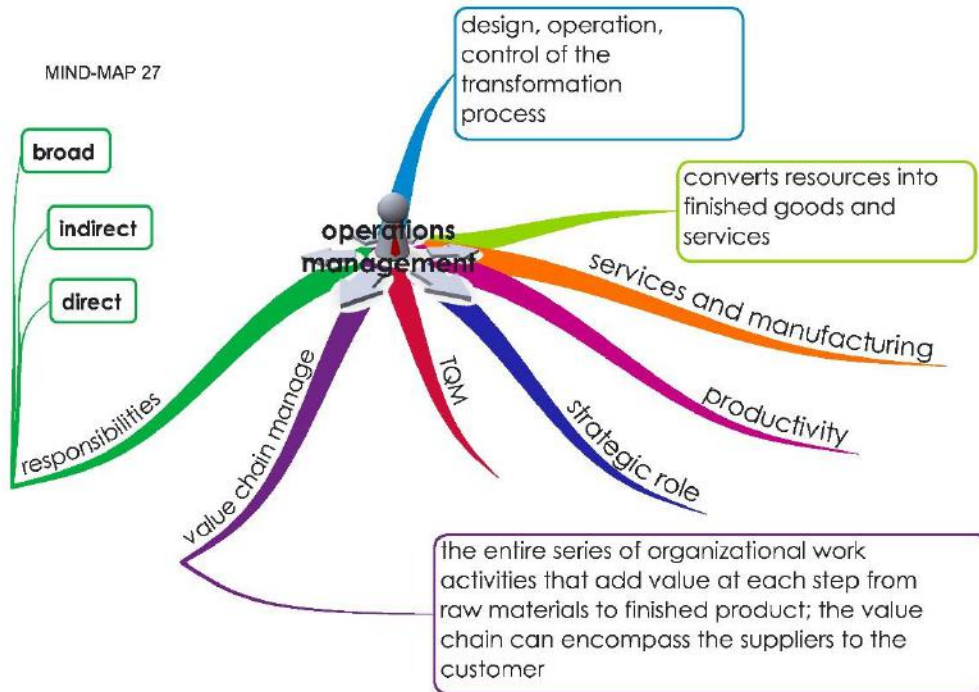
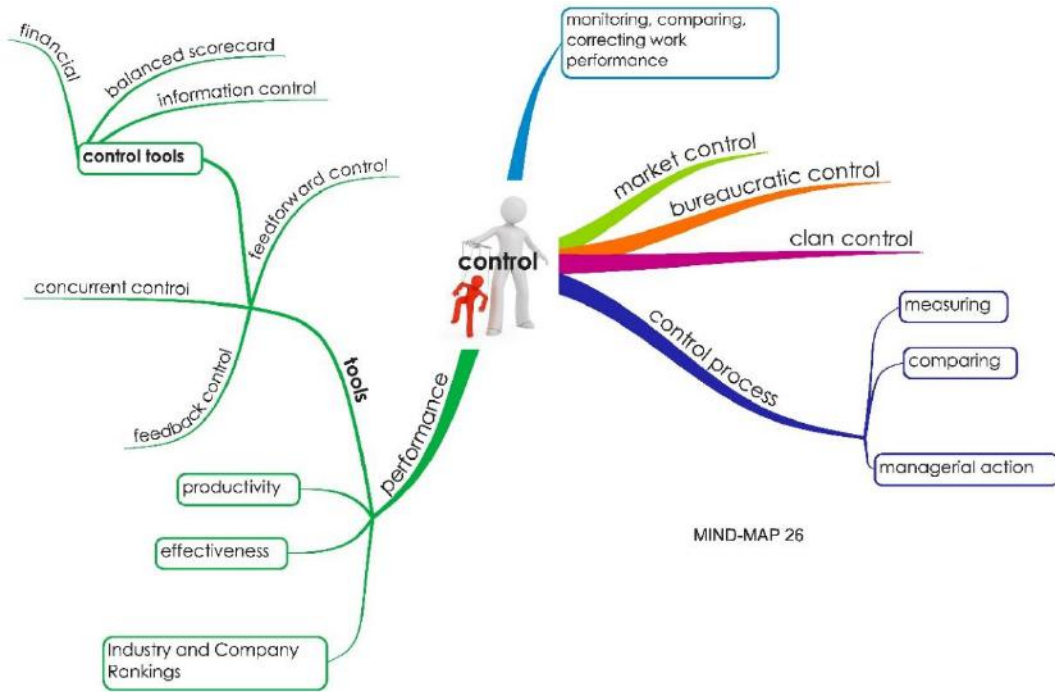


MIND-MAP 24



MIND-MAP 25





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