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ORGANISATIONS AND THEIR ENVIRONMENT

Chapter 1

THE NATURE AND STRUCTURE OF ORGANISATIONS

1. Organisations

An organisation can be defined as:

"A social arrangement which pursues collective goals, which controls its own performance, and which has a boundary separating it from its environment."

This is, perhaps, a deceptively simple definition. Probably the most important word is 'social'. Organisations consist of people and we are all social animals. We have to get on with our colleagues; ideally we would like our boss, or at least respect our boss. We have to get on with customers; we have our own ambitions; we have our own motivations.

Early management theory tended to neglect the social side of organisations and management and had a rather cold, militaristic approach. Modern theories have changed this considerably.

Another important aspect of the definition is that of 'collective goals'. There has to be an assumption that people within an organisation are ultimately aiming at the same end results, if they are not, then chaos is likely to rule. One of the functions of management is to arrange the business and the people in it so that everyone is pulling in the same direction, and the collective goals are reached.

Business organisations are organisations that focus either on making profits (like a conventional commercial company) or on improving society (like a charity).

2. Systems

The definition of an organisation included the terms 'boundary' and 'environment'. These terms come from systems theory.

The environment is what the organisation sits or lives in. For example a business lives in its national or country environment and perhaps in the international environment. The boundary separates the environment from the organisational system. Input normally goes into the organisation and output comes out of the organisation; some sort of processing takes place within the organisation.

Environment
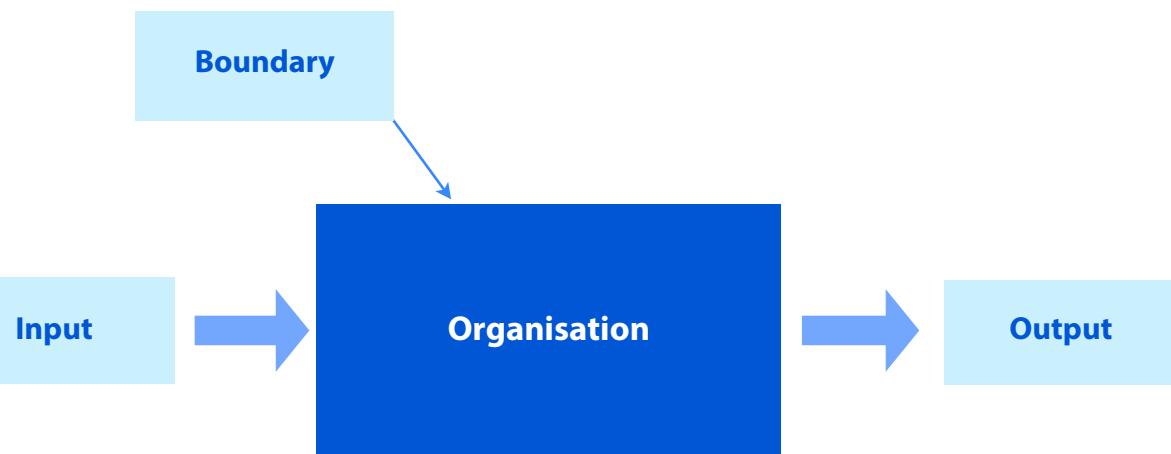
All organisations or systems can be divided into subsystems. For example, an organisation will have a sales and marketing department, an accounting department, a manufacturing department and so on. Subsystems can then be further split down into even smaller subsystems. For example, the accounting department will consist of the receivables ledger, the payables ledger, the cash book, the nominal ledger and so on.

Some systems are known as 'closed systems': they take no input from the environment and give no output to it. These are very theoretical and do not have a long life. It will be difficult to see an organisation continuing to compete successfully if it paid no heed to technological advances, to what its rivals were doing, or to what its customers wanted.

Open organisations, on the other hand, do receive input from the environment and produce output which is sent to the environment. These are the only ones of any practical importance.

3.   Types of organisation

You need to be aware of the characteristics of several types of organisation.

◉   **Commercial organisations** are profit-seeking. They can be sole traders, partnerships, limited liability partnerships and limited companies. The main advantage of limited liability partnerships and limited companies is that if the organisation hits hard times and has to go to liquidation, the owners of the organisation are protected. Creditors and banks can pursue only the assets which are in the company and the owners' liability, but not the organisation's, is limited. In contrast, sole traders and partners have unlimited liability for all the business's debts.

Commercial organisations are usually be classifies as:

▸ Primary sector: the extraction and production of raw materials.

▸ Secondary sector: manufacturing.

▸ Tertiary sector: provision of sales and services.

Sometimes a quaternary sector is split out from the tertiary: research and development industries, such as IT and pharmaceutical research.

◉   The second type of organisation is a **not-for-profit organisation**. An example of a not-for-profit organisation could be a charity, such as a charitable hospital. Instead of producing a profit and loss account, they tend to produce income and expenditure accounts. Ultimately their income has to exceed or match their expenditure or they will run out of money.

◉   **Public sector organisations** are owned by the state either at a national level or at a local level. Examples could be the defence department, many health services and educational systems. In some economies other industries or businesses are also owned by the state. For example, many national airlines are state-owned. Public sector organisations can be profit-seeking, but often are not.

◉   **Non-governmental organisations** tend to be not-for-profit organisations but with an international brief. Many United Nations organisations will fall into this category.

◉   **Co-operatives** are owned by the people who work in the organisation. Some farmers, for example, set up co-operatives to market their products more effectively than they could on their own. Usually they seek some sort of profit, but the ownership is shared widely amongst the people who are working in the organisation.

4.   Organisation structures

Organisation structures can be described as:

◉   entrepreneurial,

◉   functional,

◉   divisional,

◉   matrix or

◉   boundaryless

Entrepreneurial structures are very simple; basically it's a boss and the workers. They are small, often family-owned, and are not large enough to be divided into separate departments. There is often no separation of owners and managers or directors.

Once a business begins growing it will normally develop into a **functional structure**. This means that there are separate departments according to function – a sales and marketing department, an accounting department, a payables department, a receivables department, a research and development department and so on. This can be a very efficient structure as expertise is concentrated in each department and there could be great economies of scale through efficient operation.

Functional Structure
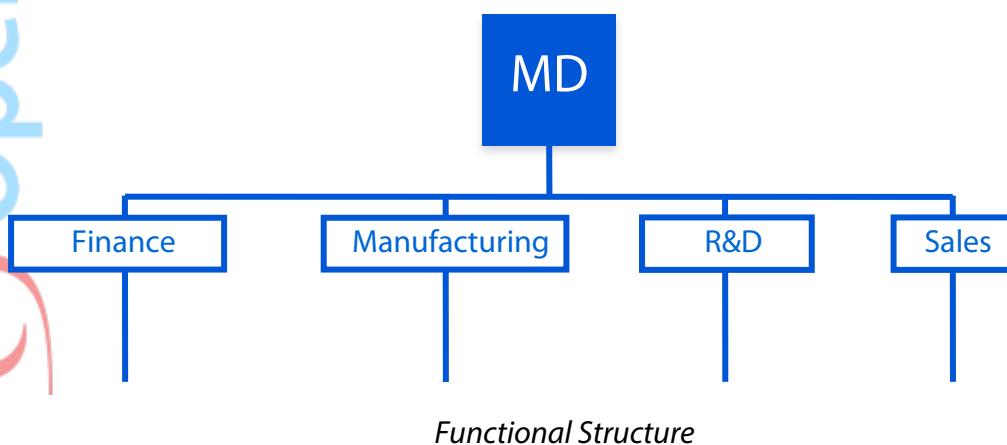
The main functions within in organisations are:

◉ Ordering and purchasing - provision of raw material and non-current assets. Negotiating with suppliers and placing orders

◉ Manufacturing/production - this is what customers pay for. The manufacture of goods either standard goods or made to customer order (bespoke).

◉ Direct service provision - a business that specialises in providing services as opposed to manufacturing and selling goods. For example: lawyers, accountants, architects, consulting engineers. These businesses usually need to have qualified staff members available to perform the services that it offers to consumers. Note that services cannot be stored (in contrast to manufactured items) so client demands cannot be met by supplying from inventory.

◉ Sales and marketing (finding customers, selling to them). See 'Marketing' in a later chapter.

◉ Distribution. This can be achieved by using the business's own transport. However, nowadays this function is often outsourced to a a specialist logistics company, such as UPS or DHL.

◉ Administration - the background tasks that keep the organisation running. For example, the office functions, dealing with correspondence, record-keeping.

◉ Research and development - the development new products and services and the development of new manufacturing processes.

◉ Human resources - recruitment, training, retention and, sometimes, removal of employees

◉ Accounting and finance - including payment of suppliers and employees, invoicing customers and collecting payment, cash management, and financial statement preparation. The credit control department assesses the credit-worthiness of new customers, sets a credit limit and will chase slow-payers.

◉ Cash and working capital management. Often this is part of the accounting department, but it is important to realise the importance of cash management: businesses fail, not because they make losses (owners could keep pumping in new funds), but because they run out of cash and cannot pay suppliers, staff salaries, interest, bank loan repayments or the tax authorities. A cash flow forecast (or cash budget) is a key document, showing the expected inflows and outflows of cash each month and the balance at the end of the month. This should provide long-range warnings so that the company might be able to raise new finance or defer some expenditure. The management of working capital can also help:

  ‣ Encourage customers to pay faster

  ‣ Delay payments to suppliers (potentially dangerous if overdone)

  ‣ Reduce inventory so that less cash is tied up in stocks.

◉   Treasury management. Typically, treasury departments are found only in large companies. Their function is to consider:

▸   Is there enough long term capital? Do additional shares need to be issued? Do we need to approach banks for loan capital? What dividend can we afford to pay?

▸   How can we manage and minimise risks arising from foreign exchange exposure? For example the company has exported to the USA and expects a US$ receipt. But is the US$ weakens, the amount received in the home currency will reduce.

▸   How can we manage interest rate risk? For example, should the company borrow at a fixed rate or a variable rate of interest.

▸   How can the company's or group's tax liabilities be minimised? You will note that companies like Apple, Google and Facebook have been criticised for their tax-mitigation methods.

Note that once organisations grow there is usually a separation between its owners (eg shareholders), those who direct it (eg the board of directors). There will also be a separation between the direction of the company (by the board of directors) and the hierarchy of managers who implement to board's decisions.

If the business continues to grow it may find it worthwhile to **divisionalise**. This means splitting the company up, perhaps on the basis of product or geography. For example you might have a North American division and a European division. You might have a division which makes and sells paint and you might have a division which makes and sells pharmaceuticals. The rationale for splitting a company up into divisions is to achieve specialisation. If you are selling paint and pharmaceuticals it is likely that the manufacturing is very different, the markets and competition will be very different, as will the regulation of the business. There is probably not much point in keeping it all together as one unit, and the business is better off being divided up into different divisions which can specialise in their own products and markets.

Divisional Structure
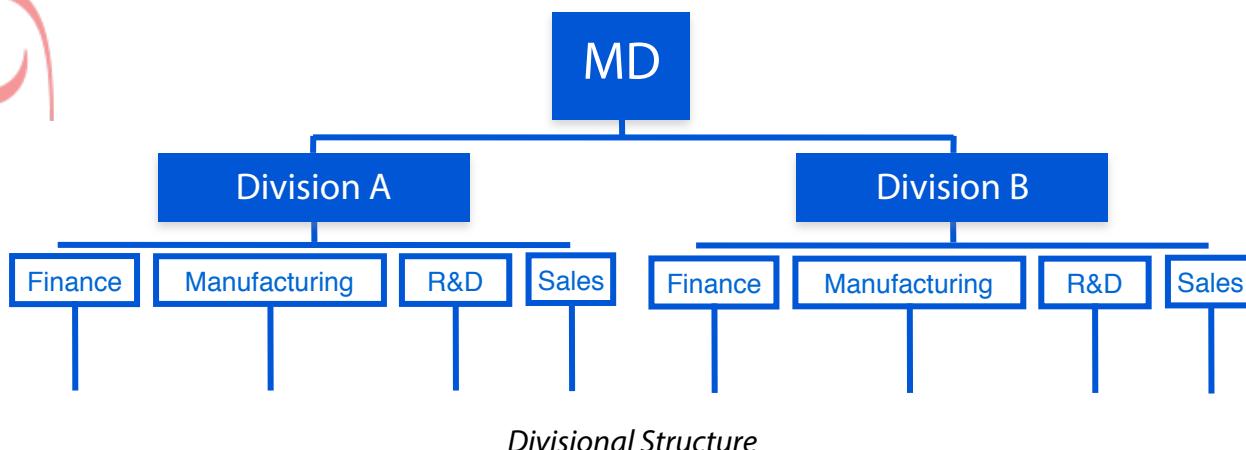
A **matrix organisation** is more complex. A good way to think of a matrix organisation is to think of a project team. A project team for project A, for example, will have a project leader or manager for project A. The members of the team report to that manager. But the members of the team also have functional responsibilities. For example, there will be a project accountant and someone who looks after the quality control aspects of the project perhaps someone who deals with the personnel involved in the project.

Matrix Structure
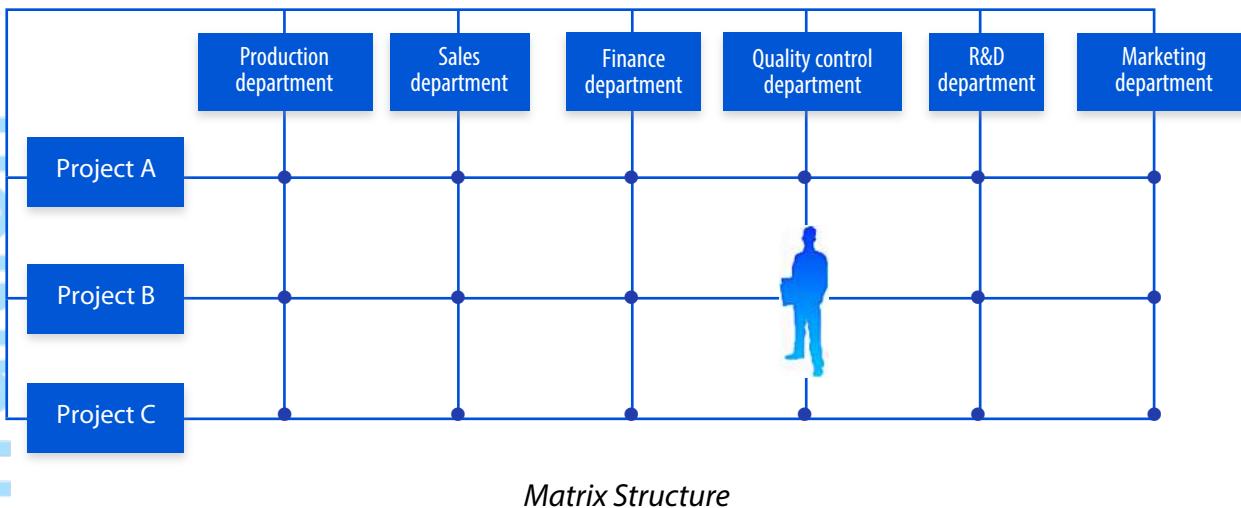
These people, as well as reporting to the project manager, also have to report to their functional heads. Therefore each person can have two bosses. Classical management theory suggested that this was unfair. But in fact depicting the organisation as a matrix doesn't cause there to be extra pressure on the people who work for the project. It is perhaps simply a more honest representation of the pressures that the project members are under.

It should encourage more cooperation between managers. For example, if Project B were running behind time, the Project B manager and the Quality Control manager might be able to negotiate a way in which the quality control processes could be (safely) speeded up. The new approach can then be given to the quality control staff to implement.

A **boundaryless** organisation can be virtual, hollow or modular:

◉   **Virtual:** create a company outside the organisation to respond to exceptional, often temporary market opportunities.

◉   **Hollow:** all non-core operations are outsourced eg accounting, human resources, legal services and manufacturing could be outsourced, leaving the company to concentrate on its core competence eg design of new products.

◉   **Modular:** order parts from different internal and external providers and assemble into a product.

5. Mintzberg's structures

Mintzberg divides organisations into five parts.

The **strategic apex** is equivalent to top management or the Board of Directors.

The **middle line** is the middle managers, sometimes called the scalar chain. This is the hierarchy that passes instructions down through the organisation.

The **operating core** are the people near the bottom who, for the most part, do the day-to-day work.

Support staff would include the accounting staff and IT staff.

The **technostructure**. This is perhaps the hardest to understand and is the part of the organisation responsible for devising and enforcing standards and procedures. It is the technostructure that would write the quality control manual, the employee handbook, the health and safety manual, the finance manual.

As drawn initially the diagrams show what Mintzberg would have called the machine bureaucracy which is, basically, a large mass manufacturing organisation.
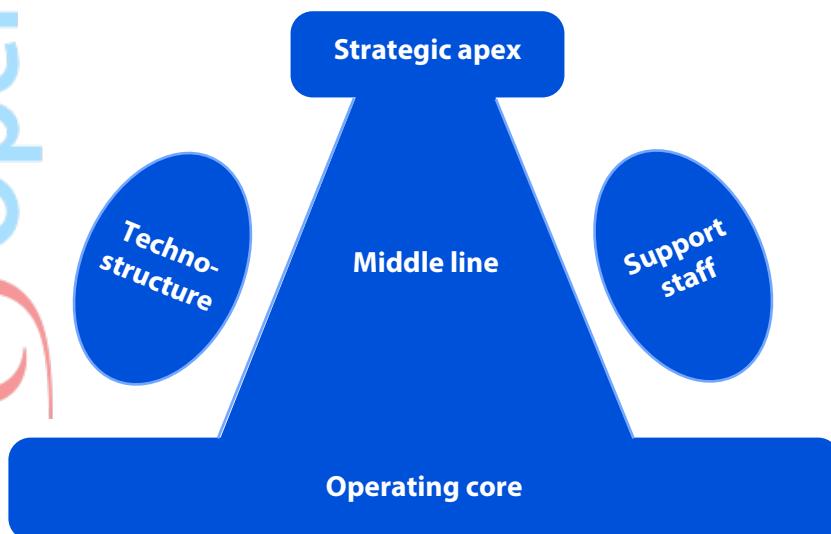
The size and importance of the five parts of the organisation change as we change the organisation. In an entrepreneurial (or simple) organisation there will be a strategic apex and the operating core. You may remember that entrepreneurial organisation was a basically a boss and the workers with little middle line and the organisation was so small that there was not much support staff and no need for technostructure.

One of the most interesting adaptations of the basic structure is what Mintzberg called the professional organisation.
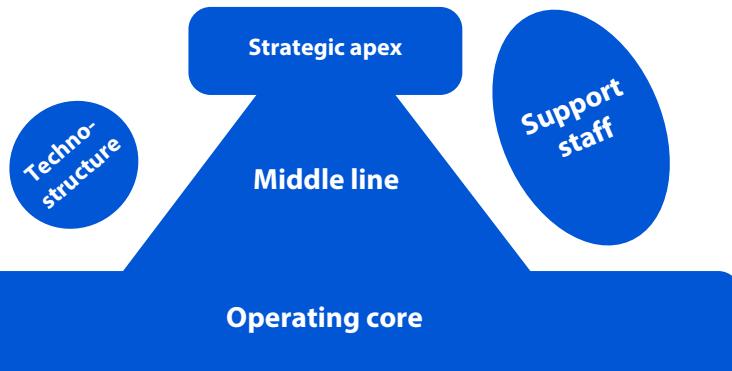
He was thinking of something like a large firm of accountants and lawyers. In these organisations, the middle line is much shorter, representing that there is really quite a close relationship between the partners at the top of the organisation and the people doing the audit or legal work at the bottom. These people need to communicate and cooperate very closely. There are of course middle managers but the middle line is relatively short.

Support staff is still quite large. But what is surprising is that the technostructure is very small. Auditors and lawyers have large files of standardised procedures, for example, audit programs to fill in, and you might think that audits and legal work were highly regulated and standardised. But if you think about it, every client an auditor goes to, or every client coming to see a lawyer, will have slightly different problems. We are not in the mass production manufacturing industry anymore. We are dealing with tailoring solutions to clients. So the technostructure, represented by standard forms, is somewhat superficial. Each client and each service has to be individually devised and delivered, so the power of the technostructure is relatively small.

6. Levels

Organisations are often regarded as having three levels, known as the 'Anthony hierarchy':

The top level is the **strategic level.** This is basically the very top managers and the board of directors. They should be looking after the strategy of the organisation, and whenever you hear the word "strategy," you should be thinking of something like a five-year plan for the whole organisation. What will the organisation be doing in five years? In what countries will it be operating? Will it still be manufacturing or will it have switched to predominantly service provision?

Right at the bottom of the organisation is the **operational** level. This is the level where the day-to-day activities are carried out. The time horizons are very short, often things are dealt within a day, and planning is often not much longer than a week or two. These people are predominantly dealing with or recording transactions which are either happening or have already occurred: processing invoices, sending out orders, dealing with customer queries, these are all at the operational level.

In between there is the **tactical level**, think of the tactical level as being the level of a manager of a department. Typically this person will have a time horizon of about a year because this person will often be concerned with meeting the year's budget. Of course they have to deal from time-to-time with day-to-day activities, but their particular priority will be to make sure that they organise their department to meet this year's budgets and expectations.

7.   Tall/narrow, wide/flat

Organisations are often described as being tall-narrow or wide-flat.

In the tall narrow organisation each manager or supervisor looks after relatively few people.

 Here the diagram has been drawn so that each supervisor directly looks after two people. That will be described as having a **span of control** of two.

In the wide flat organisation the span of control is much wider. In this diagram we've shown a span of control of seven, meaning that each supervisor or manager has seven people reporting directly to him or her.
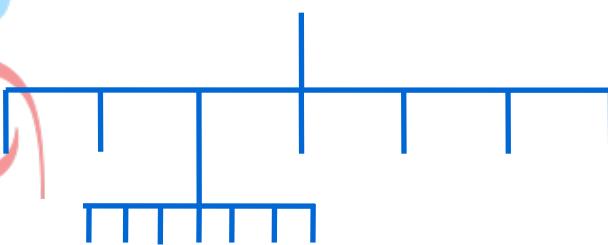
You will see in a tall narrow structure there are many layers and because each manager looks after only a few people, there can be very close supervision. Indeed it might not be mere supervision: it might be closer to re-performance or interference.

The tall narrow structure is sometimes described as very bureaucratic, very formal, strict job descriptions, great importance placed on exactly what one's grade is, and the sort of pay and benefits and conditions that would go with that grade. The wide flat organisation is much more egalitarian; there is much less distance between top and bottom in the organisation and communication between top and bottom will be much faster. Because it is more egalitarian, there tends to be less emphasis on strict job descriptions and a greater emphasis on how can we get the job done, a greater emphasis on all being a part of a team, rather than being a part of a hierarchy.

In the 1990s there tended to be deliberate moves from tall narrow to wide flat by many organisations. They called this 'delayering' or 'flattening' the shape of the organisation. There were two motives for doing this.

First of all in the '90s there began to be very great cost pressure from Far Eastern manufacturers where manufacturing was relatively cheap. In response to this, Western businesses had to be somewhat ruthless. They had to ask, "Is any value being added by these people in the middle, or are they just

managers, managing supervisors, managing assistant supervisors?" It was decided that often these people were not adding value and that they could safely be removed from the organisation.

Secondly in the 1990s, things began to move quickly. Technology changed very rapidly; there were huge changes in world markets, and operations based in China or India or Malaysia became very skilled and very adept at designing and launching new competing products. Western organisations therefore had to change and respond quickly and the tall narrow organisation was very slow to change. Many layers had to agree to the change, and many people were protecting their own particular grade. Therefore to get faster and more flexible responses to change, the wide flat organisation was often adopted.

Note that the term '**scalar chain'** refers to the chain of command from the top of the company down to the bottom.

8.   Centralisation/decentralisation

The shape of the organisation is independent of where power lies within the organisation. You could have two organisations of exactly the same shape and structure, yet in one a particular grade of employee could be given an expenditure authority of only 100 Euros but in another, the same grade of person could be given an expenditure authority of 10,000 Euros. Decentralisation or centralisation describes how far down the organisation power is passed. Generally it is agreed that some decentralisation is good but too much decentralisation can be counterproductive.

Claimed advantages are as follows.

◉   If nothing is decentralised, all decisions have to remain at the top of the organisation, with the managing director or the board of directors. Those people would be overworked, they will be mixing up trivial decisions with important decisions, and really their skills should be reserved for making important decisions.

◉   Secondly, if requests have to be passed up through an organisation for a decision to be made and then the answers are passed down, decisions are likely to be much slower. So decentralisation adds speed.

◉   Third, it might be better to decentralise power to areas of expertise. For example the best person to make a decision about where to place advertising is somebody in the sales and marketing department, not the managing director who may have come from an accounting or engineering background. Similarly, perhaps the best person to deal with competitive pressures in South America is the head of the South American organisation, not somebody based in London or Paris. The person in South America has local or geographic expertise.

◉   Fourth, motivation: good employees like to make decisions and like running their own departments or divisions. If you don't decentralise and allow them to have power, the good people will leave.

◉   Finally, training and assessment. If you never allow any junior people to make decisions, how will you know who the good ones are and who should be promoted in the future?

The big potential disadvantage is poor co-ordination, sometimes described as dysfunctional decision-making. That's where one division could make a decision which although good for it may harm the organisation as a whole. It might be, for example, that a manufacturing division stops making a component which is vital somewhere else in the organisation. Poor co-ordination means it's all messed up. Therefore there has to be some degree of co-ordination between the various departments and divisions in an organisation, and this may require the head office or the board of directors occasionally to interfere with the decentralisation and to impose decisions.
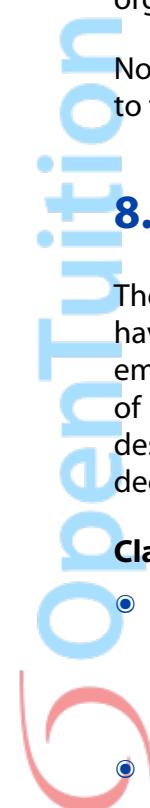
9.   Recent trends

There have been some recent trends in organisational structure, including:

◉   Downsizing (shrinking the business) has been necessary to keep costs down and, perhaps, to gain efficiency through outsourcing (see below)

◉   Delayering, we have discussed recently, moving towards wider, flatter organisations, both to save costs and to achieve flexibility.

◉   Outsourcing means getting an outside firm to perform some of your operations. These operations will generally be your support operations. Therefore, it is relatively common to outsource your IT and perhaps your receivables ledger. Most businesses don't make money from the receivables ledger or from their IT and these are necessary evils. They may make their money from clever engineering or thinking up clever adverts if they are an advertising agency. The thought behind outsourcing is that firms should concentrate on what they are good at, their core activities, and try to outsource everything else, because those functions are liable to be management distractions. Management should concentrate on where it adds value: where the organisation can makes its money.

◉   Offshoring is moving part of your business abroad usually to make use of cheaper labour rates found there. The processes could be outsourced to abroad or the company could set up its own operations there.

◉   Shared services refers to the consolidation of business operations that are used by several parts of the same business. For example, IT and accounting could be located in one city and country to service the needs of an international organisation.

10. Formal and informal organisations

The formal organisation is what management has deliberately designed, it's what management knows about, and also it's often written down in some manner. Therefore management knows about the organisation chart and knows who is manager of the department, who is supervisor, and who works in it. Management will have caused procedures manuals to have been written to set out the proper ways of doing things. Staff appraisals, showing which staff may be better and which ones have certain weaknesses will also be carefully recorded.

However, an enormous amount of the organisation is informal.

Staff appraisals   **Mission statement**

Organisation charts   **Procedures manuals**

Personal ambitions

Group norms

Personal preferences

Rumour/gossip

Alliances

Shortcuts

Mutual cover-up
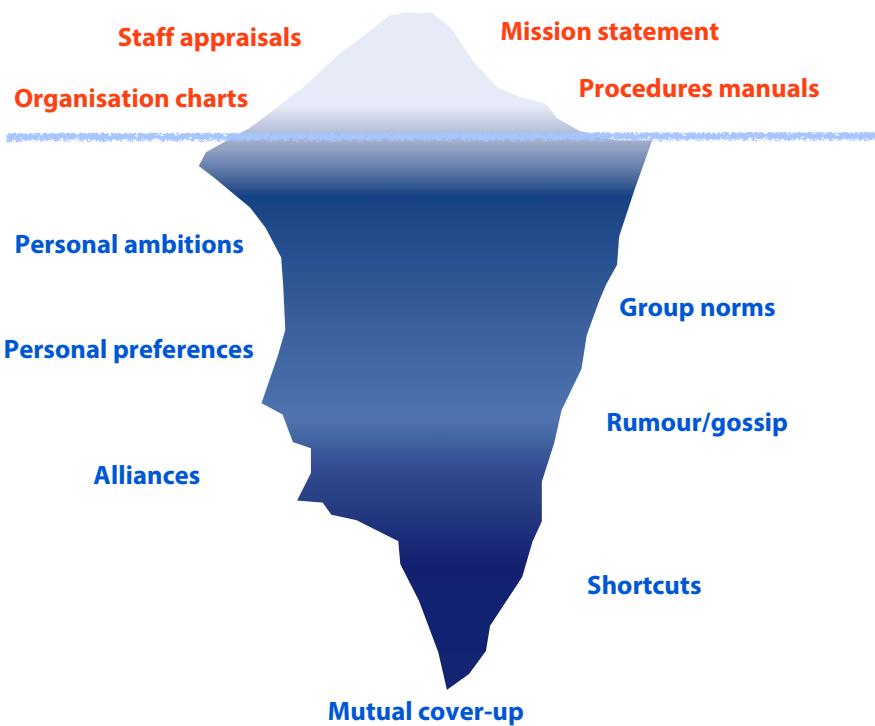
This diagram is supposed to depict that, because what it shows is an iceberg. Only a relatively small part of an iceberg is seen or is known about. By far the greater part of it is invisible, but dangerous. If management is unaware of the informal organisation then they are liable not to be able to manage very well. So, for example, if you have two people who dislike each other but nevertheless, according to the organisation chart, are supposed to co-operate, then that department will not work well. Similarly, despite lower management issuing newsletters and e-mails to all their staff , rumour and gossip gets around organisations very quickly. It's often inaccurate, but that doesn't mean it's not going to be believed.

Group norms is another important example. A group norm is an arrangement people come to, often slowly, about how they should behave. For example it might be the group norm that nobody ever works past 5 o'clock on a Friday. They have come to this arrangement somewhat informally but anyone new joining the organisation will generally fall in line so that they fit in and are acceptedly colleagues. Once certain group norms have been adopted by a number of people, it can be very difficult for management to shift those norms to something else as all of those people resist together.

Mutual cover-up. If you make a mistake, it should be reported to your manager, but you have a friend in the other department and you and your friend agree to conceal that mistake. After all, your friend never knows when he will need the favour again one day.

Management nowadays is generally familiar with the existence of informal organisations, but will find it difficult is to understand the nature and details of the informal organisation. What are people's personal ambitions? What alliances have been made? What personal problems or relationships have been formed? What ways have people decided to act that could be wildly different from what's laid down in the procedures manuals?

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 2

AN ORGANISATION'S ENVIRONMENT

1.   Environmental influences – PEST(EL)

This paper is called "The Accountant in Business." And of course businesses exist within an environment. and it is therefore useful to categorise the environmental influences that businesses may suffer. The PESTEL model looks at environmental influences which are very large and powerful: the macro-environment. PESTEL stands for Political, Economic, Social, Technological, and relatively recently, Ecologica. l and Legal. It's easy to see how these will influence how a business gets on.

Political

For example joining/leaving the EU, political tensions, war, alliances and change of government can all influence many businesses.

Economic

It goes without saying that economic changes can have very serious influences on business and under "economic" will come effects such as interest rates, exchange rates, tax rates, and whether the world economy seems to be doing well or is in decline.

Social

Social changes include what's known as 'demographic changes', that is, changes in the population. And in many Western countries, this is characterised by relatively few young people and more and more old people in the population. This can have serious implications when it comes to recruitment or in calculating the pension or medical liabilities of businesses.

Also under the heading of social influences are taste, fashion, fad, values and attitudes. For example, in many countries vegetarian and vegan lifestyles currently seem to be increasing   in popularity. Nowadays people have got used to relatively cheap air travel and there is an expectation that travel will be easily available. Fewer people watch regular broadcast television as streaming services, such as Netflix, have become more popular.

Technological

Technological changes are easy to understand. You only have to consider what the Internet has done to many businesses. Banks, for example, need fewer branches, as more and more people opt to deal with their accounts online. Many bookshops and music shops have been affected by Amazon which makes sales online through a sophisticated website.

Companies are also making much more use of the information they can gather about customers and their purchases, preferences and habits so that much more focussed marketing offers can be made. If you use a loyalty card in a supermarket, be assured that the company notes everything you purchase, storing it in a data warehouse (with other customers' data) and will the company will be mining the data in the hope of finding useful marketing information.

Another example of technological change is seen in vehicle manufacturing where ranges of electric or hybrid vehicles and battery technology are being developed and which will play a big part in the future.

Ecological/environmental

Ecological influences are relatively new considerations. These are effectively green issues. Some businesses are affected more than others. Airlines for example, are coming under increasing pressure because it is claimed that jet travel makes damaging emissions high in the atmosphere. More and more businesses are paying attention to packaging, to waste disposal and to their carbon footprints.

These efforts should improve the long-term sustainability of the business. More efficient use of material resources and energy should ultimately benefit shareholders. So will avoiding fines by regulators and the cost of putting right environmental disasters. The reputation of a company is likely to be improved because the business is seen to be environmentally responsible. This should lead to more sales and higher profits.

Legal

Legal is sometimes included under political influences but obviously new laws, such as consumer protection, safety laws, and employment protection legislation can have profound effects on how businesses operate.

2. Competitive forces

Having considered the macro-environment using PESTEL, we can 'zoom in' and consider matters relating to specific industry sectors. Porter's 5 Forces model is a popular and useful framework with which to analyse industry sectors and industry attractiveness.

Industry attractiveness refers to how easy a business will find it to make reasonable profits. By reasonable profits we mean profits large enough to compensate investors for their risk, and also to make enough money to reinvest to keep the company successful.
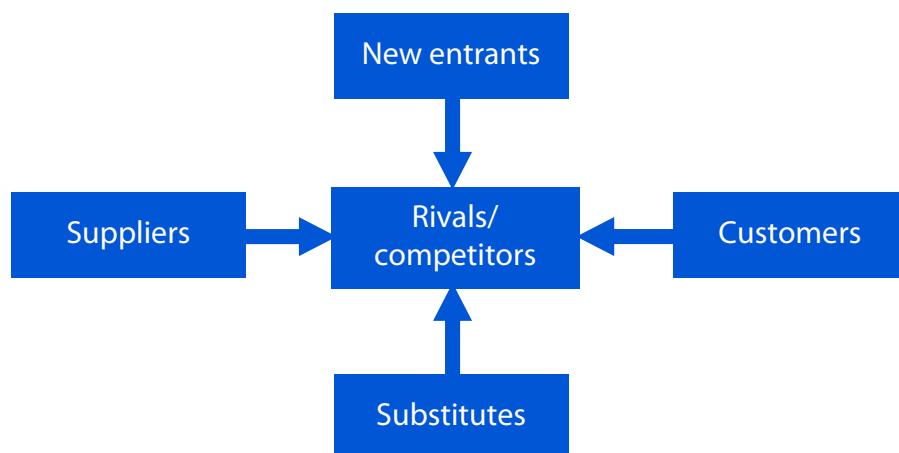
The first of the forces is competition or rivalry. This can range from perfect competition where sellers have no choice as to the selling price that is charged (they are governed by the market price) all the way through to monopoly. A monopoly gives sellers much more choice as to what price can be charged, though the price will normally alter demand. And remember, just because you have a monopoly doesn't mean you will make profits - you might be the monopoly supplier of something

nobody wants. However, by and large, the nearer an industry gets to monopoly, the easier a time its participants will have. Therefore, provided it's legal, it could be a useful strategy to take over a rival or to force it out of business by, perhaps, lowering prices temporarily.

Now we will look at buyer pressure. If buyers are very powerful, then they can exert pressure on prices, quality and delivery times. Selling almost all output to a few powerful buyers will be an uncomfortable situation. The more buyers you have and the harder it is for them to switch between different suppliers, the better. Businesses should try to build in switching costs, that is, real costs or impediments that mean that buyers prefer to stay with existing suppliers.

Similarly, on the other side when you are buying goods from suppliers, if you have to buy a special component from a monopoly supplier, you will be in an uncomfortable position. That supplier could raise prices and you have to pay. Or even worse, that supplier could be taken over by one of your competitors, and then you will have no supplies at all. Ideally a firm should try to multi-source and if they get really worried about assurance of supply they should think about setting up their own supply organisation or perhaps taking over an existing supplier.

Potential entrants are sitting on the edge of the industry and may be attracted into it if they can see that good profits can be made. Anything which keeps out potential entrants is known as a 'barrier to entry'. Occasionally, potential entrants are deterred because there is a legal monopoly within the business. Sometimes regulations make it hard for potential entrants to get into a business. For example, setting up as a bank is relatively difficult because of the various regulatory authorities that have to give their permission. The need for high capital expenditure and for know-how are two other impediments to potential entrants.

Substitute products arise usually by the advance of technology. Often the appearance of substitutes will surprise a business and take it off-guard. For example, landline telephone companies thought that they were almost in a monopoly position because the cost of digging up roads and laying landlines into houses, apartments and businesses would have been a considerable barrier to entry. However, then mobile telephones, cell phone technology, was invented, and good telephone coverage can be achieved with much less expense. There is not much you can do to avoid substitutes. Once technology is invented, it can't really be sent suppressed. Most old industries have to join the new industries as well. So, now, many conventional telephone companies also have mobile phone networks in an attempt to retain their overall market share in telecommunications.

3. Porter's value chain

Porter's value chain is used to examine how a business makes profits or margin.

Profit, or margin
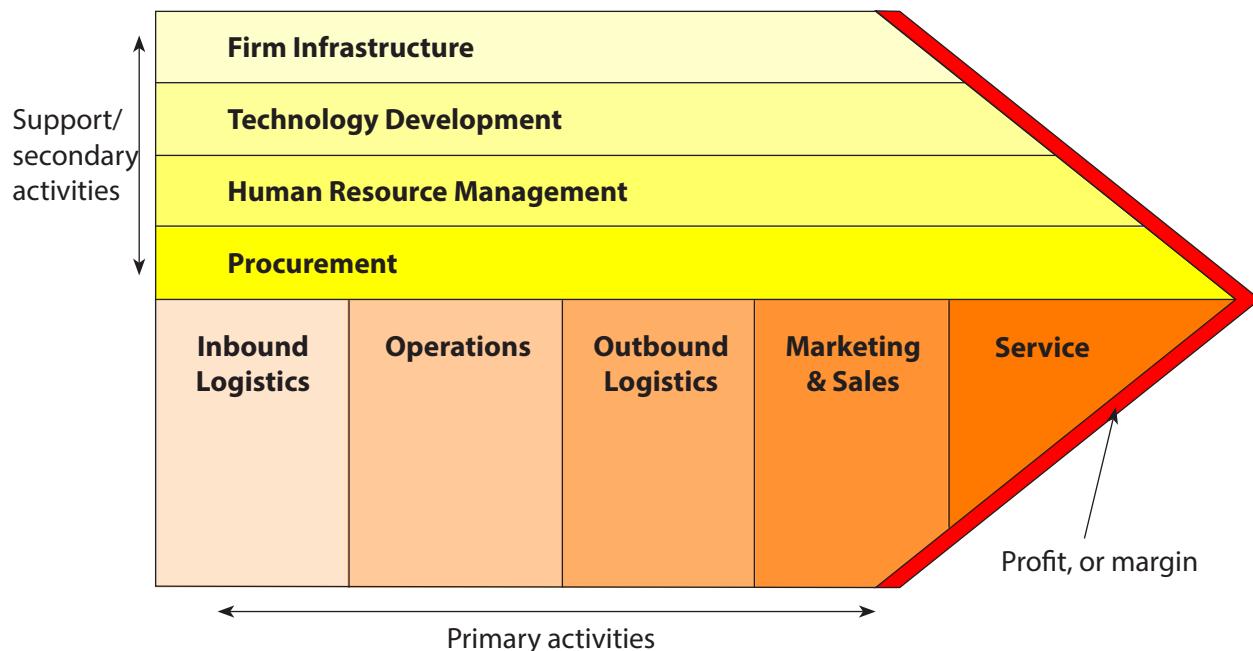
Across the bottom of the diagram, are set out inbound logistics, operations, outbound logistics, marketing and sales, and service. These are the primary activities. More or less these activities will equate to direct costs.

At the top of the diagram are firm infrastructure, technology development, human resource management, and procurement. These are the support activities. By and large they equate to indirect costs.

It has to be stressed that *activities* are shown in the diagram. However, every activity has an associated cost, and if all activities are represented there, so should all costs, and these could be allocated and apportioned, and so mapped to somewhere on to this diagram. Rent, for example could be apportioned over the operations (ie the factory), the warehouse, head office, and the marketing and sales department. Similarly with depreciation, heating costs, wages and salaries.

So, all the organisation's costs can appear on this diagram. Let's say these amounted to $10 million. The goods and services produced by the organisation will be sold, let's say for $15 million. How come therefore buyers are willing to spend $15 million on what cost the organisation only $10 million? For what possible reason are customers willing to spend an extra $5 million over and above what the goods or services cost to produce?

The extra $5 million has to be explained somehow. It is known as 'value-added', and it is explained by arguing that the organisation accomplishes more for its customers than simply carrying out the activities and incurring the costs that can be spread over the sections of the value chain. The organisation must be doing something else. For example, it could be bringing skills and know-how to the process. Effectively it is bringing competencies to the process. It could bring convenience to the buyer, allowing the buyer to keep everything bought from the organisation as a variable cost rather than taking on board many of the fixed costs. It may bring economies of scale and the buyer is willing to pay for this because it will be impossible for the buyer to replicate these on a smaller scale.

The organisation must understand what it is that adds value, as this is the reason it can make profits. It is the secret of their competitive advantage. For example, the organisation might have very efficient

manufacturing which allows it to sell goods a lower prices than competitors. Or it might have very good research and development which allows it to design better products that could be sold at a premium price.

The organisation must also understand how the different sections of the value chain are linked. It could be that if more were spent on human resource management perhaps less would need to be spent on operations because employees are better trained. If more were spent on technology development perhaps less could be spend on after sales service because the quality of the finish goods was higher.

Understanding the value chain is essential for organisations so that they know how their profit is generated. It has to be said, however, that sometimes organisations make mistakes identifying what it is about their activities that adds, value for the customer and they make changes which reduce their ability to make profits.

Each organisation has its own value chain, but what customers buy is usually the end-result of the efforts of many organisations: raw material producers, component manufacturers, logistics companies, assembly, and retail distribution and sales. Each organisation should be contributing to the value of the final product and the whole set of organisations is called a **value network**.

4. An organisation's Strengths, Weaknesses, Opportunities and Threats can be summarised using a SWOT analysis.

Strengths and weaknesses are internal. For example, the organisation might have strong finance but a weak portfolio of products.

Opportunities and threats are external. For example, there might be a threat from a large overseas competitor coming into the country, but there could be opportunities to take over an ailing competitor.

Organisations should seek to match strengths to opportunities. For example, strong finance would allow the takeover of a weak competitor.

They should avoid relying on areas where they are weak, or should try to make good the weakness to defend themselves.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 3

AN ORGANISATION'S STAKEHOLDERS

1. Stakeholders

The term "stakeholder" refers to any person or institution in any way affected by organisation. Stakeholders can be broken down into three groups though this is not particularly helpful in any further analysis.

Internal stakeholders are those who are definitely inside the organisation. A good example would be the employees and the managers.

Connected stakeholders are outside the organisation but connected by way of a contract of some sort. Good examples here will be suppliers, customers, shareholders and lenders.

External stakeholders are entirely outside the organisation with no contractual relationship. A good example for this is will be the people living nearby a factory. They are obviously affected, but have very limited contractual rights over what the factory does. The government is also an external stakeholder.

Why is the study of stakeholders important? Really the reason is that usually what stakeholders want will be in conflict. Shareholders want higher profits but employees want higher wages; customers want better quality at lower prices, shareholders want higher profits; customers may want the operation to run 24 hours a day, 7 days a week but employees might want to only work 5 days a week, 8 hours a day. If your organisation was an airport the local populace would want you to run fewer flights (and certainly not after about 11 o'clock at night), whereas your customers and your shareholders may want you to run services more frequently.

There is no easy way of resolving these conflicts. Basically it comes down to management trying to get stakeholders to compromise. They have to try and keep most people happy most of the time, bearing in mind, however, that some stakeholders may be able to stop co-operating altogether. For example when employees want better wages, they could go on strike and ultimately this can affect the profits which are enjoyed by the shareholders. Management has to be aware that there are conflicts and try its best to manage these.

The study of stakeholders allows us to introduce the **agency relationship** that, in particular, exists between two major categories of stakeholder: shareholders (owners) and directors/management.

Once a company becomes larger, shareholders usually take no part in the day-to-day running of the business. Instead, the directors do that. In the relationship, the shareholders are the **principals** and the directors the **agents**. It is the legal duty of agents to act in the best interests of the principals but it is tempting and easy for directors to begin putting themselves ahead of the shareholders. For example, directors might award themselves large bonuses, first class air travel, board meetings in exotic and pleasant locations. They might decide to embark on a risky project that will reduce profits if it goes wrong but nevertheless leave their salaries intact. These choices will reduce shareholder returns but potentially enrich directors.

At one time, the management of the relationship between shareholders and directors was very poor. After several large financial scandals new rules were introduced to increase the supervision of

directors so that their decisions are more likely to be in the best interests of the shareholders. More details of the rules are covered in the chapter on Corporate Governance.

2.   Mendelow's matrix

About the only tool or model available for the analysis of stakeholders is Mendelow's matrix.

Level of interest

	Low	High
Low	Minimal effort	Keep informed
High	Keep satisfied	Key player

Power

It sets out on one axis the power that a stakeholder can wield and along the other axis their interest, by which we mean how likely is it that the stakeholder will take action. Stakeholders who have high power and high interest are known as **key players.** Management really needs to keep those people happy. They have the power and they have the willingness to take action if they are upset.

Some stakeholders have high power but they are not likely to take action even if management does something which they dislike. They may be unwilling to take action because of professional or ethical reasons. For example, medical staff in hospitals are very unlikely to take industrial action. Management doesn't have to be quite so careful with these people. However they have to be **kept satisfied**, otherwise they could be provoked to take action and turn into key players.

People with low power but high interest have to be **kept informed**. They can't do much about it themselves but they might be able to influence key players to take action on their behalf.

Finally we have people with low power and low interest. Management can nearly ignore these people. After all, what are they going to do if they don't like what's happening? They are unlikely to want to take action anyhow. They require **minimal effort** by management.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 4

ORGANISATIONAL CULTURE

1. Cultural web

Whereas PESTEL and Porter's 5 forces relate to influences outside the business, within the business its culture is very important. Charles Handy defined the culture as "the way we do things around here."

You will be aware of the effect of culture. For example whenever you join a new organisation, whether school or college or work, you tend to go carefully for the first couple of days or couple of weeks until you see how people behave, and then you usually try to fit in.

The influences on culture could be represented by the cultural web.

Symbols
&
Titles

Myths
&
stories

Power
relations

**Organisational
Assumptions (Paradigm)**

Rituals
&
routines

Org'n
structure

Control
systems
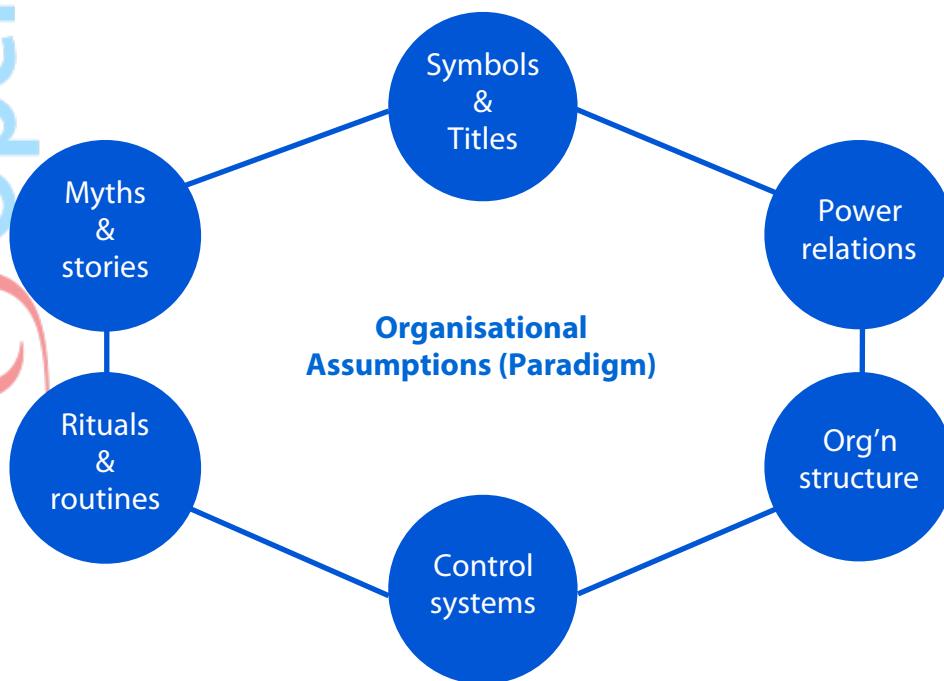
Starting at the top, **symbols and titles**. Are you an organisation with many presidents and vice-presidents? Where everyone has a particular title implying that the organisation might be rather formal? Where symbols might be those such as a private dining room for top managers, or reserved parking spaces, or particular perks which only those of a certain grade obtain? Some organisations are quite hierarchical like that, others try to be much more egalitarian.

Power relations. Do top managers keep most power to themselves or is it dispersed? Are you told what to do or is it more likely you will be asked to contribute your ideas about what should be done?

Organisational structure. Some organisations are 'tall narrow' with many layers, each layer being carefully supervised by the supervisor or manager above. Other organisations are 'flat wide' organisations, with relatively few vertical layers and each manager therefore having to look after a relatively large number of people, but inevitably because they are looking after more people, people have to be better at looking after themselves without intense supervision.

Control systems. For example, how carefully do you have to account for your time. Some organisations, perhaps for billing purposes, insist that people record what they are doing every 12 minutes. Other organisations don't control individual activities quite so closely and are more interested in the overall results.

Rituals and routines. For example, in some organisations when a sale is made, the person who has made the sale has to stand up and ring a bell. Other people then applaud. To some of you this may seem childish. But those organisations which do it presumably think it's worthwhile in terms of morale-boosting and challenging others who have not yet made the sale. In some organisations you are expected to socialise, say on a Friday evening after work.

Myths and stories. How the company in the past won a particular contract which was very valuable, the way in which a clever presentation was made or the way in which they worked hard against the clock to ensure that a job was finished on time. Myths and stories are often used to illustrate desirable behaviour.

Organisational assumptions. For example, the assumption that we are the best, that we are never beaten, that we only produce work of the highest quality.

2. Types of culture – Handy's classification

Charles Handy identified four types of organisational culture. Each of these categories was given the name of a Greek god. Those names are very useful but you ought to know them for the exam anyhow.

Power culture. First, there is the power culture (Zeus). In the power culture power is concentrated in the hands of essentially one person, the boss - probably the person who started the company, or at least the person whose name is probably the same as the company. This person's word is law. There is very little delegation, very little decentralisation. Almost all decisions are made by that person.

Role culture. It becomes difficult to sustain a power culture as the business grows, there is simply too much to know, too much to do, and it may then change into a role culture (Apollo). In the role culture there is effectively a management structure with different people having different roles. The problem with the role culture is that sometimes the title and the job description, are regarded as more important than actually getting the job done. Often associated with role culture are very strict job descriptions and if something isn't in the description then people will refuse to do it even if it hurts a client or customer.

Task culture. The task culture (Athena) is where there is a great emphasis on getting the job done and achieving the task. People do not depend so much on their job specifications or their particular place in a hierarchy. Really, everyone pulls together for the sake of the organisation and to please clients and customers.

Person culture. A relatively rare type of culture is the person organisation (Dionysus). Here you have people who are essentially pursuing a private ambition in the context of an organisation. It's not very important in business. An example might be a surgeon in a hospital. The surgeon gets enormous job

satisfaction from performing operations and making people better. To some extent surgeons might not be terribly interested in interacting with the rest of the organisation. They are there primarily to fill their personal ambitions and the rest of the organisation is almost an essential evil.

3.   Schein - three levels of culture

Schein usefully identified three levels of culture.

Artifacts. The topmost and the most superficial level is that of artifacts. These are essentially what you see: the way people dress, the way they behave, the structure of the company as set out in the organisation chart, the way in which you have to have your expenses approved. These are most obvious things that you see when you join an organisation but in some ways the least important.

Espoused values. At a slightly deeper level are espoused values. These are the stated goals, strategies, and philosophies. The mission statement of a company, for example, may set out what the company's purpose is and how it perceives itself within the marketplace, how it values employees, how it tries not to harm the environment.

Underlying assumptions. The most fundamental level is the basic underlying assumptions. These are very important but are often the most difficult to identify and to understand. They will often not be stated, but there is an assumption about the quality of work, about never missing deadlines, about our willingness to work overtime even if not paid in order to hit a deadline, the assumption that we are the best. It can take time before these basic underlying assumptions are understood by new members of organisations.
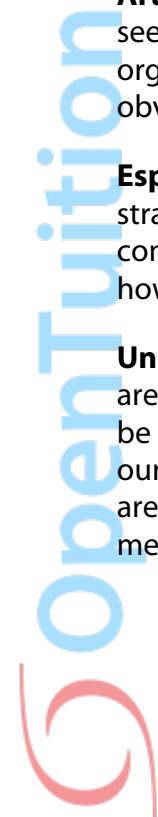
4. National cultures

Hofstede examined how people from different countries are likely to develop different organisational cultures and how national culture influences how people work and expect to be managed. Hofstede identified the following variables:

Power/distance. Do people expect to be told what to do and then do it without question? Or do people come from a national culture where that approach would not be expected and probably not be acceptable, where they expect to have a more participative role to contribute to decisions?

Uncertainty avoidance. Some national cultures shy away from taking risks; those people may prefer certainty. They don't come from a background which expects people to take gambles and which supports failure. It's sometimes said that the American business culture is one where failure, and effectively therefore uncertainty, is well tolerated, that there is no disgrace in trying and failing, and the only disgrace is in not trying. It could be that this is what partly contributes to the dynamism of the American economy.

Individualism-collectivism. To what extent are all people within the organisation expected to agree with particular decisions and to conform to what other people are doing, or are they expected to go their own way? To a large extent Japanese culture expects collectivism. Everyone is expected to agree on what's being done and an individual approach is frowned upon. In some countries individual approaches are likely to be praised and they have great respect for the maverick.

Masculinity. This looks at the extent to which social gender roles are important. Cultures with high masculinity value assertiveness, competition, material success, and being dominant, whereas in those cultures feminine values of modesty, reaching consensus, understanding, and relationships are not valued so highly.

> **When you finished this chapter you should attempt the online AB MCQ Test**

GOVERNANCE, ETHICS AND THE LAW

Chapter 5

CORPORATE GOVERNANCE AND ETHICAL CONSIDERATIONS

1.   Corporate governance

Corporate governance refers to how companies are directed and controlled.

The real problem is the separation of ownership and control.
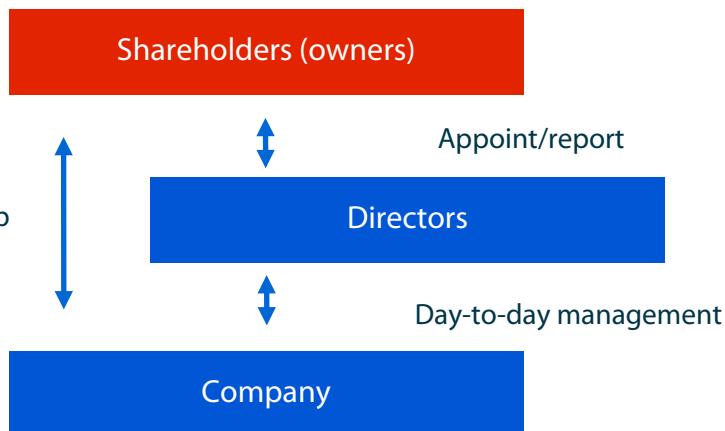
As mentioned in an earlier chapter shareholders own the company, but unless the company is very small they will not normally be dealing with the day-to-day running of the company. Instead shareholders appoint directors to do that. Technically the directors are the agents of the shareholders. The shareholders are the principals in this relationship and the directors should act in the best interests of the shareholders. Another way of describing this is stewardship. The directors are the stewards of the company assets. They look after them on behalf of the shareholders. But how do we know if the directors are acting in this way?

Directors have day-to-day management responsibilities and shareholders may only get a set of financial statements (accounts) once a year and attend an annual general meeting once a year. It can therefore be very difficult for the shareholders to know whether or not the directors are running the company in the shareholders' best interests. There have been many examples of directors abusing the trust put in them by the shareholders. They can award themselves excessive amounts of salary and share options, give themselves generous perks; they can make loans from the company to themselves; they can take undue risks because, if the risk pays off the directors' salaries may increase, but if the risk doesn't pay off it's the shareholders who will lose the most, and the directors' positions can remain relatively secure.

Corporate governance rules have recently been tightened up so that shareholders can better monitor what the directors are doing and how their company is actually performing.

2.   Corporate governance

2.1 Principles of corporate governance

The Organisation of Economic Cooperation Development (OECD) promotes six Principles of a corporate governance framework:

- It should promote transparent and fair markets and support effective supervision and enforcement.

- It should protect shareholders' rights and ensure all are fairly treated (ie including minority shareholders).

- It should provide for stock markets to contribute to good corporate governance (eg by prohibiting insider trading).

- It should recognise the rights of all stakeholders, not just shareholders.

- It should ensure timely and accurate disclosure of all material matters, including financial position, performance, ownership and governance.

- It should ensure the strategic guidance of the entity, effective monitoring of management by the board and the board's accountability to the entity and their shareholders.

2.2 The UK Corporate Governance Code

The OECD principles are put into effect in a variety of ways in different countries. The UK Corporate Governance Code published by the Financial Reporting Council (FRC) is an example of best practice. The Principles of the Code emphasise the value of good corporate governance to the long-term success of the company.

Main principles of the UK Code

- **Board leadership and company purpose**

  Every company should be headed by an effective board which is collectively responsible for the long-term success of the company. All directors must act with integrity, lead by example and promote the desired culture.

- **Division of responsibilities**

  There should be a clear division between the running of the board and the executive responsibility for the running of the company's business. No one individual should dominate decision making. This means that the roles of CEO and chairman should not be performed by one person as that concentrates too much power in that person. The chairman is responsible for leadership of the board

  Non-executive directors (NEDs) must be appointed to the board and they should constructively challenge and help develop proposals on strategy. NEDs sit in at board meeting and have full voting rights, but do not have day to day executive or managerial responsibility. Their function is to monitor, advise and warn the executive directors. There should be roughly a 50/50 balance between executive and non-executive directors.

- **Composition, succession and evaluation**

  Appointments to the board should be subject to a formal, rigorous and transparent procedure led by a **nomination committee**. A majority of the committee should be independent NEDs.

The board and its committees should have a combination of skills, experience and knowledge. The length of service of the board as a whole should be considered and membership regularly refreshed. The post of chairman should not be held beyond nine years.

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

All directors should be submitted for re-election annually.

◉ **Audit, risk and internal control**

The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit and the integrity of financial statements.

This means that an Audit Committee (NEDs again) should be established to liaise with both internal and external auditors. Before audit committees, the finance director liaised with auditors, but this was not satisfactory because the finance director was often the person responsible for accounting problems. Therefore, auditors were often reporting problems to the person who caused them. The directors are responsible for establishing an internal control system and must review the need for internal audit.

The board should present a fair, balanced and understandable assessment of the company's position and prospects and should establish procedures to manage risk, oversee internal controls and determine the nature and extent of the principal risks the company is willing to take to achieve its long-term strategic objectives.

◉ **Remuneration**

Remuneration should be sufficient to attract, retain and motivate directors of sufficient quality… but avoid paying more than is necessary.

A significant proportion of executive directors' remuneration may be structured to link rewards to corporate and individual performance. In other words, profit related pay is encouraged so that directors do not receive high pay irrespective of company performance.

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. This means that a **remuneration committee** (NEDs) should be formed to fix directors' remuneration.

Compliance-based or principles-based

The UK Corporate Governance code and that of most European countries is principles-based This means that broad principles are laid down and it is the board's responsibility to apply those principles as they see fit to their particular company. This approach allows flexibility to deal with a wide variety of circumstances.

The USA takes a compliance approach where very specific requirements and rules have to be signed off by the board and often also the auditors. This approach, embodied in the Sarbanes Oxley Act, allows much less flexibility but it does increase the strictness with which the rules are applied.

Comply or explain

The Code has no force in law and is enforced on listed companies through the Stock Exchange. Listed companies are expected to "comply or explain" and this approach is the trademark of corporate governance in the UK. Listed companies have to state that they have complied with the code or else explain to shareholders why they haven't. This allows some flexibility and non-compliance might be acceptable in some circumstances.

3.   Corporate Social Responsibility

We stated earlier that shareholders own companies and they appoint directors to run the companies for the benefit of the shareholders. That is certainly the legal position, but recently people have questioned whether running companies purely for the benefit of shareholders is all that should be done. This has given rise to the somewhat fashionable idea of **corporate social responsibility**.

To what extent should the interests of other stakeholders be taken into account? For example, certainly companies should be run within the law and no doubt there are laws relating to minimum wages, maximum working weeks, and permitted levels of pollution. If companies adhere to those laws should they go further? Should they pay people much in excess of the minimum? Should they reduce the hours that people have to work? Should they tighten up even further on the discharges made from the factory?

Many observers argue that companies should go further than simply meet the minimum obligations as set by law. But this can be a difficult area. First of all, going further with these social responsibilities normally reduces the profit of a company. Profit is of itself a good thing as profit enables a company to exist more permanently, to put money into research and development, to give more stable employment. And of course, the higher the profit, the higher the taxes, and taxes are then spent for the good of society as a whole. Companies should certainly not be embarrassed about making profits.

Secondly it can be argued that instead of a company, say, making charitable donations, shareholders if they get larger dividends can make those donations themselves, and furthermore, they can make those donations to parties they feel most deserving.

Thirdly, do directors have the legal authority to make non-essential payments? This is the directors using company assets which are ultimately the assets of the shareholders. People could argue that they have no right to give those away or to spend them needlessly.

Lastly who decides the beneficiaries? Are the beneficiaries simply the pet charities and interests of the directors? What exactly is a democratic relationship when it comes to decide who benefits from the extra donations or the extra benefits distributed amongst non-shareholders?

4.   Ethics – importance

There are valid arguments about whether or not a company should adopt corporate social responsibility. But when it comes to ethics there is very little argument, and one doesn't have to appeal to a moral or ethical stance to see that companies should be ethical. An ethical stance can be justified on a purely economic basis. This rests on the fact that if the company acts unethically or immorally it will usually be found out and, when it is found out, it is usually punished, either through the operation of the law, compensation, or by the loss of goodwill and reputation. Therefore, an ethical company reduces risk.

Everyone can make mistakes but if you own up to mistakes then you are limiting the damage, and you are reducing the risk that further damage will be done and you will reduce the punitive damages that may later be awarded against you.

If risk is lower so too is cost. Ethical organisations often have to spend less ensuring that regulations are followed. Lower risks also means that banks and other providers of capital will be willing to supply the money at lower rates. In general lower returns are required because risk and return go together.

If your reputation is good, you are more likely to find good, willing partners with whom you can co-operate perhaps to form joint ventures or perhaps just to be satisfied customers.

A good reputation will tend to attract better employees. If possible, no one really wants to be associated with a company that has a poor reputation.

Finally, a good reputation should increase goodwill and increase sales. Companies that are regarded as being unethical tend not to be trusted and certainly not liked by customers. Customers will always be trying to find an alternative.

Therefore for very sound commercial reasons, it pays companies to be ethical.

5.   Ethics, the law and regulation

Ethics are a set of rules on how we should behave. In addition to ethics we receive rules from laws and from regulations, for example the regulations of a professional body such as ACCA.

This diagram shows how they are related. We have to comply with the law, but then, in addition we might have to comply with more demanding regulations and finally, we must comply with the system of ethics. Again, the assumption is that ethics will impose higher demands and duties than the law or regulations.

Law

Regulations
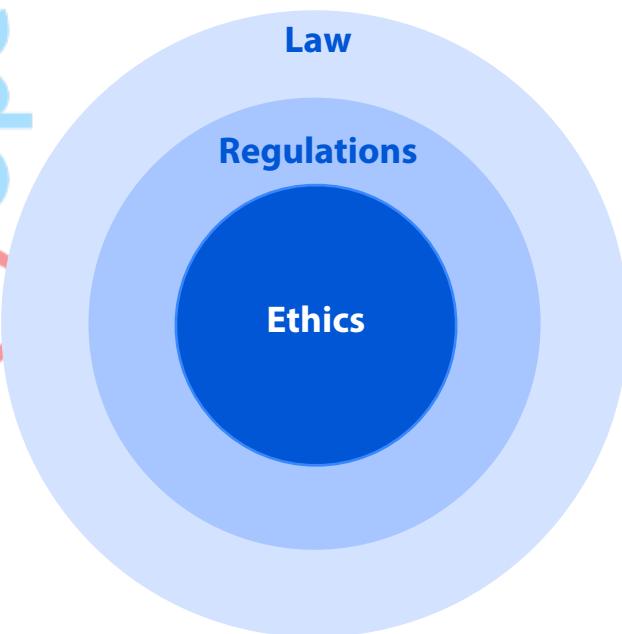
Ethics

6. Ethical principles

Ethics can be approached either by consequentialism or duty (the deontological approach)

Consequentialism

For example: utilitarianism 'the greatest good for the greatest number'. This might sound attractive and logical, but could, for example, be used to justify killing someone and using their body parts to save many others. So the approach of, say, one person dies to save six others is unlikely to be acceptable to most of us, even though it might represent the greatest good for the greatest number.

Duty (deontological approach)

Behaviour should be based on absolute moral values. We have a duty to follow those values or codes.

7. Relativist or absolute?

Relativism

There are many acceptable ethical standpoints. This approach provides some flexibility and more tolerance but might lead to too little guidance as to what is acceptable and an 'anything goes' approach. However, this approach is capable of providing some level of tolerance and cooperation towards those with different values

Absolutism

Behaviour should be based on absolute moral values, but what is their source? Although the followers of a given code have a sure basis for their ethics, perhaps the main danger is that of serious conflict between followers of different absolute ethical codes.

8. Examples of ethical problems facing managers.

◉ Profit/public good eg pharmaceuticals. Pharmaceuticals are expensive to develop and companies need profits. However, what approach should be taken to providing medicine to people who cannot afford to buy it at a price which yields a profit?

◉ Profit/health and safety eg aircraft. New aircraft (and new drugs) are tested very extensively, but at some point a line is drawn and the products are launched. If more testing were carried out the product might be slightly safer, but more testing costs more and delays any benefits arising form the product.

◉ Equal opportunities eg recruitment. Increasingly laws, certainly in the EU are intervening in matters of employment to reduce the likelihood of racial, sex, religious, sexual orientation and age discrimination.

◉ Payments:
  ‣ Extortion
  ‣ Bribery
  ‣ Grease money
  ‣ Gifts

Most people have no difficulty accepting that extortion is wrong. It is the obtaining of money or advantage by violence, intimidation and blackmail.

Bribery is also normally regarded as unethical. It is money given to bring about an illegal or dishonest act.

Grease money is more controversial. This is where you provide money to get someone, usually an official, to do what they should do anyhow. It is used to speed up legal transactions.

Gifts are normal business practice in some cultures, but could be regarded as a form of bribery in others.

9.   Promotion of ethical behaviour

The following values should promote ethical behaviour in organisations:

◉   Openness

   For example, employees must be open with their managers if an accounting error is found. Trying to cover it up could not be considered ethical.

◉   Trust

   For example, employees must trust that their managers, because of their knowledge and experience, give good guidance and direction.

◉   Honesty

   This does no need much expansion, but it is important that honesty with colleagues, suppliers and customers is encouraged.

◉   Respect

   This will encourage the proper treatment of stakeholders and reduce the chance that they are treated unethically.

◉   Empowerment

   Employees should be empowered to 'do the right thing' and to refuse to behave in a way they know to be contrary to the organisation's ethical code.

◉   Accountability

   Accountability means that people do not try to avoid issues or obligations. If you are given something to do, you should try to do it to the best of your ability.

10. The public interest

IFAC (The International Federation of Accountants) defines public interest as:

"The net benefits derived for, and procedural rigour employed on behalf of all society in relation to any action, decision or policy"

The 'public' includes investors, shareholders, employees, pensioners consumers, suppliers, tax payers, electorates and citizens.

Although the impact of accountants varies amongst these groups, there is a fundamental obligation for the accountancy profession to act in the public interest. 'Interests' include:

◉   Increased economic certainty in the marketplace

◉   Sound decision-making

◉   Sound and transparent financial information

◉   Comparability across different organisations and jurisdictions

◉   Sound corporate governance

◉   Effective performance management

◉   Increased efficiency and better resource utilisation

◉   Accountancy professionals play a vital role in delivering the public interests shown above and they should:

◉   Provide sound financial and non-financial reporting to shareholders, investors, taxpayers and all parties in the market place directly and indirectly impacted by financial and non-financial reporting from all organisations - including public sector organisations.

◉   Provide truthful, effective communication with parties (boards, shareholders management and others) directly and indirectly related to the corporate government processes for which they are responsible.

Essentially, acting in the public interest can be viewed as accountants and others exercising social responsibility. Their duties do not simply rest with their clients, employers or shareholders and they are encouraged or required to make positive impacts on all stakeholders.

11. Corporate codes of ethics

A corporate code of ethics can be defined as: a written set of guidelines issued by an organisation to its workers and management to help them conduct their actions in accordance with its values and ethical standards.

A code that is implemented and supported by top management can bring the following advantages to an organisation:

Areas covered can include:

◉   Equal opportunity/discrimination

◉   Bullying

◉   Use of the internet

◉   Reporting wrong-doing

◉   Bribery

◉   Money-laundering

◉   Response to conflicts of interest

The code must be fully supported by top management if it is to be effective. Staff training is also needed to illustrate decision-making processes. A code that is properly implemented can bring the following advantages to an organisation:

- Emphasises the organisation's values.
- Guidance to employees and directors.
- Risk reduction through avoidance of regulatory and legal problems.
- Good public relations and reputation.

Here is an excerpt from Amazon's code of ethics:

I.   Compliance with Laws, Rules and Regulations

Employees must follow applicable laws, rules and regulations at all times.

II.   Conflicts of Interest

...employees are expected .. to act ... in the best interests of Amazon.com. A "conflict of interest" exists when an employee's personal interest interferes with the best interests of Amazon.com. For example, a conflict of interest may occur when an employee or a family member receives a personal benefit as a result of the employee's position with Amazon.com. ... the Legal Department will consider the facts and circumstances of the situation to decide whether corrective or mitigating action is appropriate.

III.   Insider Trading Policy

Employees of the Company may not a) trade in stock or other securities while in possession of material non-public information or b) pass on material non-public information to ... or recommend to others that they trade in stock or other securities based on material non-public information.

IV.   Discrimination and Harassment

Amazon.com provides equal opportunity in all aspects of employment and will not tolerate any illegal discrimination or harassment of any kind...

V.   Health and Safety

Amazon.com provides a clean, safe and healthy work environment. Each employee has responsibility for maintaining a safe and healthy workplace by following safety and health rules and practices and reporting accidents...Violence and threatening behaviour are not permitted. ...

VI.   Price Fixing

Employees may not discuss prices or make any formal or informal agreement with any competitor regarding prices ...

VII.   Bribery; Payments to Government Personnel

Employees may not bribe anyone for any reason, whether in dealings with governments or the private sector. ....

VIII.   Record-keeping, Reporting, and Financial Integrity

Amazon.com's books, records, accounts and financial statements must be maintained in appropriate detail..

IX.   Questions; Reporting Violations

Employees should speak with anyone in their management chain or the Legal Department when they have a question about the application of the Code of Conduct ...The Amazon.com Legal Department has developed ... reporting guidelines for employees who wish to report violations of the Code of Conduct. ... Amazon.com will not allow retaliation against an employee for reporting misconduct by others in good faith...Employees who violate the Code of Conduct will be subject to disciplinary action up to and including discharge.

12. Ethical conflict and its resolution

An ethical conflict arises when a person encounters one or both of the following:

◉   Obstacles to following an appropriate course of action due to internal or external pressures.

◉   Conflicts in applying relevant professional and legal standards.

Here are some examples of ethical conflicts:

◉   You are a pharmaceutical company developing new drugs. How much testing should be carried out before the drugs can be marketed? More testing might identify unwanted side-effects, but more testing will delay treatment for people who are very ill.

◉   Your factory is old and inefficient and you are thinking of moving to new one with more efficient use of energy, in another area of the country with better transport connections. Carbon foot-print will be reduced, but existing employees will lose their jobs.

◉   You run an airline. You transport passengers for business and leisure and to visit overseas family members. However, airlines also cause noise and air pollution.

◉   House-builders create accommodation for families, but they might build over attractive land and displace wild-life.

◉   You are an accountant reporting to a lender on the prospects of a client. A poor report will lead to business closure and redundancies but an optimistic report might lead to the lender losing their investment.

◉   You might be asked by a manager to remain silent about certain matters that would have an adverse impact on the financial accounts of an organisation, thereby testing the employee's loyalty to his or her manager on the one hand, and the responsibilities as a professional on the other

◉   You might may consider that the employer's policies are unethical and may find it difficult to reconcile personal values with those of the organisation.

Once an ethical conflict is encountered, a member may be required to take steps to best achieve compliance with the rules, fundamental principles and the law. The IFAC Code offers a framework through which ethical dilemmas may be addressed.

When faced with ethical conflicts, the decision taker should:

(1)   Consider the facts of the situation.

(2)   Consider the ethical principles involved.

(3)   Consider relevant internal procedures. Many organisations will have well-developed procedures that should be followed in the first instance.

(4)   Consider the alternative courses of action.

▶   Escalate internally; consider grievance procedures.

▶   Document every action you take to resolve the conflict.

▶   Escalate externally to auditor, legal advisors, professional body.

Consider the consequences of each alternative course of action.

Ultimately, if resolution seems unlikely, disassociate yourself from the issue – in writing if necessary. Legal advice may be needed if this affects your employment status or if you are implicated in any way with the issue.

Note that in some cases there might be a statutory duty to report on problems (eg money laundering).

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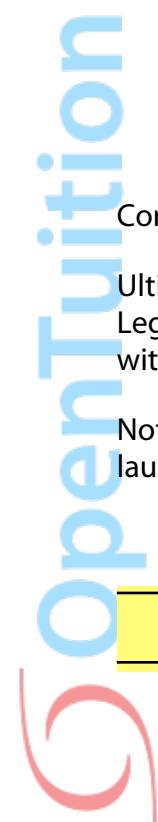
Chapter 6

SOME LEGAL OBLIGATIONS

1. Sources of law

We now come to the part of the syllabus which deals with law, and we start by looking at sources of law.

For countries in the European Union, European Union law will often supersede or overrule national law. European Union law can come into effect in two ways:

First, through **regulations**. If the European Union passes that regulation it immediately becomes directly applicable to all member states. They do not have to pass their own similar laws.

Secondly, the European Union can make **directives,** which are instructions to national governments to pass their own national laws to be in line with the directive. Normally governments are given a time period in which this legislation can be put forward and passed.

Most modern laws are legislation or statute, where they are written and passed by European or domestic parliaments. However, in some countries, particularly the United States and the United Kingdom, there is a very strong tradition of case law. Case law can come from the very ancient common law or equity, and often depends on the idea of **precedent.** Precedent means that if the case has been decided in a higher court then in the future lower courts must follow the precedent or example set by the higher court.

Case law does not overrule any type of statute law but even with tightly worded statute law an interpretation problems can exist and cases can be looked at to shed light upon interpretation and how the laws should be applied.

2. Data Protection Act

Many jurisdictions have laws protecting their population from misuse and exploitation of personal data. In the European Union, this is achieved through the General Data Protection Regulation which, in the UK, has been implemented in the Data Protection Act 2018.

The Data Protection Act in the UK relates to *personal* data ie data relating living people who can be identified from the information and which is processed wholly or partly automatically. We are not talking here about data relating to companies: we are talking about data relating to people.

The act sets out certain principles:

◉   Data shall be processed fairly and lawfully.

◉   It can only be obtained for one or more specified and lawful purposes.

◉   It must not be excessive to what's required.

◉   It must be accurate and kept up-to-date.

◉   It must not be kept for longer than necessary.

◉   IT must be held and processed securely.

The data **subject** is a person about whom the data is held and that person has certain rights:

◉   The right to be informed about the information being held.

◉   The right to access the data.

◉   The right to have the data rectified and corrected.

◉   The right to have the data erased (for example, if it is being held without good reason).

◉   The right to restrict processing. This is a limited right which might mean that data can be held but not processed or used.

◉   The right to data portability. Individuals have the right to obtain and reuse their data for their own purposes.

◉   The right to object. For example, to object to data being used for direct marketing.

◉   Rights relating to automated decision-making and profiling.

◉   There are special rules dealing with data held by the police and security services. You cannot, for example, insist that the government erases your criminal record, nor do you have a right to access data the security services might hold about you.

◉   The GDPR restricts the transfer of data outside the European Economic Area (where the GDPR applies) unless the rights of individuals are protected in some other way.

3.   Risks to data

Data can be subject to a number of risks.

◉ **Human error.** For example, someone deletes an important file or important information or indeed leaves a disk on the bus going home.

◉ **Technical problems**. Hard disks can crash and data can be lost.

◉ **Catastrophic events** would include events such as a fire or a flood destroying computers and the data they hold.

◉ **Malicious damage** occasionally occurs. Sometimes this is done by an employee who is unhappy or who has been sacked. Sometimes it is done by hackers, people from outside the organisation who infiltrate the organisation's data and change or steal it.

◉ **Industrial espionage or sabotage.** Rivals obtain any data for their own purpose or deleting your data to put you at a disadvantage.

◉ **Dishonesty or fraud**. For example, illegally causing cash to be transferred, goods to be delivered, receivables to be written off.

Organisations must try to safeguard their data. Not only can lost or stolen data cause financial loss and loss of reputation, but it can also in some cases leave them open to prosecution.

4. Health and safety – employer's duties

Health and safety legislation imposes duties on both employers and on employees. First, look at the employer's duties and there is probably not much here that is surprising:

◉   Work practices and the work environment must be safe and healthy.

◉   The plant and equipment should be maintained to the necessary standard.

◉   There should be information, instructions, training and supervision so people know how to work the machinery and that safe working practices are adopted.

◉   People should know that there is a policy.

◉   People should be aware of the organisation's safety policy

◉   Employers must carry out risk assessments, thinking ahead, identifying risks, seeing to what extent those risks need to be worried about, and providing training, guidance, and protection as necessary.

◉   Note there is a requirement to share hazards and risk information with others.

◉   You have to identify employees who are particularly at risk.

◉   You must employ competent safety and health advisors

◉   Within the organisation there will be a safety representative effectively from the employee side, and probably a safety committee which meets regularly to consider health and safety matters.

5. Health and safety – employees' duties

Note here, some of the employees' duties.

◉   They have to take reasonable care of themselves and others and, for example, these duties could be breached by employees playing practical jokes with their colleagues.

◉   They must allow the employer to carry out the duties in relation to safety. They mustn't interfere intentionally or recklessly with machinery for example by taking off guards from machine.

◉   They must inform the employer of any situation which they think is a danger. For example if an employee sees that a machine has deteriorated and is now perhaps dangerous they have a duty to inform their employer.

◉   They have to use equipment properly, making use of all the safety features that it may incorporate.

6. Health and safety policy

Some companies establish and publish a health and safety policy. This will usually have the following sections:

◉   A statement of the principles.

◉   There will then be a section on certain health and safety procedures, for example, relating to fire safety procedures or handling corrosive chemicals.

◉   They may emphasise how important it is to comply with the law, and in some cases state what is necessary to comply with the law.

◉   There may be a section on the detailed instructions about operating machinery.

◉   A section dealing with the training requirements, and perhaps the qualifications needed to ensure that health and safety policies are properly implemented.

7. Employment protection

The law increasingly gives employment protection. Health and safety was one aspect of that, and as we'll see later, there are laws governing equal opportunities. Here we deal with the termination of employment and this could be carried out in three ways:

◉   Retirement

◉   Resignation

◉   Dismissal

Fairly obviously, controversy is going to arise only in the case of dismissal. There are three ways in which an employee can be dismissed:

◉   A contract can be terminated. For example you could tell somebody that they are sacked.

◉   If someone has been employed on a fixed-term contract, let's say, three years and at the end of that term that contract is not renewed that also ranks as dismissal.

◉   Finally there is constructive dismissal. Constructive dismissal occurs when the employer breaches the contract of employment to such as extent that the employee is allowed to assume that he or she has been dismissed.

With dismissal we have to then ask, 'Has the dismissal been fair or unfair?'

8. Fair/unfair dismissal

Grounds for fair dismissal are as follows:

◉ Redundancy, provided that the selection for redundancy is fair and that the job disappears, then people may be made redundant. They may be entitled to some redundancy compensation.

◉ Legal impediment. For example, if to work in a particular organisation you have to be of a certain nationality and it's discovered you are not, then you can be dismissed.

◉ Non-capability. Simply not being able to do the job. Provided you were given adequate chance of improvement and training, and you still can't do the job then you can be dismissed for non-capability

◉ Misconduct. Provided a suitable series of warnings have been issued to give you a chance to improve you can be dismissed if the behaviour continues. There are certain cases of gross misconduct where you can be immediately dismissed.

◉ Other substantial reasons. For example, if you are married to a competitor your employer doesn't have to run the risk that commercial secrets are going to be transferred.

It's up to the employer to prove that the dismissal was fair, but there are certain cases of dismissal which will automatically be regarded as unfair, such as unfair selection for redundancy, involvement with a trade union, pregnancy, insisting on certain documentation, and where you carry out certain necessary activities in connection with health and safety.

Don't mix up unfair dismissal with wrongful dismissal. Wrongful dismissal is rather narrower. It deals purely with a breach of the contract of employment. So for example if your contract of employment said you are entitled to two months' notice and your employer only gave you one month's notice that will be wrongful dismissal although overall the dismissal could be fair.

9. Remedies for unfair dismissal

In the UK, someone who feels they've been unfairly dismissed can take their employer to an employment tribunal which is a form of court. If the tribunal finds for the employee then there are three possible remedies.

First is **reinstatement**. The employer gives the employee the old job back. However, you'll understand that usually the old job isn't available anymore because it will have been given to somebody else.

Secondly, the employer could take the employee back and **re-engage** them by giving the employee a job comparable to the old one. Of course there might not be a suitable job and again you'll realise by this stage of events the employee and the employer probably aren't on best terms anyhow.

And finally by far the most normal remedy is **compensation** and sometimes the compensation can be very high if it's found that the employer has acted very badly.

10. Consumer protection

The first type of protection arises from the law of contract. For example, you agree to pay someone $250 in exchange for a certain product or service. If these are not delivered, then you do not have to pay, or if you already had paid, you are entitled to get your money back. The courts will enforce these rights.

Most contracts include express terms and conditions or these might be implied. For example, where the buyer makes known to the seller any particular purpose for which the goods are being bought, there is an **implied condition** that the goods supplied under the **contract** are reasonably fit for that purpose.

If terms or conditions are broken then the injured party will be entitled to either:

◉   Damages (monetary compensation) or

◉   Rescission (which is the unmaking/reversal of a contract between the parties. When a contract is rescinded the parties are, as far as possible, returned to the position in which they were before they entered into a contract. Money and goods will be returned).

◉   In addition to long-standing remedies given through the law of contract, most jurisdictions have introduced further consumer protection legislation. For example in the UK:

◉   Consumer Rights Act 2015 which states that products must be of satisfactory quality, fit for purpose and as described. If they are not then you will be entitled to repair, replacement of a refund.

◉   General Product Safety Regulations 2005 gives consumers protection against the sale or manufacture of goods that are unsafe. Both civil remedies (eg damages) and criminal remedies (for example fines or even prison sentences for the directors of the supplying company) are available.

When you finished this chapter you should attempt the online AB MCQ Test

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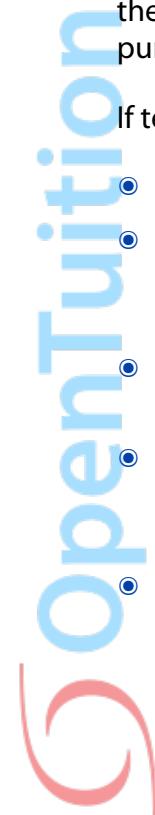
ACCOUNTING, INTERNAL CONTROL, FRAUD AND IT

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Chapter 7

ACCOUNTANCY, ACCOUNTS AND AUDITORS

1. Influence of the accountancy profession

The accounting profession has the very wide-ranging influence.

◉ **Financial accounting**. The accountancy profession deals with how items should be shown in the accounts. In other words, the profession establishes the accounting standards.

◉ **Auditing**. Once companies get to a particular size they have to be audited. An audit is an independent gathering of evidence that allows the accountants to report whether or not the accounts produced by the company show a true and fair view.

◉ **Management accounting**. Within companies there needs to be management accounting. This will be looking at budgets, future estimates and will be recording on a month-to-month basis how the company is doing, and investigating why it might not be on track to hit the required profits.

◉ **Consulting**. Many accountants also provide consultancy. For example relating to the IT system, particularly for the accounts function, and in setting up remuneration schemes and systems of internal control.

◉ **Taxation**. Accountants have a very important role in helping organisations to calculate their tax liabilities and reporting this to the government revenue authorities.

◉ **Government.** Within the public sector, that is government organisations, accountants are very important in tracking and recording the expenditure of public funds that have been raised by taxation.

Accountants are usually regarded as **professionals.**

The Marriam-Webster dictionary defines 'professionalism' as:

"the conduct, aims, or qualities that characterise or mark a profession or professional person"

and it defines a 'profession' as:

"a calling requiring specialist knowledge and often long-term and intensive academic preparation'. Certain attributes are implied or required by these definitions:

- Competence (specialist knowledge is worthless if it is wrong, out-of date or a mystery)
- Honesty and integrity (to apply knowledge and competence properly)
- Reliability (clients expect to have their requirements met on time)
- Flexibility (for example, staying late, working weekends to meet deadlines)
- Respect for others (for example, recognising that others might have valid but different views)
- Self-control (no matter how much provoked, professionals should remain calm and business-like).

2. Professional ethical codes

The International Federation of Accountants is the global organisation of the accountancy profession. It works in over 120 countries and jurisdictions to protect the public interest by encouraging high-quality practices by the world's accountants. Through its independent standard-setting boards, IFAC develops international standards on ethics, auditing and assurance, education and public sector accounting standards. It also issues guidance to support professional accountants in business, small and medium practices and developing nations.

The IFAC Code of Ethics is a good illustration of a professional ethical guide. The code states that the accountancy profession has a responsibility to act in the public interest and it then goes on to establish detailed guidance on fundamental principles and ethics. You will shortly see what the fundamental principles refer to.

Having identified the fundamental principles, the framework then requires accountants to identify, evaluate, and address the threats to compliance, applying safeguards to eliminate the threats or to reduce them to an acceptable level. For example, you will shortly see that one of the fundamental principles is independence. But how can an auditor be independent if the auditor receives an audit fee from the client? So there we have a fundamental principle and we have identified a potential threat to that fundamental principle. The safeguard applied is to put a limit on the amount of fees coming from any one client so that that the auditor would not feel unduly threatened if that client were to leave after a dispute about the financial statements.

3. ACCA Code of Ethics and Conduct.

The ACCA's fundamental principles are as follows:

◉ **Integrity**. Basically, this means that the members should be honest and straightforward. If they see something is amiss, they should say so. They shouldn't try to conceal, they shouldn't try to be ambiguous. They should state things plainly.

◉ **Objectivity**. Members should be influenced by the facts and the facts only. They must avoid bias, conflict of interest, and undue influence.

◉ **Professional competence and due care.** Accountants must keep themselves up to date with legislation and recent developments. They shouldn't take on work which they are not qualified for or for which they have no skills. They must be diligent, they must be careful.

◉ **Confidentiality**. Members, particularly perhaps auditors, have access to information which is highly confidential and which is price-sensitive. That information must be held confidentially. Members should not disclose confidential information unless they have a legal or professional duty to do so. An example of the legal duty to disclose information can arise if a member thinks that a client or the person that they are working for is involved in money laundering. Many countries have very strong regulations nowadays stating that money laundering suspects should be reported to the authorities.

◉ **Professional behaviour**. Accountants should comply with the law and they should avoid any action which discredits the profession. So, for example, when they are trying to advertise their services, they shouldn't say that other members are bad or poor. They should confine themselves to promoting what they are good at. They shouldn't rubbish other professionals.

4. Users of accounting information

The potential uses of accounting information include:

◉   Managers of the company.

◉   Shareholders of the company.

◉   Trade contacts: suppliers and customers.

◉   Providers of finance to the company.

◉   The Inland Revenue (tax authorities).

◉   Employees of the company.

◉   Financial analysts and advisers.

◉   Government and their agencies.

◉   The public.

5. Management accounts and financial accounts

Accounting information is usually divided between management accounts and financial accounts.

Management accounts are:

◉   Internal.

◉   They can be in any format.

◉   They look to the future, for example setting budgets; and back, for example looking at performance to date.

◉   They are often what's known as 'ad hoc'. That means they can contain non-routine special reports.

◉   Their form and content is not governed by statute. Management accounts are governed simply by the need for information and how that can be best provided.

◉   Finally, they are not subject to audit or independent checking of any sort.

◉   Management accounting deals primarily with setting budgets (a financial plan), budgetary control, planning and recording costs and providing information for decision making., for example, which products are the most profitable. When budgets are compared to actual results, the differences are known as **variances**. These van be favourable (costs less than budget costs, sales higher than budget sales) or unfavourable/adverse (costs higher than budgeted, sales lower than budgeted). Large variances imply that something unexpected happened and management can focus their attention on investigating their cause.

Financial accounts are:

◉ The published accounts of a company, particularly provided for the members or shareholders of the company.

◉ The format and content is tightly regulated by statute.

◉ They always look back, what the balance sheet at a particular date was at what the profit and loss account for a period was.

◉ They are absolutely routine, normally appearing annually.

◉ They must comply with statutory and other accounting rules

◉ Often they are subject to audit and certainly are once a company becomes a significant size.

◉ Financial accounting deals primarily with recording financial transactions and producing financial statements. Financial statements consist of:

   ‣ Statement of financial position

   ‣ Statement of profit or loss

   ‣ Statement of cash flows

   ‣ Notes to the financial statements

◉ Statement of changes in equity.

◉ It is becoming increasingly common for companies to publish, as part of their annual reports, sustainability and integrated reports. These widen the information given to shareholders and will, for example, indicate human capital (the skills of employees) and resource capital as well as financial capital and steps the company is taking to achieve long-term sustainability (for example, using renewable energy sources and reducing waste).

6.   External audit

We have made several references to the term "audit" and we were referring to external audit. So let's just cover a little bit more about what that might entail.

If you remember back to the problems of corporate governance, these arose from the fact that the owners of the company, the shareholders, appointed directors to run the company on a day-to-day basis. But how do the owners know that the directors are running the company properly? Originally the only real check was that once a year the directors had to produce a set of financial statements (accounts). To try to ensure that the financial statements are what's known as "true and fair," independent, **external** auditors are appointed by the members to check them.

If the directors do not file financial statements on time there are severe penalties because this information is required for the public record. In the UK, all companies - private or public, large or small, trading or non-trading - must send their accounts and reports to Companies House every year. If you submit company accounts and reports late, the law imposes an automatic penalty. Failure to file annual accounts is a criminal offence which can result in directors being fined personally in the criminal courts.

The financial statements comprise the:

◉   Statement of profit or loss.

◉   The statement of financial position (often colloquially called the balance sheet).

◉   Cash flow statement

◉   Notes to these documents.

◉   Statement of reserves.

The external auditors look at these financial statements, do many checks, look for supporting evidence about the figures in them, and come to a conclusion about them. The conclusion is given in the **Audit Report**, which is attached to the financial statements.

◉   'True' means that the financial statements are more or less arithmetically accurate.

◉   'Fair' is a slightly more difficult concept and means they are not misleading. Something can be arithmetically accurate, yet still give an incorrect impression.

Additionally, the auditors examine the system of internal control of the company and transactions that happened during the year and they then produce reports to management about the company's accounting procedures. So if the auditors find, for example, that invoices are not being priced up properly, they will report this to management, and management can then take action to try to ensure that and errors or problems do not occur again in the future.

If the auditors conclude that there are material misstatements in the financial statements (ie significant errors) then they will be unable to state that the financial statements show a true and fair view and will modify their audit report appropriately to explain the issue: thus warning the shareholders about the problem.

It is important to note what external auditors do NOT do:

◉   They do not prepare the financial statements: management does.

◉   They do not check every transaction: this would not be economically viable in all but the smallest companies. Instead, they look at a sample of transactions.

◉   As a consequence of the above, the auditors do not guarantee that the financial statements are correct. They can only give **reasonable assurance that the financial statements are free from material misstatement.**

◉   They do not specifically look for fraud. Many incidents of fraud are relatively small and fraudsters often cover their tracks very cleverly. There is a reasonable chance of large frauds being detected but it is not the auditors' duty to guarantee that no frauds have occurred.

◉   They do not give guidance as to whether the company is a good one to invest in.

◉   They are not responsible for establishing the system of internal control: management is. However, they will inform management if any internal control deficiencies are discovered during their audit.

Note: most countries' legislation allows audit exemptions for very small companies (such as family companies) because in such companies the owners are usually involved with the day-to-day activities of management so an independent audit is unnecessary.

7.   The regulatory system

In the UK, financial statements are regulated as follows:

◉   **Company law**. This, for example, insists that companies produce accounts roughly every year. Although there are certain statutory disclosures set out in company law, by and large company law doesn't go into huge amounts of detail about exactly how different elements of the financial statements must be shown. That's really too complex a matter to have in law because frequent changes and great expertise is needed to decide how things should best be shown.

◉   **Accounting standards.** The detailed regulations about disclosure and presentation are usually found in the accounting standards. The major bodies of accountants must subscribe to the accounting standards. The system for establishing accounting standards in the UK is headed up by the Financial Reporting Council. Internationally   this function is carried out by the IASB (International Accounting Standards Board). The IASB works towards harmonising accounting standards throughout the world by issuing International Accounting Financial Reporting Standards (IRFRs). The FRC usually adopts IASB standards. In general, all sets of financial statements should comply with the financial reporting standards.

◉   **Auditing standards** are governed by IFAC, the International Federation of Accountants and, in particular one of its sub-committees the IAASB (International Auditing and Assurance Standards Board). Auditing standards set out how audits should be conducted and how audit evidence should be obtained.

◉   **IESBA (International Ethical Standards Board for Accountants).** This is part of IFAC and sets out the ethical framework for accountants (eg integrity, objectivity, professional competence and due care, confidentiality and professional behaviour). By and large, ACCA adopts   the IESBA's code as its Code of Ethics and Conduct.   From time to time urgent issues arise, for example, the recent banking crisis could potentially have given rise to issues which had to be dealt with very quickly. Rather than going through the full and perhaps rather slow process of establishing financial reporting standards in the normal way, the Urgent Issues Task Force can deal with these urgent matters quickly.

- ◉ **Financial Reporting Review Panel.** Sometimes companies depart from the financial reporting standards and the Financial Reporting Review Panel is concerned with examining and questioning why that has taken place. Occasionally they may conclude the departure is justified, but this tends to be a relatively rare occurrence.

- ◉ **Public Interest Oversight Board.** Oversees IFAC and concentrates on audit, education and ethics. It has representatives from a wide range of users of financial statements. It widens the range of opinions taken into account when accounting and auditing standards are being formulated.

- ◉ **EU Law.** Listed companies in the European Union have to adopt IFRSs.

- ◉ **GAAP**

    GAAP stands for Generally Accepted Accounting Practice (UK) or Generally Accepted Accounting Principles (in any parts of the world).. This is a common set of accounting principles, standards and procedures that companies use to compile their financial statements.

    GAAP is a combination of statute, accounting standards, international accounting standards, stock exchange rules, and convention. GAAP are imposed on companies so that investors have a minimum level of consistency in the financial statements they use when analysing companies for investment purposes. Companies are expected to follow GAAP rules in reporting their financial data through their financial statements.

8. Internal audit

The role of internal audit is:

..to provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively (Chartered Institute of Internal Auditors).

Internal auditors should be independent from the company's operations and, in particular, independent from the company's accounting operations. They should have access to the board, usually through the audit committee if there is one.

Internal audit should consist of qualified, skilled and experienced staff. The members of the internal audit department should comply with ethical and professional standards.

Although internal audit can be assigned a number of tasks, most of their regular work is examining the design and practical operation of the company's system of internal control. Internal auditors obtain very detailed skills and knowledge about their company's operations and this can provide very useful information and recommendations for the board to consider.

External auditors sometime liaise with internal audit, for example, to avoid audit work being duplicated. However, the external auditor is sole responsible for the opinion expressed in the audit report attached to the financial statements.

9.   Internal audit compared to external audit

	Internal audit	**External audit**
Appointed by	Management	Shareholders (members)
Report to	Management	Shareholders (members)
Employed by	Company	Independent firm
Scope of work	Potentially very wide. Whatever is required by management. Most commonly to assess the operation of the company's internal control systems, but special investigations might be undertaken such as looking into an incident of fraud or assessing a department's value for money.	To report on whether the financial statements show a 'true and fair' view.
Work governed by	The company's management.	The law, auditing standards and accounting standards. External auditors have a legal right to see all company documents they require and to receive all explanations they ask for.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 8

INTERNAL CONTROL, FRAUD

1. Internal controls

The term 'internal controls' refers to the collection of mechanisms whereby an organisation tries to ensure that all its transactions are properly authorised and recorded, and that its assets are safeguarded.

The proper management of a business (and indeed now part of corporate governance requirements) means that there has to be a good system of internal control in place if directors and other managers are going to exercise their stewardship responsibilities correctly. It is the directors' responsibility to ensure that there is a good system of internal control operating.

The system of internal controls fall into two parts:

Control environment. This essentially refers to the culture within the organisation. Some organisations put a very high priority on having a good system of internal control in place whereas others see these as a nuisance. If the system of internal control is going to be effective there must be a good control environment, otherwise detailed controls which are there in theory would simply be ignored in practice because people don't feel that these are important.

Detailed control processes. For example:

◉ If someone works overtime you expect this to be authorised by a manager.

◉ Once a supplier's invoice has been paid, you expect that to be cancelled in some way to prevent it being paid twice.

◉ Before you send goods to a new customer you should take up credit references, perhaps by writing to their bank and then setting a credit limit.

◉ It should be impossible to dispatch goods to that customer if it puts it over their credit limit

◉ There should be a system of reviewing receivables and following up slow payments to try to prevent the occurrence of bad debts.

◉ Segregation of duties means that each part of a transaction is carried out by a different person. For example, one person orders goods, another checks their receipt, another checks the invoice and another pays it. Splitting up a transaction in this way reduces the incidence of fraud and error.

◉ Internal control methods include

▸ Physical safeguarding (eg for cash and inventory)

▸ Authorisation (eg authorising overtime)

▸ Segregation of duties (eg splitting up a transaction so that several people are involved)

▸ Reconciliations (eg comparing the cash book to the bank statement or payables balances to suppliers' statements)

▸ Trial balances and control account reconciliations

- ▸ Recalculation and re-performance (eg recalculating an invoice and ensuring the correct prices are used)

- ▸ Internal audit.

- ▸ Some businesses deal with clients' money. For example, lawyers often hold clients' cash during property purchase transactions so that when all the legal formalities are sorted out, payment can be quickly made by the lawyer on behalf of the client. There are strict rules that separate clients' money from that of the legal firm and client money must be kept in a completely separate client   bank account. If the firm of lawyers fails financially, the clients' money is kept safe as it has been held in the separate account. Mixing up client cash with the company's cash is likely to lead to severe disciplinary measures against that company.

2.   Controls in IT systems

IT poses particular risks to organisations' internal control and information systems. Once an error is introduced many transactions can be quickly affected and this can lead to their operations being severely disrupted and subsequently to lost sales, increased costs, incorrect decisions and reputational damage.

2.1   Risks include:

◉ Reliance on systems or programs that are inaccurately processing data, processing inaccurate data so that they report inaccurate, misleading results.

◉ Unauthorised access to data leading to destruction of data, improper changes to data, or inaccurate recording of transactions.

◉ Particular risks may arise where multiple users access a common database on which everyone in the organisation relies. The data could be incorrectly amended and all users will be affected.

◉ The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties.

◉ Unauthorised changes to data in master files. For example, changing a selling prices or credit limit.

◉ Unauthorised changes to systems or programs so that they no longer operate correctly and reliably.

◉ Failure to make necessary changes to systems or programs to keep them up-to-date and in line with legal and business requirements.

◉ Potential loss of data or inability to access data as required. This could prevent, for example, the processing of internet sales. These problems can be caused by viruses, hacking (improper outside access to data) and disasters affecting the IT system, such as a fire destroying the computers.

◉ Cyber-attacks in which outside actors might change or steal information, take over processes such as the computerised control of machines, mount denial of service attacks in which web-sites are bombarded messages or demands for information so that the web-site goes down. Cybersecurity is the system of technology, processes and controls used to protect systems form cyber attacks.

2.2   Controls in computer systems can be categorised as general controls and application controls.

General controls:

These are policies and procedures that relate to the computer environment and which are therefore relevant to all applications. They support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations. A data centre is a central repository of data and it is important that controls there include back-up procedures, anti-virus software and firewalls to prevent hackers gaining access and other forms of cyber attack. Organisations should also have disaster recovery plans in place to minimise damage caused by events such as floods, fire and terrorist activities.

- System software acquisition, change and maintenance. System software refers to operating systems, such as Windows or Apple's OS. These systems often undergo updates as problems and vulnerabilities are identified and it is important for updates to be implemented promptly.

- Application system acquisition, development, and maintenance. Applications systems are programs that carry out specific operations needed by the company – such as calculating wages and invoices and forecasting inventory usage. Just as much damage can be done by the incorrect operation of software as by inputting incorrect data. For example, think of the damage that could be done if sales analyses were incorrectly calculated and presented. Management could be led to withdraw products that are in fact very popular. All software amendments must be carefully specified and tested before implementation.

- Access security. Physical access to file servers should be carefully controlled. This is where the company keeps it data and it is essential that this is safeguarded: data will usually endow companies with competitive advantage. Access to processing should also be restricted, typically through the use of log-on procedures and passwords.

- Any system connected to the Internet must be protected by:

  ‣ Passwords.

  ‣ Virus-checkers

  ‣ Fire-walls (which detect and prevent unauthorised access from outside the system).

  ‣ Encryption. Messages are encrypted before being sent and can be decrypted only by the proper recipient. Anyone intercepting the message will be unable to understand it and will be unable to change it without detection.

2.3   Application controls:

Application controls are manual or automated procedures that typically operate at a business process level, such as the processing of sales orders, wages and payments to suppliers.

These controls help ensure that transactions are authorised, and are completely and accurately recorded, processed and reported. Examples include:

◉   Edit checks of input data. For example, range tests can be applied to reject data outside an allowed range; format checks ensure that data is input in the correct format (credit card numbers should be 12 digits long; dependency checks where one piece of data implies something about another (you have probably had a travel booking rejected because you inadvertently had a return date earlier than the outward date); check digits, where a number, such as an account number, is specially constructed to comply with mathematical rules.

◉   Numerical sequence checks to ensure that all accountable documents have been processed.

◉   Drop down menus which constrain choices and ensure only allowable entries can be made.

◉   Batch total checks. Here, the total value of the documents to be processed (for example ,invoices from suppliers) is first calculated. Each one of the batch of documents is then keyed in and the computer checks that the total of the documents entered agrees with the pre-established batch total.

On-line, real time systems can pose particular risks because any number of employees could be authorised to process certain transactions. Anonymity raises the prospect of both carelessness and fraud so it is important to be able to trace all transactions to their originator. This can be done by tagging each transactions with the identity of the person responsible.

Cyber-espionage is also a growing threat. Governments, competitors and criminals attempt to steal intellectual property or information about customers and contracts. Quite obviously the theft of valuable know-how will undermine a company's competitive advantage and it is essential that for organisations to defend themselves as far as possible against these threats.

3. Implications of fraud

If a good system of internal control is not in place and if corporate governance is not operating correctly then there is a much higher chance that fraud will occur, and this has got serious implications.

◉ **Financial.** The company may find that it hasn't made the profit it thought, it may have lost assets, it might have a liquidity crisis. Most fraud means removing assets from a company and, of course, this will adversely affects its performance.

◉ **Misrepresentation.** At a higher level directors sometimes commit fraud to misrepresent how the company is actually doing, and there have been several high profile events recently where financial institutions have pretended to be in a much better situation than they actually were.

  If the finances of the company are incorrectly recorded then incorrect decisions could be made. The company might decide to expand when in fact the cash is not there or it may think a particular cost is very high, but that cost has artificially been boosted because of a fraud. The misrepresentation could also encourage investors to pay a higher price for shares than they are actually worth.

◉ **Reputation**. The reputation of the company could be badly affected, and indeed many companies, for relatively minor frauds, prefer to keep these secret. It doesn't look good if the directors have to admit that someone has been defrauding the company over a number of years. It rather makes people ask: what have the directors been doing? How competent are they? Do we want to have dealings with that company?

For fraud to occur the following conditions are necessary:

◉ Opportunity: for example, poor internal control, unguarded inventory and unguarded cash

◉ Motivation/incentive: for example, an employee being short of money - or just simple greed.

◉ Attitude: the willingness to carry out the fraud because of poor ethical principles and poor guidance.

4. Detecting and preventing fraud

Preventing and detecting fraud depends on the following:

First, **a good internal control system**. As we said before, make sure that overtime payments are authorised, purchases are authorised, invoices are cancelled, bank reconciliations are performed and so on. This makes it much more difficult that either innocent or deliberate manipulation of figures can occur. Part of the internal control system will be internal audit. This is a team of people within the organisation whose function is to go around the organisation, checking if the system of internal control is effective and being operated as expected.

Secondly, **ethics.** It goes without saying that if everyone within the company has high ethical principles, fraud will not be committed. It's therefore essential to emphasise the role of ethics. This is particularly important at the higher levels of the company where managers might be induced to misrepresent figures so the company appears to be doing well.

Both control systems and ethics depend on training. If training is not given:

How will people know how to act appropriately?

How to comply with the internal control system as set down?

How to deal with ethical dilemmas? (Which can sometimes mean asking for help and advice.)

5.   Money laundering: introduction

Money laundering is a process whereby the proceeds of criminal activity are converted into assets appearing to have a legitimate origin.

Dirty money is made clean-looking. The money typically comes from extortion, drugs, prostitution, illegal gambling, illegal arms sales and people-trafficking.

6.   The stages of money laundering

The process of money laundering can be described in the following three steps:

Placement: this is the process of introducing the money into a legitimate business activity so that its origins appear bona fide. Methods include:

⦿   Blending funds: mixing the dirty money with legitimate cash such as boosting the cash takings n a business. Tax will have to be paid, but that's a small price if the remainder of the money is safe-guarded.

⦿   Gambling: winnings are artificially increased and this can be used to explain the source of the funds.

⦿   Currency smuggling: move the cash to a lax jurisdiction where few questions will be asked.

You will notice that cash transactions facilitate placement because cash is relatively difficult to trace compared to bank or credit transactions

Layering: repeated transfer of money through different bank accounts and different countries in an attempt to conceal or camouflage its origins. That way, even if the placement process becomes known to the authorities it becomes difficult for them to trace the cash and recover it.

Integration: the movement of previously laundered money into the economy so that the money can be safely used. Examples include the purchase of assets such as expensive cars and art works and jewellery.

7. Legislation

Many countries now have legislation attacking money laundering and the proceeds of crime and also to interfere with money being used by terrorism organisations. As well as creating criminal offences for the immediate perpetrators of the crimes the legislation can also cover the behaviour and responsibilities of auditors and accountants.

In the UK the Proceeds of Crime Act 2002 sets out five types of offence:

◉   Concealing, disguising, converting or transferring money that is from the proceeds of crime.

◉   Entering into an arrangement to launder the proceeds of crime or having the suspicion that money laundering is taking place yet not reporting it.

◉   Acquisition, use and possession of criminal property

◉   Failure to disclose

◉   Tipping off

The penalties are severe. For example, taking part in money laundering attracts a maximum prison sentence of 14 years and/or a fine.

Note that if the prosecution can show that a defendant had a even *suspicion* that money had criminal origins that the defendant can be found guilty of these crimes. So, 'turning a blind eye' is no defence

Obviously an accountant could be directly participating in or abetting money laundering, but here we will assume you are all ethical and won't take part in that. However, it is easier to inadvertently commit some of the other offences.

For example, suspicions would be expected to arise if:

◉   You work in a bank and see a customer dealing in large amounts of cash without any reasonable explanation of their origin.

◉   You are an auditor and see cash passing through various banks accounts for no apparent reason.

Tipping off is the offence of acting in a way that discloses to the potential suspect information that is likely to prejudice an investigation. So, saying to a client "I think this is money laundering and I am going to report my suspicions to the authorities" is clearly tipping off. However, what if you repeatedly ask for evidence about a transaction. The client then knows that you might be suspicious and that your next step is to report the matter. However, if you make no enquiries at all or inadequate enquiries, you might fail to uncover a perfectly innocent explanation.

8.   Risk factors for money laundering

- A cash-based business

- Many similar deposits and withdrawals in various bank accounts for not obvious reason

- Many jurisdiction involved in the transfer of money

- The use of tax havens

- Bearer bonds or cheques

- Higher profits than could be reasonably expected

- Poor documentation for transactions

- Secrecy

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 9

BUSINESS USE OF COMPUTERS AND IT

1. Spreadsheets

You have almost certainly used a spreadsheet, such as Excel.

The program presents you with a grid and each cell can be referenced by its column and row. Each cell can contain:

⦿   A number, or

⦿   Text or

⦿   A formula

The formula can reference other cells so that if cell A2 contained 5 and A3 contained 9, if you typed into cell A4:

=A2 + A3

it would show 14. If A2 were changed to 10, then A4 would immediately change to 19.

Spreadsheets are immensely useful for creating budgets and cash flows. Usually, the amounts to put into these documents are not certain and spreadsheets allow assumptions to be changed and the budget is immediately recalculated.

Graphs and charts can be created by the spreadsheet by defining which cells are to be shown on the diagram. Charts and graphs can often be more informative and memorable than simple columns of figures.

2. Databases

We probably understand that databases hold large amounts of data. They do, but their key characteristic is that many people can share the data for their own purposes. So an employee database would allow the wages department to calculate wages, the personnel department to see who had a certain qualification and the costing department to see how much an hour of someone's time would cost.

Each piece of data is held only once. This means that it only has to be updated once and also that every user sees the same data. There will be no timing differences where two versions of the records might show different information.

Because there is such a huge and varied amount of data, the data must be safeguarded and access to the database must be strictly controlled so that users cannot access data that is none of their business and that data cannot be incorrectly changed - otherwise a wide variety of users is likely to be using wrong information.

Typically, a database will consist of a number of related computer files. However, files are usually constructed as follows:

Each **file** consists of **records**. Each record is for an entire such as a customer, a supplier or an employee.

Each record consists of fields or **attributes**. So an employee file would have attributes of: employee number, name, salary, tax code, department, date joining….etc. One attribute is unique to each record so that the record can be clearly identified. In the employee example, employee number would be the normal unique attribute (or key field).

Each attribute is made up of **characters**. So if the name attribute were 'J Smith', each letter of the name is a character.

One data has been entered into the database is can be easily retrieved using a **structured query language** (or SQL)**.** So:

Command	Interpretation
From: Employee	From the employee database
Select: Name, salary	Select or show the employee name and salary
Where: Salary>$40,000	Only pick employees whose salary is> $40,000
Order: Name	Display in alphabetical order of name

You will easily appreciate how useful it can be to search and retrieve information relating to specific entries - for example in a customer database finding all customers who have bought goods worth more than $500,000.

3. Big data

There are many definition the term 'big data' but most suggest something like the following:

 "Extremely large collections of data (data sets) that may be analysed to reveal patterns, trends, and associations, especially relating to human behaviour and interactions."

In 2001 Doug Laney, an analyst with Gartner (a large US IT consultancy company) stated that big data has the following characteristics, known as the 3Vs:

◉ Volume: a very large amount of data. More than can be easily handled by a single computer, spreadsheet or conventional database system.

◉ Variety: disparate non-uniform data of different sizes, sources, shape, arriving irregularly, some from internal sources and some from external sources, some structured, but much of it is unstructured.

◉ Velocity: data arrives continually and often has to be processed very quickly to yield useful results.

Sometimes a fourth 'V' is added: veracity: Is the data true? Can its accuracy be relied upon?

Think about the volume, variety and velocity of data that the following applications deal with:

◉   Retailers:

▸   Via loyalty cards being swiped at checkouts: details of all purchases you make, when, where, how you pay, use of coupons.

▸   Via websites: every product you have every looked at, every page you have visited, every product you have ever bought. (To paraphrase a Sting song "Every click you make I'll be watching you".)

◉   Social media (such as Facebook and Twitter): Friends and contacts, postings made, your location when postings are made, photographs (that can be scanned for identification), any other data you might choose to reveal to the universe.

◉   Mobile phone companies: Numbers you ring, texts you send (which can be automatically scanned for key words), every location your phone has ever been whilst switched on (to an accuracy of a few metres), your browsing habits. Voice mails.

◉   Internet providers and browser providers: Every site and every page you visit. Information about all downloads, searches and all emails (again these are routinely scanned to provide insights into your interests). Search terms you enter.

◉   Banking systems: Every receipt, payment, credit card payment information (amount, date, retailer, location), location of ATM machines used.

This data can be both structured and unstructured:

◉   Structured data: this data is stored within defined fields (numerical, text, date etc) often with defined lengths, within a defined record, in a file of similar records.

◉   Unstructured data: refers to information that does not have a pre-defined data-model. It comes in all shapes and sizes and this variety and irregularities make it difficult to store it in a way that will allow it to be analysed, searched or otherwise used.

Clusters of computers are needed to hold the vast volume of information. Single servers are of little use and thousands of machines are needed each offering local computation and storage.

The processing of big data is generally known as **big data analytics** and includes:

◉   Data mining: analysing data to identify patterns and establish relationships such as associations (where several events are connected), sequences (where one event leads to another) and correlations.

◉   Predictive analytics: a type of data mining which aims to predict future events. For example, the chance of someone being persuaded to upgrade a flight.

◉   Text analytics: scanning text such as emails and word processing documents to extract useful information. It could simply be looking for key-words that indicate an interest in a product or place.

◉   Voice analytics: as above with audio.

◉   Statistical analytics: used to identify trends, correlations and changes in behaviour.

Google provides web-site owners with Google Analytics that will track many features of web-site traffic.

Obviously, organisations which amass big data have to be very careful to hold it securely and confidentially. Leaks of data are expensive both in terms of reputational damage to the company, damages claimed by victims and fines imposed by regulators.

4.   Artificial intelligence

Artificial intelligence (AI) is a general term that uses to a number of technologies to make machines 'smart'. It can use techniques such as machine learning, image recognition, speech recognition and deep learning, which uses networks capable of learning unsupervised from data that is unstructured.

One of the recent great successes of AI was a program called AlphaGo, developed by DeepMind, a subsidiary of Google. The program was taught the rules of the game Go, then it proceeded to play thousands of games against itself, gradually learning winning strategies. No human was involved in coaching the program, yet after a relatively short time it became world-beating and, in fact, discovered a number of innovative and unexpected winning moves.

Many organizations are now investing in AI research and applications to automate processes and to enhance, support or replicate human intelligence. The applications are particularly relevant to analytical and decision-making tasks.

AI can have great relevance to auditing. For example, a good auditor might know almost instinctively that a set of financial statements 'looks wrong'. Or the auditor might identify inconsistencies between different amounts. For example, if average borrowings have increased it would be reasonable to expect interest payments to increase also. AI opens the possibility that machines could learn to identify potential problems then alert human auditors who could investigate further.

Artificial Intelligence has also been used successfully in fraud detection. AI can learn which account movements are normal (for example, that a payment happens regularly each month) and therefore detect irregularities and predict possible fraudulent behaviour. It will then automatically alert users so that further investigation can be carried out.

Artificial Intelligence can also be used to create predictive models to forecast revenues and cash flow. For example, AI can analyse large amounts of data better than humans and can detect very complex or subtle patterns. This allows them to make more precise predictions in more complicated environments and, vital to the idea of learning, analyse why sometimes the predictions are wrong so that next time results should be more accurate.

5. Accounting packages

Accounting packages maintain the business accounts, allowing the debits and credits to be easily recorded. They will always ensure that debits = credits, and that the trial balance will therefore always balance.

Once the debits and credits have been recorded, accounting packages then allow a series of reports to be produced quickly. For example:

◉   Profit and loss account

◉   Statement of financial position

◉   Aged receivable analysis

◉   Lists of amounts owing from customers/owing to suppliers

◉   Inventory movements

◉   Invoice production

◉   Comparison of actual and budgeted results (if budgets had been set up), comparison of this period to last period etc.

Accounting packages allow accounting information to be:

◉   Recorded more quickly

◉   Recorded more accurately

◉   Analysed and used more quickly and creatively.

◉   Recorded and used more economically (fewer employees are needed).

Packages can be a simple or as complex as the business needs and now, even very small businesses are unlikely yo use manual recording methods.

6.   Cloud computing

In traditional computer networks each user has a computer know as 'a client' and documents, spreadsheets etc would be stored centrally on a machine called 'a server'. When a document is being worked on it is copied from the server to the client machine where it is operated on by Word, Excel etc. It is then saved back to the server.

The advantage of this is that the central storage of documents means that they can be used and shared by everyone on the network. A major disadvantage is that every client machine has to have a copy of the programs: Word, Excel etc. Not only is this expensive, it can cause major problems if the software has to be updated as every copy has to be changed. Inevitably, different machines end up with different software versions.

Another problem is that client machines have to be powerful enough to run every application they might need to, even if powerful computing were needed only occasionally (such as by graphics-intensive programs).

With cloud computing there is only one copy of each program and this is held on the server within a web-based interface. Users log onto the system and processing is then carried out on the server or 'cloud' of servers. It appears to each user that they are operating a local version of the software but the processing is actually performed on the server. As more computer power is needed more cloud resources can be used. This gives great flexibility.

Client machines can be 'thin clients', meaning that they are not powerful. Hardware, software and maintenance costs are greatly reduced, though the system is more vulnerable to disruption as continuous links are needed to the server. For example, relatively small machines, such as laptops, can be used for computation intensive graphics operations because the processing is performed on the server and the operator's commands and computer results are shown on the local laptop.

Hotmail and Gmail are examples of cloud processing. Whenever you log on and write an email, the processing is carried out by the system's cloud - not on your local computer. All your computer has to do is to handle the interface.

7.   Blockchain technology and distributed ledgers

Blockchain technology allows data to be added to a set of records, but once added it cannot be changed without detection.

When a piece of data is added (a 'block') a hash amount is calculated by a complex mathematical process. When another block is added (like adding a link in a chain, hence 'blockchain') the hash of the previous block is also included with the new block and a hash of the whole new block produced.

Any alteration of data in, say the first block, will change its hash, but that will then not agree with what is recorded in the second block, and so on down the chain. The integrity of the records has been interfered with and will lead to internal inconsistency that could only be rectified by huge computational power. New blocks can be added, but previous ones cannot be amended or removed without detection.

For example, information in each block could be dealing with ownership, taxes paid and planning permissions given for a piece of land so that the chain of blocks will display everything about the land in a way that cannot be changed, but which can be extended.

Another feature of blockchain technology is that the information is held simultaneously in many computers on a network and the copies of the information are continually compared and validated. This distributed processing effect, known as a **distributed ledger**, means that the blockchain is secure from attack. If one computer is damaged, there are many copies still left on the network.

Cryptocurrencies, such as Bitcoin and Ethereum, make use of blockchain technology to record transaction and ownership. The following is a simplified explanation.

(1)   Think of a bitcoin as especially constructed number. It takes enormous computing power to produce a valid number.

(2)   When you acquire a bitcoin your record of ownership is entered into the bitcoin's blockchain and you are given a key (like a password) that will let you carry out transactions with the bitcoin.

(3)   If you pay someone using the bitcoin, the blockchain is updated with information about that transaction by adding another block. It will note you do not own it and that someone else does and the date and time of the transfer is noted too.

To update the blockchain you have to use the key, so that keeps the transaction secure. You will not be able to spend that bitcoin because the blockchain has recorded that you are no longer the owner. The blockchain is itself secure because of the use of hashing and the distributed recording of the chain. Note that transfers of cryptocurrencies and software value tokens do not require an intermediary such as a bank. This makes transaction faster and cheaper. Effectively, they cut out the intermediaries.

4.   Internal and external information

Information used by business is obtained form both internal and external sources. Here are some examples of internal and external information. Be aware of the very wide variety of information and information sources that might be useful to organisations.

- ◉   Internal sources
    - ‣   Sales analyses
    - ‣   Inventory reports
    - ‣   Debtor ageing
    - ‣   Attendance records
- ◉   External sources
    - ‣   Internet
    - ‣   Marketing literature
    - ‣   Conferences and courses
    - ‣   Commercial databases
    - ‣   Government

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 10

MANAGEMENT

1. The purpose and process of management

We now turn to consider the subject of management. There are many possible definitions and here are two:

"Getting things done through other people". Management implies that you are in some way organising what other people are doing, and indeed the idea of organising should make us consider what's meant by an organisation.

"A social arrangement with a controlled performance of collective goals". The important words here are "social," "controlled," and "collective."

The word "social" recognises that we are not machines, that we are people, that we have an important social or human aspect to our characters. We will see that in the early theories of management, the social dimension was often rather understated.

The idea of "controlled" is important. Basically one of the roles of management will be to set some sort of goals or targets and then to try to ensure that people achieve that.

Finally, "collective"; the idea that in an organisation we should all be working together.

Supervision is giving employees specific instructions and monitoring their output. Typically, managers decide on the actions or goals and supervisors ensure employees carry out the necessary tasks.

Managers carry out administrative tasks potentially at a high level. They usually have power because they have the title 'manager' and it is their subordinates' duty to carry out lawful managerial instructions. Managers 'do things right' ie primarily focus on current processes and strategies.

Leaders, on the other hand concentrate on 'doing the right things'. They are focussed on the future direction and strategy of the business and managers, supervisors and subordinates should follow. The best leaders can also inspire people to follow other than simply relying on their title and position in the hierarchy.

2.   Trait theory

Much of the discussion of management concerns what makes a good manager and what activities good managers should actually undertake.

One of the earliest theories is known as "trait theory." Here the hope was that we could perhaps spot who will be a good manager through certain other traits that they might possess such as intelligence, initiative, self-assurance, even how tall the person was. This never really got very far; it was too subjective. For example, how would you balance intelligence versus charisma? Many good leaders are tall but then leaders such as Napoleon and many others were rather small and were perhaps overcompensating.

Trait theory was really a dead end: it proved to be no good whatsoever by predicting who the good managers might be.

3.   Henri Fayol - Classical Management

One of the earliest management theorists was Henri Fayol who was active in the early 1900s. He believed that the management theories could be developed, then that management could be taught. He said that managers have five functions:

- **P**lanning
- **O**rganising
- **C**ommanding
- **C**oordinating
- **C**ontrolling.

There are perhaps two things to note here. First of all, he really said nothing about inspiring or leading or motivating; much of the social aspects of management were missing. And secondly, although none of us is likely to deny that planning, organising, commanding, coordinating, and controlling are important aspects of management, dividing the management tasks into these five functions doesn't necessarily help us to be better managers.

We are unlikely to set our diaries saying that from 9:00 to 10:00 in the morning we will do a bit of planning, from 10:00 to 11:00 perhaps a bit of commanding and so on. Knowing what you should do is very different from being able to do it at appropriate times.

Fayol's work comes under the heading of "classical management" and classical management theories hold a view that there is a correct way of managing, just as classical architecture put forward the idea that there are proper proportions of buildings which please the eye and which are therefore correct. Classical management held a view that there was a set of 'golden rules' and if you obeyed these you would be a good manager. In general classical management is not believed, or at least not naively believed, any more.

4. Taylor – scientific management

Frederick Taylor was an American who developed his theories of scientific management in the late 1800s. He was the first man who deemed work deserving of systematic observation and study. You must remember that really until the late 1800s most businesses had been relatively small, often consisting of one or two people, perhaps within a family, making use of individual crafts and skills. As businesses grew in size, until Taylor came along, no one thought that employees should be told how to do something. That was simply not thought to be a function of management.

Taylor said that it is a function of management to study work, to develop a science of work, and from that to work out how jobs could be designed so that they could be carried out efficiently. This could allow employees to earn more. Rule of thumb methods should be replaced by methods based on scientific study of the tasks. Scientifically select, train, and develop each employee rather than letting them train themselves; provide detailed instructions and supervision of each worker; divide work nearly equally between managers and workers so that the managers apply scientific management principles to planning the work that the workers have to actually carry out.

Inevitably this led to task specialisation, which is basically the classic production line, because it was discovered that one of the most efficient ways of carrying out work was to do a relatively simple task over and over again. In later life Taylor was criticised for dehumanising work. But it's important to remember that his ambition was not to do this: his ambition was to enable workers to earn more through working in a more efficient environment.

Potential benefits arising from Taylorism are:

- Increases in productivity,

- Fair and higher wage allocation based on output, and

- Workforce care programs because if you didn't care for your work force, you have to waste money through additional recruitment, training, and inefficiencies.

On the downside it had a great capacity for dehumanising work.

5. Human relations school

Around 1935, Elton **Mayo** carried out a very important series of experiments at the Hawthorne plant of the Western Electric company.

In one of these experiments he divided a department into two. Half of the workers were the control group, but for the other half he varied the lighting, sometimes making it better, sometimes worse. He then asked those workers what lighting they preferred and what suggestions they might have for improving it. Much to his surprise he discovered that whether or not the lighting was increased or decreased, the productivity of the people in the experimental group went up.

The conclusion from this experiment was that by making these people feel special, by asking their opinions, by asking for suggestions, they were motivated. They enjoyed being treated as individuals, as people, rather than simply being told what to do. This led to what was called a "human relations school" in recognition that there is more to good management than simply planning, organising, controlling, coordinating, and communicating.

The second part of these studies dealt with groups. Management had tried to increase productivity by offering people higher wages, and was surprised to discover that productivity did not increase.

What Mayo discovered was that there was a sophisticated but informal system whereby people agreed what the proper level of productivity actually was. These people formed what's now known as a group: a number of individuals who develop group norms, in other words, an accepted standard of behaviour. If you don't comply with the norms of the group, you are likely to be excluded from that group. Note that management did not deliberately form groups; these were formed by people just because they worked together or relied on each other or they became friends. People inevitably liked being part of the group and being associated with other people. These groups have a very profound influence on how people are likely to behave.

6. Style theories

We have already said that trait theory has been discredited. We now come on to what's known as "style theories", in other words, a good manager becomes a good manager because of his style of management. Whether or not this information helps to be a good manager is another matter but you have to know the names and the key terms that they were associated with.

7. Drucker

First, Peter Drucker who stated that management has three functions. You have to

⦿   Manage a business

⦿   Manage other managers

⦿   Manage the workers and the work.

He broke these down into five categories of activity.

Drucker said that a manager's activities consist of:

⦿   Setting objectives,

⦿   Organising the group,

⦿   Motivating and communicating,

⦿   Measuring performance, and

⦿   Developing people.

There are two important additions here to what Fayol suggested. First, Drucker said that motivation is a very important part of management, and secondly, developing people is also important, so they feel fulfilled, that they are growing, that they are gaining new skills, that they are achieving their maximum potential.

Really the rest of the list isn't very much new on what Fayol suggested about planning, organising, controlling, coordinating, and communicating.

8. Mintzberg – managerial functions

Mintzberg divided up managerial functions in a slightly different way and again whether you find this useful or not is irrelevant and you must be able to associate the name of Mintzberg with the terms in bold below:

Interpersonal roles	Arising from formal authority and status and supporting the information and decision activities	◉ Figurehead ◉ Liaison ◉ Leader
Information processing roles.	For example, they monitor information maybe by looking at management accounts and they distribute information	◉ Monitor ◉ Disseminator ◉ Spokesman
Decisional roles	Making significant decisions, perhaps about how resources should be allocated, negotiating with suppliers or lead members of staff, and dealing with disputes; in other words, the disturbance handling role	◉ Improver/changer ◉ Disturbance handler ◉ Resource allocator ◉ Negotiator

Once again, knowing that management might have these three functions - interpersonal, information processing and decisional - doesn't necessarily help one be a better manager.

9. Power, authority, responsibility, delegation

There are four important terms regarding management:

Power. Power is the ability to influence people or events.

What gives people power? There are several sources:

◉ Rational-legal, that's the power your manager has. You do what your manager tells you because that person is called "manager" and part of your contract of employment implies that you should do what your manager tells you provided that it's legal.

◉ Coercive power - use of force.

◉ Reward power – offering you more pay or promotion if you do what you are told.

◉ Knowledge power - the power that some people have because they have specialist knowledge which they release selectively.

◉ Charismatic power - the power that some people have simply by their force of personality or their charm.

Authority. Of course having power doesn't mean you have a right to exercise that power. If you have the right to exercise power then you have what's known as authority. So for example, you will be well aware of the term "authority limits" where people may be able to buy non-current assets up to $1,000 but not beyond that. Having power without authority is poor but so is having authority without power. We probably all remember some school teachers who have the authority, the right to tell the class to sit down and be quiet, but when they try to exercise that authority, they had a complete lack of power over the class.

Responsibility. This is the same as accountability. If you are made responsible or accountable for something then as the saying goes "the buck stops with you".

Delegation. This is the transfer of authority. Note that it is the transfer of authority: you cannot transfer responsibility. If your manager asks you to do something and you delegate that task to one of your staff members, and that staff member messes it up, when your manager reprimands you, you can't blame that staff member. The task was yours and either you have to do it yourself or ensure that you delegated it properly to a staff member who had the time and skills, and whom you could supervise to make sure that the task was actually completed.

When you finished this chapter you should attempt the online AB MCQ Test

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Chapter 11

LEADERSHIP

1.   Ashridge Management College model

The Ashridge Management College model identifies four types of leadership style, but remember these are only points in the continuum of management styles.

Tells   Sells   Consults   Joins

Autocratic   ← ————————————— →   Democratic

First and the most autocratic or dictatorial is "tells." The manager simply tells the staff what to do. The manager does not even feel a need to have to explain why that's what has to be done.

A slightly more liberal approach is "sells." Here the manager tells people what to do but then sells that idea to them, convinces or persuades them, or explains why it has to be done that way.

Next, there is the "consults" style. Here the manager will ask staff what they think ought to be done, but then the manager will make the final decision. However, this is quite a participative style.

Finally there is "joins" or "joins with". This can be entirely democratic where the manager effectively asks people to vote on what should be done. This might be the sort of style adopted for deciding things like where should the summer outing be. However, many people regard this extremely democratic style of leadership as abandoning one of the important functions of management which is to direct and control.

2.   Blake and Mouton's managerial grid

The final style theory we look at is Blake and Mouton's managerial grid. These researchers measured two elements of management or leadership. First, the leader's concern for people, and second their concern for the task that had to be accomplished.

Concern for people

1, 9 country club	9, 9 team
	5,5 middle of the road
1, 1 impoverished	1, 9 authoritarian

Concern for task
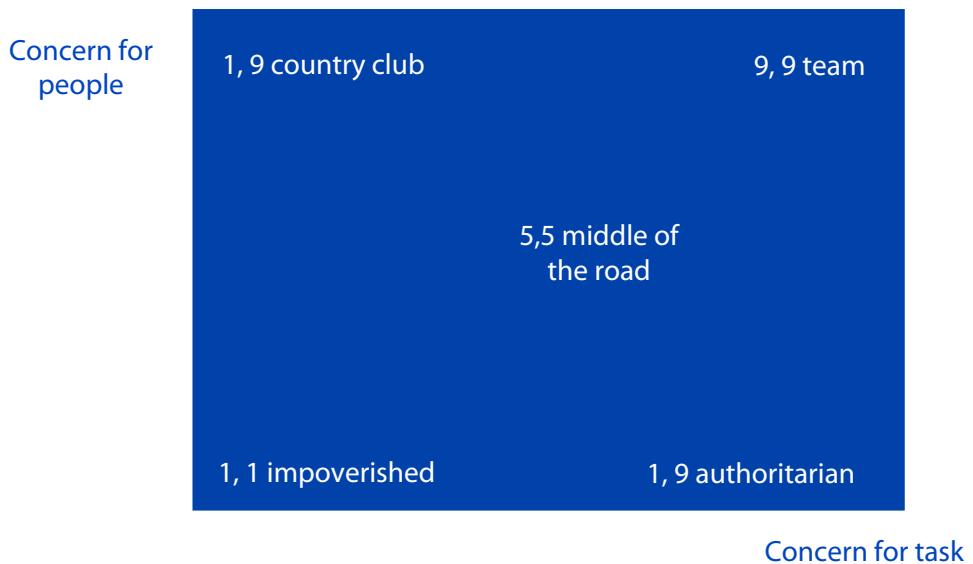
The grid was initially devised as a way of analysing a manager's approach through a series of questionnaires and their position would then be plotted on the grid. This would give them some indication of where improvement was needed.

First of all we go to the top left of the grid - someone who has a very high concern for people but relatively low concern for accomplishing the task. This manager adopted a country club style. In a way they weren't really very interested in accomplishing tasks at all as long as people had a nice time. Hence their name "country club": everything was fine as long as people were happy.

The other extreme is at the bottom right of the grid, the authoritarian or task-oriented style. Here the leader puts all their energies into getting the task done but couldn't care less about the people. These managers wouldn't be very nice to work for: they will put you under a lot of pressure, they certainly wouldn't be interested in dealing with any personal issues that you might have which stood in the way of getting the task done.

The best style is presumably at the top right, someone who has great concern for people and also great concern for the task. This is regarded as the team leadership style: someone who will be a very good leader will get tasks accomplished as required but will also make their staff feel wanted, valued, and will have time to deal with their concerns.

Most ordinary managers are probably going to be near the middle, the 5,5 position, the middle of the road style. Reasonably good with people, reasonably good with the task, but of course what we want to do is to try and shift people up towards the 9,9 position.

There will be some managers at the 1-1 position, the impoverished style: not much good at anything. One really has to ask: Why are they managers? Is there any way their performance can be improved at all?

3.   Contingency theories

We now come to a group of theories known as "contingency theories."

These are the most modern theories and are miles away from the original classical theories. If you remember, the idea behind classical theories was that they presented a set of golden rules which promised that if you manage like this, then you will manage successfully.

Contingency theories say that there aren't any golden rules. There is no single, proper way of managing. If you ask someone, "How should I manage?" the appropriate reply is, "Well, it depends."

It might depend for example on the people you are managing, the urgency of the task and the resources you have available. Contingency theories mean that style of management is contingent or dependent on the situation. You will probably find some of these more interesting and more helpful than others, but again that doesn't much matter, they are all mentioned in the syllabus. You have to be able to tie up the key words used in each theory with the author of that theory.

4.   Adair – action-centred leadership

Adair is associated with action-centred leadership.
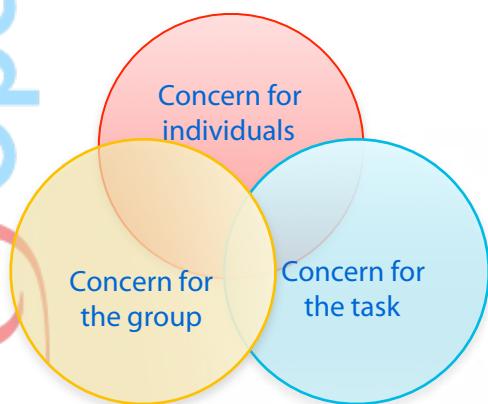
We know that Blake and Mouton plotted people's approach to leadership by looking at their concern for individuals and the concern for the task. Adair added a third variable - a recognition that there should be a concern for the group.

How shall we manage? Well, according to Adair, it depends. On some occasions there may be a very urgent task and we have to reduce our concern for individuals and the group and concentrate on the task. Sometimes there may be a crisis within the group; perhaps their leader has left, perhaps there is disagreement within it, and then the manager or leader should pay more attention to making sure that the group operates properly. Of course, sometimes the proper approach to leadership will mean concentrating on an individual and seeing to their needs, perhaps like giving advice or training.

5. Bennis

Bennis makes a distinction between the term "manager" and the term "leader."

A manager is primarily concerned with administering the status quo. In other words, primarily looking after the existing business somewhat in the short term, keeping an eye on the profit for the coming year. That's not to say it's not an important activity. But best to think of a manager as having a time horizon of about a year.

A leader is more concerned with innovation, will be looking at the long-term future of the organisation, will not be so concerned with matters of detailed control, but will be focusing on people, inspiring trust, asking "How can we improve, where should the business go, what should the business do?".

The leader can therefore be regarded as transformational - in other words, concerned with doing the right thing; whereas the manger is more concerned with transactional leadership - in other words, doing things right, but not necessarily questioning whether what we are doing and controlling is useful.

Bennis suggested that great leaders have certain qualities. You might like to compare this list with the qualities of good managers you have known or good world leaders and politicians you know about.

* Integrity – that really means honesty;

* Dedication;

* Magnanimity - magnanimity is like generosity, particularly when you have won a battle; humility;

* Openness, so that people can trust you;

* Creativity, so that you can think of novel solutions to difficult problems.

6. Heifetz – adaptive leadership

Heifetz was responsible for the idea of adaptive leadership. The principles of this approach are as follows:

* Move between the balcony and the battlefield. In particular, make sure you move to the balcony where you get a long view, an overview of a whole problem. Make sure you don't concentrate purely on fine detail.

* Identify what the adaptive challenge is. This will be a challenge for which there is no ready solution and where there may be a gap between current behaviour and the behaviour required.

* Create a holding environment. That is a safe environment, an environment where you will agree to support those who are responsible for putting through the changes. Don't impose change but give it back to the people without problem.

* Protect the voices of leadership from below. Leaders are not always the top of a hierarchy, there could be important and influential leadership well down in a hierarchy and their views and interests must also be taken into account.

* Regulate the distress. Give comfort and encouragement where needed.

* Sequence and pace the work so that it doesn't become too overwhelming.

* Pay disciplined attention to the issues, keep people focused, use conflict positively and ensure that people keep their eye on the ball.

7. Fiedler

Fiedler suggested that leadership effectiveness depends on:

◉ **Leadership style** - that's the leader's own attributes, and the leader can either be psychologically close or psychologically distant, and

◉ **Situational favourableness** - the degree to which a situation gives the leader control and influence.

A leadership style which is psychologically distant is one where there tends to be very formal, effectively distant relations between the leader and the subordinates. For example, they prefer formal consultations with subordinates rather than more informal seeking of opinions.

A psychologically close leader will be more concerned to maintain good human relationships at work than to ensure that tasks are being carried out well. They are a friendlier, perhaps more easygoing type of leader.

A favourable situation is one where there is a good relationship between the leader and followers. For example, if the followers trust the leader, or where the structure of the task is clearly defined so that everyone knows what has to be achieved, or where the leader has power to, for example, reward and punish.

Successful or effective leadership depends on adopting the right style so that it matches the situation.

Fiedler suggested that a psychologically distant style would work well where either the situation was very favourable or very unfavourable. So in these two extremes, the leadership style should be psychologically distant. If however the situation was unfavourable, a more difficult situation, then it would be more important for the leader to try to adopt a close leadership style.

8.   Kotter

Kotter had similar ideas to Bennis, making an important distinction between leadership and management. He said that leadership and management are two distinct and complementary systems and both are necessary.

	Transformational Leadership (Leadership)	**Transactional Leadership (Management)**
Creating agenda	Establishing direction	Planning and budgeting
Developing HR	Aligning people	Organising and staffing
Execution	Motivating and inspiring	Controlling and problem solving
Outcomes	Produces changes – often dramatic	Produces predictability and order

Management is about coping with complexity. Without good management complex companies and organisations tend to become chaotic. Good management brings order and consistency.

Leadership by contrast is about coping with change. All change always demands more leadership.

Companies manage complexity by planning and budgeting, by organising their staff, by controlling performance, and problem-solving.

Leading an organisation, however, involves setting a direction, developing a vision of the future, developing strategies to achieve that vision, motivating and enthusing people to keep them moving in the right direction.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 12

THEORIES OF MOTIVATION

1. Motivation

Motivation has been described as the urge to run towards a target rather than merely ambling towards it. Understanding motivation is important for managers. You want your staff to be keen to run towards targets, to never be satisfied, to always seek improvement. If you don't understand what motivates individuals or how they can be motivated then it can be difficult to get them to work enthusiastically in a way that will fulfil the organisation's objectives.

There are two groups of motivation theory.

First, **content theory.** This asks what is the job content or the rewards of the job that will motivate people.

The other theory is **process theory.** This tries to look at the mental process by which people become motivated. What thought processes do they go through before people decide to act in a particular way and head towards particular goals?

2. Maslow's Hierarchy of Needs

One of the most famous theories of motivation is Maslow's Hierarchy of Needs which was put forward in 1943. This is a content theory of motivation. Maslow stated that we all have a variety of needs and we're motivated to try to meet those needs. However, he said the needs form a hierarchy.

First if you have absolutely nothing, your world will be dominated by physiological needs. Those are physical needs: somewhere to live, food, warmth.

Once those needs have been satisfied then you turn your attention towards safety needs. Not only do you want somewhere to live but you want somewhere relatively safe to live.

In terms of jobs and organisations one might argue that once one earns enough to satisfy physiological needs then one might turn towards satisfying safety needs - physical safety in the workplace, medical coverage, job security.

Once the safety and physiological needs have been met, we then turn our attention to social needs, the need to get on with people, to feel wanted, to have friends.

After that there is esteem, the need to be respected, to be recognised, to be looked up to, to be praised, to feel that you've done something well.

Finally the self-actualisation needs. This is a need we might have to think that what we're doing, the way we're living is worthwhile, that it's not all simply a waste of time.

Maslow said we all have these needs. Some of them can be met at work perhaps. Some people don't need to meet them at work if they were born extremely rich as there is no problem with their physiological needs or safety needs and there will probably be no problem either with their social, esteem or even self-actualisation needs.

There are many critics of this theory. For example that not all people go through the needs or place their needs in the same hierarchy, and it could well be that many people have higher social needs than are suggested in this diagram. Sometimes we might be able to meet these needs through work. Sometimes work may give us no opportunity to meet these needs.

Perhaps the main lesson to be learned from this theory is that there is more to motivating people than money. People may prefer stable employment to a pay rise, for example. They might prefer a small promotion with little increase in salary. They may respond very well to being praised and they may respond very well if they feel what they're doing is worthwhile.

3.   Hierarchy of needs - limitations

Here are some of the potential limitations of Maslow's theory.

◉   First of all is the order in which we want to fulfil needs correct? Is that the only order?

◉   Secondly, we are all individuals, we may have different needs, they may be in different orders, and the importance of needs may well change throughout our lives.

◉   The theory might not properly explain altruistic behaviour; that is behaving in a way which doesn't fulfil our needs but which is more directed and fulfilling other people's needs first.

◉   Finally the theory is dominated by Western cultural values. Maslow developed his theory in America and it could well be that that culture is more interested in material well-being than some other cultures where, perhaps, social needs are more important. We certainly have to be careful when applying Maslow's hierarchy of needs internationally. It's well known that people from different cultures may have different priorities.

4.　Herzberg

Herzberg presents another content theory – the so-called hygiene theory of motivation.

He was using the word "hygiene" as an analogy with hospitals. If the hospital is going to make you well it must be hygienic; in other words, clean. If it's not hygienic you'll get worse. But hygiene itself doesn't make you well: hygiene is just a starting point.

First he argued that an organisation must get its hygiene factors correct. If a hygiene factor is missing then people become dissatisfied. Examples of hygiene factors would be enough money to live on, reasonable relations with colleagues and your superiors, reasonable physical conditions in which you're working, a feeling that you're being fairly treated. If any of these is missing you are likely to be so upset that none of the other motivating factors that the organisation tries will work.

Once the hygiene factors are in place then you can have the motivating factors such as recognition, praise, a feeling that you are advancing and getting better skills, a feeling that what you're doing is worthwhile interesting work.

It should be noted that the Herzberg hygiene factor theory is not completely different to Maslow's hierarchy of needs. Many of the lower order needs (physiological needs and safety needs) are very similar to what Herzberg would call hygiene factors. The higher order needs (social needs, esteem needs, self-actualisation needs) are very similar to Herzberg's motivating factors.

The Herzberg theory is sometimes known as a two-factor theory (hygiene factors + motivation factors).

5.　Vroom – Expectancy theory

Vroom suggested a process theory called expectancy theory.

Remember, a process theory looks at the process by which you become motivated and Vroom said that the motivating force depends on what he called valence and expectancy.

> **Motivating force = Valence x Expectancy**

By 'valence' he meant how much you want the outcome that could be achieved by a certain course of action. The 'expectancy' is your mental expectation, your assessment of the probability that you'll actually achieve that result, and he said both of these are taken into account in the motivational process.

So if you want something very badly, for example a promotion, but you think there is very little chance of you getting that promotion because there are no vacancies, valence might be high but because expectancy is very low the motivational force will be very low. If however you very much wanted promotion and you thought that somebody was going to be leaving, so that there's a reasonable expectancy that you would be promoted, then you're going to work quite hard for a while to impress your superiors.

Similarly if your superiors or the organisation offered something that you weren't terribly interested in, perhaps a bonus that you thought was rather trivial, even though you might be able to get that fairly easily (high expectancy), because you don't want that outcome very much, the motivational force will be low.

Therefore to get the highest possible motivational force you must offer people something they want and value, and also present them with a reasonable chance that they will achieve that.

6. McGregor – Theory X and Theory Y

McGregor's name is associated with Theory X and Theory Y. This can be regarded as a theory of motivation, but it can also be regarded as a theory of management, in particular a contingent theory of management.

You might remember the Ashridge model of management style: tells, sells, consults, joins with, a range of style going from very autocratic and dictatorial to one which was increasingly democratic and participative. Theory X and Theory Y simply represent the two extremes.

The Theory X manager assumes that people really don't want to work, that they have to be watched very carefully, that they are lazy, that they only go to work with some reluctance because they have to earn money to live.

The Theory Y manager believes that the workforce thinks that work is as natural as play, that they get enormous social rewards from going to work, that they get enormous interest from going to work, that they like being given problems to solve, and they like recognition.

So how do we motivate people?

McGregor's was called Theory X and Theory Y to be entirely neutral, not Theory Wrong and Theory Right. Basically he was saying that if you are put in charge of people who don't like to work and who go there reluctantly, then perhaps the way you have to get the best work out of these people is to be very strict with them, to watch them carefully, to control them closely.

If however you are a manager of people who have good qualifications, who are used to being asked their opinion, who have high technical skills, then by far the best way to motivate them is a much more participative approach.

So motivation is effectively a matter of contingency. It depends whom you are trying to motivate. Different people are motivated by different managerial approaches.

7. Intrinsic and extrinsic rewards

Motivational influences can be termed "intrinsic" and "extrinsic rewards."

- Intrinsic rewards come from within - a feeling of achievement, challenge, personal advancement, self-fulfilment.
- Extrinsic rewards come from outside. Typically they would be pay, praise, recognition.

8.   Increasing motivation

So how on a practical basis could we go about increasing motivation?

The first approach which is normally suggested is participation. Elton Mayo's investigations in the 1930s suggested that taking an interest in people, asking their opinion, allowing them to contribute towards decisions, seems to motivate.

The second approach is job design, of which there are three main types. Probably the first two here aren't going to be very motivating in fact.

Job enlargement means more of almost exactly the same. It is certainly what will be called a horizontal change; there is no more challenge or responsibility in the job. So if you are working in a car factory and your job was putting on the front wheels, job enlargement would let you put on the back wheels as well.

Job rotation is also a horizontal change, no real increase in challenge. Here if you were working in a car factory and your job was putting on the wheels then perhaps next week you could put in the headlights, the week after that you could fit the exhaust pipe and so on. But they are all essentially fairly basic manual jobs and at best perhaps job rotation alleviates some of the boredom.

Job enrichment is a vertical change. It's giving people more responsibility and more challenge in their job. Here we use our car factory analogy again. If your job was putting on wheels it could perhaps be enriched if you are also given responsibility for some sort of quality control. Perhaps as a car went past you'd be asked to identify blemishes in the paintwork and to report those. Here there is an undoubted increased responsibility and interest and this is assumed to increase people's motivation somewhat.

9.   Pay as a motivator

Finally on motivation we look at the extent to which pay, wages, and salaries can be regarded as a motivator.

When Herzberg originally formulated his hygiene theory pay was regarded as a hygiene factor. You had to give people sufficient pay that they could live reasonably from week to week. Later on he revised his theory and pay came in both sides. Basic pay had to be sufficient to live on, then offering people bonuses or increased pay of some sort could be strongly motivating.

If it's going to motivating it's really essential that pay is related in some way to effort or to achievement, but there are certain difficulties here. First of all businesses often don't have complete freedom relating to what to pay people. They have to bear in mind what they can afford, what the going rate is. You can't keep giving people increases over and above inflation otherwise they'll simply be priced out of their market.

Also, many large companies have strict pay bands and if you are a certain grade you'll be paid within that band irrespective of how good you are. And finally, performance-related pay can be difficult to assess unless that person's performance can be directly measured and assessed. However, in many organisations performance depends on what other people do as well as what you do, and it can become very difficult to be sure that you're giving group rewards or performance-related pay in fair ways.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 13

THE NATURE OF GROUPS

1. Groups

Knowledge of groups is an important aspect of management theory.

> Handy defined a group as :
>
> **"Any collection of people who perceive themselves to be a group."**

This is a very good definition because it includes both formal and informal groups. Handy said any group will have:

⊙ A sense of purpose or aim

⊙ An identity; in other words, there is a feeling of who is within the group and who isn't within the group.

⊙ Group norms, that is, accepted ways of behaving and if you don't fall in line with group norms, you are likely to be excluded from the group.

⊙ Communication between the members of the group.

Groups can be formal or informal.

⊙ The **formal group** is simply one which is formed by management.

⊙ **Informal groups** are not formed by management action and indeed management may not even be aware of their existence. However we are social beings and we like being part of a group and therefore understanding groups is important to management. You may remember groups were mentioned when we talked about the human relations school of management first identified by Elton Mayo. In his study at the Hawthorne plant of the Western Electric Company the existence of informal groups was discovered.

2. Team Roles

A team is an example of a formal group: the team would have been deliberately created by management.

One of the great advantages of the team is that people with different skills are brought together so that the team is stronger than any one person individually could be. So if you're forming a team to look at the implementation of a new IT system, you probably have someone with IT skills, someone with accounting skills, someone with production skills, and so on. Each of these people will bring knowledge and also can represent their own particular interests.

However, as well as bringing different technical skills it has been recognised that people bring different psychological profiles, and this has been examined by Dr. Meredith Belbin who categorised eight or perhaps nine team roles, and produced questionnaires that would allow people to assess what their particular characteristic or characteristics were.

◉ **Chairman** (sometimes called, the **"coordinator."**) This person clarifies goals, promotes decision-making and is a good delegator.

◉ **Shaper.** Is someone who is someone driven, thrives under pressure, wants to overcome obstacles, tends to want to get their own way.

◉ **Monitor/evaluator.** Sees all options, judges things accurately and fairly objectively.

◉ **Company worker** (sometimes called an "implementer"). Turns ideas into practical actions. They're not particularly the theoretical person, more the "roll your sleeves up and get on with it" sort of person.

◉ **Resource-investigator.** Explores opportunities, examines contacts.

◉ **Team worker.** Listens, builds, tries to play down potential friction, calms the water.

◉ **PlantB** rather unusual unorthodox person - creative, imaginative, and is deliberately put into the team - planted in other words - with the hope that they will solve difficult problems and bring some slightly offbeat ideas into consideration.

◉ **Completer/finisher.** This person is painstaking, conscientious, careful, looks for errors and is keen on finishing within the deadline.

◉ **Specialist.** A single-minded person who provides particular knowledge and the skills which may be in rare supply otherwise.

Belbin says that you want people with all of these characteristics within a team. This doesn't mean you have to have eight or nine people because many people are strong in more than one of these characteristics. You also have to sometimes be careful not to have more than one person of a particular sort. For example if you have two shapers – they were the people who quite liked their own way - there is likely to be some conflict.

3. Tuckman – Stages of team development

Another area of groups which will easily lend itself to questions in the examination is Tuckman's stages of team development. He said every team or indeed group will go through these stages.

First, there is the **forming stage**; a rather slow tentative stage - should we form a group? What might it be for? In informal groups, a gradual coming together of people with like interests.

Then he there would be a **storming** stage, a stage where different people might compete for different roles within the group; perhaps two people with shaper-type characteristics fighting over who is actually going to become the main spokesperson for the group.

Then there would be **norming** - establishment of how the group is going to behave, acceptable methods of behaviour.

At long last the group begins to **perform**; we get some output from it. People know each other, they know what the group is for, they know who is the leader of the group, they know who is the spokesperson of the group, they know who the completer/finisher is, they know how often they are going to meet, whether formal records are going to be kept and so on, and they can perform.

Finally there is a **dorming** stage. This is where a group meets out of habit rather than out of any real need. At the dorming stage, effectively the sleeping stage, not much is achieved and really the group at this point should be disbanded.

Are there any lessons to be learned from these stages of team development? Well, the main one is that no useful output is really achieved until the group reaches its performing stage. Therefore anything management can do to accelerate the passage from forming, through storming and norming until we get to performing, is good.

So when a formal group is created, management can form it, they will say who is in it, what it's for. They will say who the leader of the group or the team is going to be; that's the storming out of the way. They might tell the group that you will meet once a week, that we want you to report once a month. And very quickly the group can get down to actually performing so that the organisation gets useful output.

Additionally, Tuckman said was that every time the composition of the group changes - one member leaves, another one joins - you go through these stages again. There is a slight loss of performance. And once again management could take action to try to introduce a new person to the group in such a way that the group is disturbed relatively little, and the performing continues almost unabated.

4. Teams and committees

Finally on groups, a couple of descriptions of two types of formal group.

First of all a team and we use the word "**team**" automatically whether it's an IT implementation team, a project team, a football team. Teams are deliberately formed, they have very specific objectives, almost always they bring together mixed skills, and they will have a definite leader or captain.

Committees are also formal groups deliberately formed, and certainly with specific areas to deal with. However, rather than actually carrying out specific tasks they tend to be more concerned with decision-making, bringing together people from different departments, discussing matters and coming to a conclusion. There will be a chairperson or chairman, or nowadays even just called "chair." This person tends to coordinate the committee rather than giving it orders. They will be drawn from different departments and they will have mixed skills so the information is shared, and finally any decisions made are normally recorded formally, on minutes, by the committee secretary, who is also responsible for distributing the minutes and agenda.

5. Effective and in effective teams

Characteristic	Effective team	Ineffective team
Goals	Understood and agreed	Disagreement and a lack of understanding
Contributions from members	Every member participates eagerly	Some members dominate the team whilst others say little
Listening	Members listen to others and respond to the points made	Members might appear to listen but then simply reiterate their own views. No real interaction
Conflict handling	Disagreement is tolerated and might even be welcomed as a creative step	Disagreements are ignored or suppressed.
Decision-making	Consensus is usually achieved ie a united view on which all are prepared to agree	The leader might decide, over-ruling objections, or votes taken after which minorities still feel ill-at-ease.
Assignment of responsibility	People are given clear action points that they are expected to achieve	No responsibilities are allocated and often points decided upon get done by no-one.
Self-evaluation	Self-examination and self-criticism are common so that adjustments are made to the group's method of operating to keep it effective	Self-evaluation is avoided and methodologies are static.

The team leader is key to the creation of an effective team because the leader can:

- Ensure everyone understands the team's goals and purposes

- Set the agenda for the meeting

- Ensure team-members know their roles and the roles of others

- Ensure all contribute

- Stop domination by only a few

- Encourage consensus

- Protect minority views

- Record and follow-up clear action points

Occasionally team-building exercises might be used to, for example, demonstrate the importance of good communication within the group.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 14

THE RECRUITMENT AND SELECTION PROCESS

1. Recruitment and selection

Recruitment and selection of staff is a very important aspect of management. Human resources are a scarce resource and perhaps becoming increasingly scarce.

◉   The birth rate in many countries is lower

◉   The technical content of jobs is higher.

Therefore it can be difficult to find enough of the right people. It can also be mentioned that in many economies there is a move from manufacturing to service jobs. In manufacturing jobs many of the workforce never have any direct contact with customers. The workforce largely remains in the factories. Usually with service jobs there is a much greater involvement with customers either on the phone or face to face. Again, better staff and certainly better training are necessary.

Organisations must first define their requirements. They must have some sort of budget of roughly how many people they need to recruit over the next few years. They need to estimate whether they have to recruit five people, fifty people or five hundred people. They then have to work out how to attract applicants, perhaps by advertising in a newspaper or on the Internet or perhaps by going to an employment agency which may well have people on their books looking for jobs. Finally the business has to select the most appropriate candidates and send out job offers.

2. Job analysis, description and person specification

The process of recruitment starts with:

◉   job analysis

◉   job description, and

◉   person specification.

Job analysis is the process of finding out exactly what the job is. This may seem to be an odd step because you often know what the job is or at least you think you do. But if you are advertising, say, for an accounts assistant, exactly what is that person supposed to do? In one organisation the accounts assistant could be looking after budgets and spreadsheets. In another one they could be responsible for producing the monthly management accounts. In another one the accounts assistant might simply be looking after the receivables ledger. Will they be working on their own or under close

supervision? Will they be in charge of anyone? To whom do they report? Will they have a lot of contact with customers? So before you can advertise for a job you have to know what the job is.

After the job analysis, the content of the job can be written out in a **job description**. And from the job description you can create what's called a **person specification**, a specification of the type of person, their skills and their attributes, that you expect to be able to perform the job properly.

Roger's 7-point selection plan can help us to make sure that we cover most of the points. This selections plan spells out the word BADPIGS and the letters stand for:

Background. We have to be very careful about this nowadays. To what extent is a person's background actually going to be important? We would certainly have to be very careful, for example, about inquiring what the person's parents did, or their home circumstances.

Achievements. We are on much safer ground when we get to specifying their required achievements. Do they require a university degree? A professional accountancy qualification? A full driving licence?

Disposition is a sort of attitude: is the candidate ambitious? Is he or she cheerful? If you are employing someone as a receptionist or other customer-facing role, there is little point employing someone who is miserable.

Physical attributes might be relevant. If you are employing a pilot for an airline, then their sight has to be good. But in many jobs the physical aspects are not terribly important.

Interests. What are people interested in? Again, you have to be a little bit careful about this. This, if anything, is only a corroboration of other evidence. If someone for example is a captain of a local amateur football team, then this might give you some insight into their personality. They are probably fairly sociable and they are probably quite good at leading. If someone has a solitary hobby then you have to ask to what extent they might be successful as a sales person.

General intelligence may need to be assessed particularly if the person has no formal qualifications but is going to require training on the job. Will they be able to understand the technical complexities of the job?

Special aptitudes. Some people who are going to be computer programmers show special aptitudes in logic; other people show special aptitudes for learning foreign languages.

What you can do in the person specification is list out the qualifications and the attributes the person *must* have and then the attributes and qualifications that will be *nice* for them to have. When candidates come to interview, you can mark them against this objective specification. What you are not supposed to do is to compare one candidate to another. You are supposed to compare them to what you need.

3.   Advertising vacancies

Once you know the type of people you want you can begin to try to advertise or to attract the candidates. Advertising vacancies is simply done in newspapers, on the Internet, or you can approach an employment agency.

You have to describe the job in sufficient detail, so that the right sort of candidates are likely to apply. If you are too vague, you may get far too many candidates applying, many of whom are unsuitable. But if you are too restrictive you may not get enough applying. Typically, you want about 20 or 30

good applications coming in and from that you will reduce it down to maybe five or six people whom you will invite to an interview.

Using employment agencies is more common in some sectors than others. In the UK if you are searching for IT staff almost certainly you go to an agency. Agencies can often quickly match candidates looking for jobs with what you are offering. Agencies can also allow you to maintain some anonymity for a little while. Obviously if you advertise vacancies in the newspaper your competitors see what you are up to.

4.   Selection methods

Once you have all the applications received you look at these and choose five or six people to investigate further. Typical methods of investigation include:

◉   **Interviews.** It's very unlikely that you would ever employ someone you had not interviewed . However, be warned that interviews, unless done well, are often very unreliable at picking the right candidate. Candidates' charm can exceed their abilities; they can put on an act. Good candidates might be nervous and under-sell themselves.

◉   **Selection tests.** You might give candidates a variety of selection tests. We will see later what those might be.

◉   **References.** You should be strongly advised to take up references from current employers. Current employers are increasingly unlikely to be willing to pass judgment on how good an employee is but they should at least confirm factual information such as how long the person was employed for and what their job was.

◉   **Work sampling.** Some people are asked to bring along examples of their work. Say you were trying to recruit a graphic designer or someone who designed web pages. One of the best ways to see how good they are is to look at their work.

◉   **Group selection methods.** Finally, and very expensively, there are group selection methods. Here you invite many candidates together and you might spend one or two days putting them through a series of tests and role plays to make sure you get the best person. This is obviously very expensive and is usually reserved for people who are going to be fast-tracked through some sort of management training scheme.

5.   Interviews

As was mentioned, interviews are a very frequent way of trying to predict how candidates will perform. Interviews can be one-to-one, they can be one to many, the candidate can see a number of different interviewers separately but unless the interviews are well-structured and conducted by people who have the proper training and skills, they are not likely to be very reliable. Remember, if you are interviewing, that you will tend to get more information if you ask open questions. An open question is one which cannot be answered simply by yes or no.

Additionally, get the candidates to give examples of their skills. So if you ask a candidate, 'Can you work under pressure?' candidates will normally say 'Yes'. Follow that up by asking, 'Please give me an example of how you worked under pressure and how you met a tight deadline?'

Finally, remember that when you are interviewing the candidate, to some extent the candidate is interviewing you, and you don't want them to go away with a bad impression of your organisation.

6. Selection testing

Very often, candidates are formally tested to identify or verify their competence and attributes. There are four types of tests.

First of all, **psychometric** tests. These inquire into the candidate's personality. Are they likely to be good at working alone, can they prioritise, for example, are they likely to make good supervisors?

Secondly, **proficiency**. If someone comes and says they can work Excel, well it will only take a few minutes to see if indeed they can work Excel. Or if they say they can type at 80 words a minute on Word, why not test them? Remember, if you recruit the wrong person it's very expensive, not so much perhaps in money but in time lost.

Third, **intelligence**. If their formal educational qualifications aren't great, you may want to carry out intelligence tests to make sure that they will be able to deal with further training.

Finally, **aptitude tests**. Do they show particular aptitudes at logic or languages and so on?

7. Equal opportunities

There is now equal opportunity legislation in many European states aimed at anti-discrimination law with respect to employment, whether it's engaging people, promoting them or paying them.

Anti-discrimination laws relate to what are known as 'protected characteristics' and can relate to:

- race,
- sex,
- disability,
- religion,
- sexual orientation,
- age.

Equal opportunities legislation identifies three types of illegal behaviour.

Direct discrimination

An example of this would be if you advertised for a sales*man*. That is direct discrimination because you are asking only for male applicants or male employee.

Indirect discrimination

This is more subtle and indeed often employers fall into this trap inadvertently. An example of rather obvious indirect discrimination would be if you advertised for a salesperson but then stipulated that that person had be two meters tall with a large, black beard. Most courts would assume that this would favour male applicants. Stipulating height minimums would probably be an example of indirect sex discrimination because men are, on average, taller than women.

Victimisation

This is where someone has complained about discrimination and then later on within the workplace they are blamed or discriminated against because they complained.

8. Diversity

Diversity of employment is ensuring that the composition of the workforce reflects the population as a whole. There are sound reasons for diversity.

◉ First of all you're likely to attract a wider range of candidates if you are known as an employer who embraces diversity. Diversity means more than race or sexual diversity and can also mean offering people part-time work or flexibility to from home some of the time. If you can offer part-time work or home-working you may well get additional good candidates worthy of consideration. So why reduce the field by putting unnecessary restrictions?

◉ Secondly, a diverse workforce brings a variety of skills. If you employ people just like yourself you'll probably get skills just like yours.

◉ Third, the diverse workforce might better reflect customers and clients so your customers and clients are likely to feel more comfortable.

◉ And finally you may be able claim the moral high ground by having a diverse workforce and this might be attractive to customers, clients, and potential employees.

Some organisations take practical steps to try to ensure diversity:

◉ Assessing and monitoring current employment patterns is the first step.

◉ Decide where there might be shortfalls.

◉ Decide how to remedy the shortfalls. For example, placing job adverts where minority candidates are likely to see them.

◉ Emphasising in company publications and advertising material that the company is an equal opportunities employer.

◉ The above steps are examples of **positive action**. In the UK it is illegal to undertake **positive discrimination**, which means favouring recruits who are from an under-represented group. Recruitment should be aimed at appointing the best qualified candidate irrespective of their protected characteristic status.

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Chapter 15

HOW PEOPLE LEARN

1.   The learning process

There are two approaches to learning theory.

First, the **behaviourist approach**. In this approach we are assumed to learn essentially through reward and punishment. It's based on stimulus. So if we do something right and we get rewarded, we are likely to do that again. If we do something else and in some way get punished, we are likely to try to avoid that. And so as time passes and we learn, and we will tend to do more of the right things. This doesn't mean of course that we understand what we are doing. Only that we respond appropriately in certain circumstances.

The **cognitive approach** tries to look rather more at the mental process we might go through to gain understanding. It argues that the mind takes sensory information and tries to impose some sort of logic on that, some sort of rational approach. Very much more in this approach we understand or attempt to understand what's happening and why we are doing it.

Probably the cognitive approach will ultimately be more flexible. If we are presented with a new situation, we might be able to think our way through it. But if we have learnt simply on the behaviourist approach and we don't know why we are doing something, then a new situation is likely to confuse us.

2.   Honey and Mumford

There are two sets of learning theories that you need to understand for this examination.

The first is by Honey and Mumford who examined different learning styles. They categorised different learning styles as theorists, reflectors, activists, and pragmatists.

A **theorist** likes to understand the theory before moving on to practice or practical application. The theorist is likely to read an instruction book first before trying to work the new computer.

Reflectors observe what's going on and carefully consider it. They like to work at their own pace and tend to be a relatively non-participative and cautious learner.

Activists are almost the reverse of theorists. If they had a new computer they would switch it on and try and work it before ever thinking of looking at the user guide. They are excited by pressure, by new projects. However, they do tend to rush into things without adequate preparation.

Pragmatists are inspired to learn if they see a practical outcome. They willingly learn something if they see it will help them make their job better or easier. They wouldn't at all be interested in learning for learning's sake and they probably would find it quite difficult if a theoretical approach was taken to instructing them.

What's the point of these four categories? Well, if you were trying to train a group of 20 people, remember, they won't all learn in the same way. Some will be theorists, some will be pragmatists. Perhaps the best you can do is go for a variety of activities and approaches so that each type of learner is given something they can respond to.

3.   Kolb – experiential learning

The second learning theory in the syllabus is Kolb's **experiential learning:** the idea that we go through a number of cycles, gradually learning by our experience.
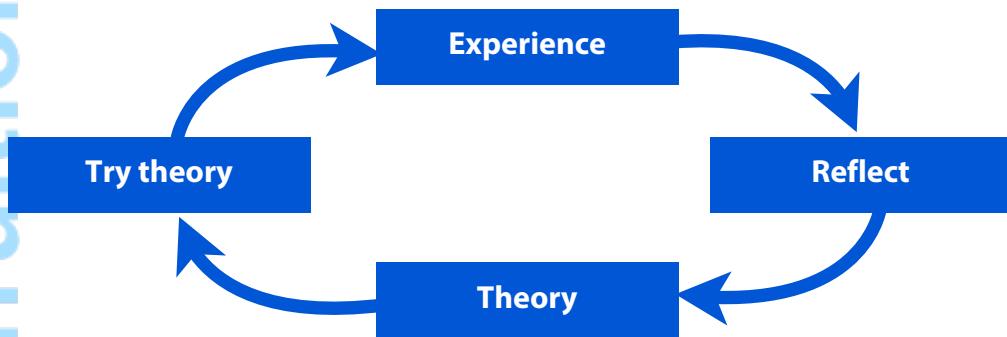
Let's take as an example a situation where we have made a presentation to a potential new client for a valuable new contract, but we don't win it. That's the experience, so we go away and think why we didn't win it. It could be that our prices were too high; it could be that our presenters didn't do a very good job. Anyhow, from this reflection we develop a theory about how to increase our chance of winning, and next time we make a presentation, we try out our ideas. If we fail to win the next job, we need a bit more reflection but if we win the next job then we probably conclude that we have moved in the right direction, that we have learned better how to pitch for new work.

4.   Developing and training

Now we need to look at some matters relating to development and training. First, some definitions.

Training. Training is very specific. It is needed for your current role. So you would talk about training in use of a spreadsheet or a database or the accounting system.

Development is much less specific; it's needed at some time in the future. Very often the word "development" is linked to management to give the term 'management development'. Say that we know that as a manager's career progresses, the manager will probably be required to make presentations, to write reports, and to interview potential new employees. The manager might not need to carry out these activities within the next month or so or even the next year. But we know that probably at some time in the future a manager should be equipped with these skills. Development provides the manager with the skills for the future.

Education is knowledge acquired gradually through learning and instruction. It might or might not be work-related.

Irrespective of what type of learning is required, it certainly needs to be properly planned. Training is expensive: the cost of trainers, the cost of employees' time and the cost of the damaging effects of missing or ineffective skills and abilities. The planning process usually follows steps like these:

- Training needs analysis: what are employees' current skills and competences and what skills and competences do they or will they need. Identify gaps.

- Agree a budget.

- Decide how the training will be provided: formal courses (in-house or elsewhere, by company staff or outside training), coaching, mentoring, shadowing a colleague, self-study or computer-based training programs.

- Provide the training.

- Measure the results to assess the success of the training and to identify if employees have now reached the required standard.

Effective training should:

- Motivate employees

- Increase productivity and efficiency

- Increase employee initiatives

- Reduce the incidence of errors and shoddy work. This reduces business risk and increases profit

- Improve customer relations and customer loyalty

- Helps the organisation to comply with laws and regulations

- Allow more delegation to employees and therefore more flexibility in assigning work.

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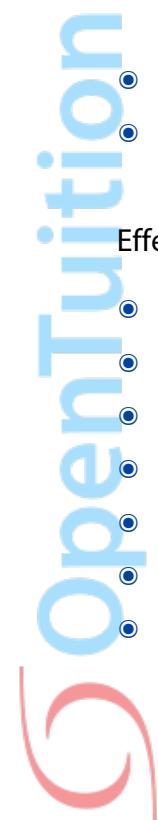
Chapter 16

HOW AN INDIVIDUAL CAN DEVELOP

1. Personal development plans

The feeling that you are developing, getting better, acquiring skills and advancing your knowledge is usually regarded as a great motivator. A personal development plan is a clear developmental action plan for an individual which will usually incorporate a wide set of ambitions, both technical and softer skills (such as better communication skills).

Personal development may require formal training, such as a course or it may require informal training, such as simply getting the correct work experience. The aim of action plans for individuals is first to improve their performance in their existing job and, secondly, seeking to improve skills and competences in future jobs or in future career steps.

It's important to try to acquire transferable skills. These are skills of wide applicability, such as a competence using excel or competence in public speaking. A transferable skill increases employability and will increase the chance that an employee will be able to arrange a change in career direction if he or she wants to. Finally, and importantly, there is personal growth. We all want to move towards jobs and occupations that we're interested in, that we feel is worthwhile and that is rewarding.

However, you need to set a plan and there is no point in just having vague wishes. The word "SMARTER" can help you set a proper action plan.

- ◉   **S**pecific.   You should set specific plans; in other words, something specific like perhaps learning Spanish. You can't simply say I want to be better at my job.

- ◉   **M**easurable.   Simply saying learning Spanish isn't good enough. It's not quite saying to what standard we're going to learn it. So we have to be even more specific and set a standard. So perhaps we align our progress with standard examinations and then we can measure how we're getting on.

- ◉   **A**greed.   We have to agree the plan with ourselves and certainly with our teachers, and perhaps with our superiors so that everyone is behind the plan.

- ◉   **R**ealistic.   It must be realistic and achievable. There is no point in setting an ambition that stating we're going to be like a native Spanish speaker within a year. Almost certainly we're going to fail and that's deeply demotivating.

- ◉   **T**ime-bound.   It has to be time-bound. In other words we're going to say how we're going on by six-months, one year, two years.

- ◉   **E**valuate.   We have to evaluate how we've gone on.

- ◉   **R**eview.   We have to review our plan. Perhaps it's too ambitious or not ambitious enough. Remember if the plan is not reviewed it is likely to become irrelevant and to become ignored. Then we are really wasting our time.

2. Competence/competency frameworks

A competency frameworks is a method of describing the values, skills and abilities that are required to perform given roles. Competency frameworks also provide clear focus to support the development of staff in order to deliver the best possible performance.

Typically, to define a framework for a given role, there will be a general description of the competency followed by a list of attitudes, behaviours, skills and abilities that would indicate competence in the relevant area.

There can also a negative statement at the end of each competency to indicate the sort of behaviour that is actively discouraged as it works against the principle of continual improvement an organisation is striving for.

Competency frameworks serve several purposes which help organisations to recruit, improve and develop their staff, products and services. They can also be used by individuals to analyse and tack their own competences and development needs.

	Target performance	Actual performance
Generic competences		
Fire safety	80	50
First aid	0	0
Ethics	75	75
Specialist skills		
Excel	100	80
Accounting package	80	80

Competency frameworks:

◉   Inform prospective recruits what is expected of them

◉   Inform staff of the sort of attitudes, behaviours and skills the organisation encourages when carrying out their duties

◉   Inform staff of what they can expect from their managers

◉   Can be used to shape and define the organisational culture based around strong principles of acceptable and expected behaviour

◉   Support and guide staff at all levels in their development in order maximise their potential

The frameworks should link to some of the key strategies that drive the objectives of the organisation as these are crucial to success. The frameworks will normally be built into appraisal methodologies and the recruitment process.

3. Time management

Time management is an important skill in the workplace. It starts by setting goals which are SMART: specific, measurable, agreed, realistic, time-bound. These overall goals can then be broken down into specific action plans, perhaps a to-do list, a list of things you're going to do that day or that week, deadlines to be put into your diary. You have to prioritise results and tasks and this has to be kept flexible. What do we really have to do today? What could we postpone to tomorrow if there is a problem?

Remember that there is a difference between what is important and what is urgent. Important tasks have to be done but they don't necessarily have to be done today. Urgent tasks really ought to be done today but if they're not done the world isn't going to end. By considering tasks which are important and tasks which are urgent we can prioritise what we have to do. Certainly at the head of the list are those tasks which are both important and urgent.

Part of prioritisation is to sequence tasks but also the sequencing of task has a logic associated with it. There are some things that we simply can't do before other things have been accomplished.

Poor time management will mean that:

- Deadlines are missed (and this can sometimes incur financial penalties)

- Time is wasted

- Colleagues are irritated as, by missing your deadline, you force them to miss theirs or force them adapt to your shortcomings

- Clients will think that you and your organisation are incompetent.

4. Coaching, mentoring and counselling

Coaching, mentoring, and counselling are important aspects of many modern businesses.

Coaching is a way of providing training. Instead of going to a formal course you sit beside or watch or be supervised by an experienced employee who helps you in your day-to-day tasks in a work environment. For example, the first day the coach is likely to be with you most of the time. But once you've learned the task to the coach's satisfaction you'll be trusted to get on with it - although you're likely to be reviewed. Coaching is sometimes preferred to formal training because it is more likely to be very relevant to your job and your work situation. It's sometimes known as 'on-the-job' training.

A mentor isn't really someone who is training you in how to do your job. A mentor is like a friend at work, someone who looks after your interests. In particular a mentor shouldn't be your boss. You should feel free to be able to approach a mentor with problems you're having at work which could include problems with the relationship with your boss. There is a long-term relationship with your mentor, someone to whom you can go in times of difficulty.

A counsellor provides guidance; though much counselling is what's known as 'non-directional counselling'. Providing guidance is not quite the same as giving advice. A counsellor is unlikely to say 'I think you should do something'. A counsellor is more likely to say, 'Well, you could do A or you could B What do you feel abut those two options, which do you prefer?' The aim of all of these is to increase productivity, efficiency, job satisfaction and comfort levels within the organisation.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 17

PERFORMANCE AND APPRAISAL INTERVIEWS

1. Performance appraisal

We now come to look in another area of human resources management, performance appraisal.

The purpose of performance appraisal is first to improve the organisational performance and secondly to develop individuals. This should be a win-win process.

Developing individuals should motivate them. They feel that they've recognised, they feel their skills maybe growing how we maybe getting towards the top of the Maslow's hierarchy of needs.

Improving organisational performance is very important. However, if you don't let people know how they're getting on, where they need to improve, or where they've done well, it is going to be relatively difficult to improve the organisation's performance because that depends on the performance of the individuals employed.

2. Appraisal systems

It's often said that there are three elements to an appraisal interview.

First, **reward**. What are we going pay these people next year?

Secondly, **performance**, looking back over the previous year and seeing whether people hit their targets and met their objectives.

And finally, **potential,** looking forward to the next period, setting objectives, listening to people's preferences, deciding perhaps where they require training.

However some human resources professionals suggest that the reward part of the appraisal should be kept quite separate from the other two parts. They argue that there is more to reward than simply basing it on performance. For example, you have to look at the market rate and what the company can afford. It doesn't look too good if you tell someone that they have done really well and then you immediately say, "…but we can't give you much of a pay rise this year." Some people therefore suggest that the reward part of the review should be about six months away from the other parts of the review.

3.   Appraisal interviews

If appraisal interviews are not conducted properly they will almost certainly do more harm than good. Remember, the employee may have waited a year for their review and this is their chance to find out how they've been doing. If they go in and find you are not prepared and haven't thought about their future, they are likely to be very disappointed.

S, the first thing you must to is to prepare the appraisal interview: look at what was said at last year's appraisal interview; look at their job specification; look at any assessments which have been received from the colleagues or the superiors of that person. Make sure you know about any accomplishments such as examinations passed, and be prepared to say something about what they might be expected to be doing in the future.

If appraisals are not properly prepared and conduct the they will fall into disrepute. They might be regarded as simply a 'box-ticking' exercise done by managers because they are part of managers' duties.

It is also important that there are a few barriers as possible to effective appraisal. For example, personal animosity (or perceived animosity) between the parties is likely to undermine the process. If you feel that your managers is biassed or reports from your colleagues are unfair then you are less likely to take them seriously. If the employee feels intimidated then they are less likely to listen and certainly less likely to interact with managers. It is also essential that managers are willing to constructively inform employees where improvement is needed. It can be easy for managers to avoid conflict by simply not mentioning unsatisfactory performance.

An appraisal should be primarily viewed as a way of improving employee performance by offering guidance and support rather than as an exercise in blaming employees for poor performance and only pointing out inadequacies.

There are a number of different ways of conducting the interview:

You can **tell and sell**. That's more or less one-way communication. Typically, the manager presents the employee with a completed assessment sheet listing their performance across a number of areas such as technical ability, leadership, getting on with customers etc.   This tells the employee what they've been doing well, what they've been doing badly, and the managers then sells those scores to the employee. In other words, convince them that the manager's view is right. This is not regarded as a particularly useful approach.

Tell and listen. Again, the assessment sheet is already completed and the manager tells the employee what their point of view is. However, the employee is asked to respond and the manager listens. Obviously this needs and encourages two-way communication so that the employee feels more able to talk about problems and ambitions or to disagree with the manager's assessments.

Problem-solving. The best of all, however, is the problem-solving approach. Here, manager and subordinate go through the performance together, jointly arriving at conclusions scores as to whether the various aspects of performance are satisfactory or not. Communication inevitably must be fairly comprehensive for this approach to work.

At the end of the appraisal interview, it is important for managers to gain commitment about what the employee is expected to do in the future, make sure everyone agrees on that and summarise it. There should be a report, probably two-part. The top copy can go to the employee with agreed conclusions and objectives. The other part will go on the personnel file.

Finally there should be follow-up. If you have arranged for training then make sure it takes place. If you have arranged for that employee to spend three months in another department make sure that

takes place. If the employee has been having difficulty you may want to monitor their progress continually before waiting a whole year till their next appraisal interview.

Increasingly, companies are using 360 degree appraisals:

◉ Managers appraise subordinates

◉ Subordinates appraise their manager

◉ Colleagues appraise each other

**When you finished this chapter you should attempt the online AB MCQ Test**

Chapter 18

THE NATURE OF COMMUNICATION

1. Communication

Communication within businesses is obviously important: in particular it's required for planning, coordination, and control.

The communication pathway is more complex than you might think and you need to know what these steps are.

Form thought ⇒ Encode ⇒ Transmit ⇒ Receive ⇒ Decode

Feedback

First of all, the person who wants to do the communicating forms the thought. Then they encode it; they find a way of expressing it, in other words. The thought is transmitted and that could be by sound, it could be by letter, it could be by email. It has to be received by the recipient and recipient has to decode it. On many occasions after it's decoded there will be some sort of feedback. Feedback could be an action, it could be nodding your head, it can be asking a question because you don't understand the message properly or it has provoked further queries.

The important thing to realise is that communication can break down at any of these stages. If the thought was garbled to start with, you are lost. If it's not encoded properly for example, if it's written down in a confusing way then that will interfere. Transmission can be messed up. We have all had, no doubt, examples of letters which have gone astray or emails which have gone to the wrong person. That person might not receive the message. One of the reasons it might not be received is they simply don't open their inbox and finally they might decode it incorrectly, they misunderstand what you are trying to communicate.

2. Communication direction and level

Communication within the organisation can be:

◉ Vertical, such as between subordinate and superior.

◉ Horizontal, between the people of the same levels and different departments.

◉ Diagonal when a subordinate in one department has to report or give information to a superior in another department.

And it can be formal or informal. Examples of informal communication would simply be chatting around the coffee machine. An example of a formal communication would be memorandum issued to all members of staff.

The communication and information needed at the various levels in the organisation differs

Strategic level

At the strategic level, the top level (think of the board planning and directing) the information tends to be:

◉ Internal and external (eg what are our sales and what are competitors')

◉ Rounded (eg to the nearest $million)

◉ Historical and forward-looking (eg what were last month's sales and what should our budgets and plans be?)

◉ Many estimates (eg almost everything in a budget is an estimate)

◉ Routine and ad hoc (ad hoc = occasional or once off Eg what is the economy doing in Brazil and should we open there)

Operational level

At the operational level or lowest level (think of the people who record transactions) the information tends to be:

◉ internal

◉ Very accurate

◉ Historical

◉ Factual and vey few estimates

◉ Routine

3. Barriers to communication

It's important to understand the factors that can act as barriers to communication.

Inappropriate language. Obviously this could mean speaking a foreign language to people who don't understand it, but in practice it is more likely to be using terminology which not everyone understands. So for example, if you are in a firm of accountants and you are writing to a client and you are talking about tax computations, terms such as "disallowable", "capital allowances", "adjustment of profits" and so on may not simply be understood by the client and if that's the case communication has not been successful.

Status. Differences in status can interfere. This can be in two ways. First of all it could be the person at the top of an organisation not wanting to hear what the people at the bottom are saying, perhaps not believing that people at the bottom have anything of value to say. It can happen the other way round where people at the bottom of the organisation are frightened to talk to people at the top of the organisation.

Emotion. If you go into an appraisal review and you are very angry or worked up about something or even just frightened about something, the chances are that communication will not be successful.

Wrong medium. If, for example, you wanted to give your employees information about the technicalities of their pension scheme, probably giving them a long lecture isn't going to be very useful. There is too much technical information in that for them to understand. Presenting the information in written form or perhaps a mix of communication might be more successful. For example, an oral presentation explaining the main points and then the detailed material available in written form.

Reluctance to transmit or receive. It could be that a manager doesn't want to point out shortcomings in a staff member's performance. It could be that the staff member is not willing to believe that there is anything wrong with their performance.

Information overload. This is a curse of the information age. We are often bombarded with so much information that we really can't see the wood for the trees. We spend so much time looking at information, deciding whether or not we need to know the information or not, that there is a real danger we overlook the important material. It is easy to suspect that this is sometimes used deliberately: send lots of information and bury bad news inside it.

Good communication should be:

- ◉   Concise
- ◉   Sufficiently comprehensive
- ◉   Understandable
- ◉   Relevant
- ◉   Timely
- ◉   Accurate
- ◉   Persuasive/effective
- ◉   Economic

4. Leavitt

Leavitt identified several other ways in which the patterns of communication could be organised. Shown here are the Y shape, the wheel shape, the circle and the chain.
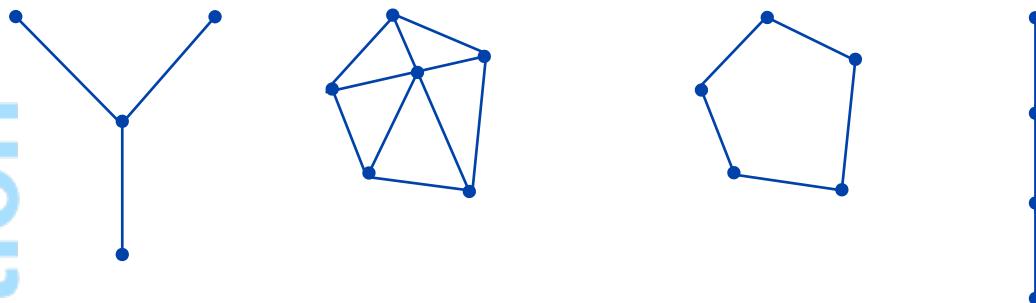
What can we learn from this?

Well, the chain represents a typical hierarchal arrangement within an organisation. At one end you might have the managing director; at the other end you have staff at the bottom of the organisation. Clearly there is going to be rather slow communication between top and bottom.

In the wheel type of communication by contrast, assuming that the boss is at the centre then there's going to be very fast communication with the rest of the organisation. This is a highly centralised, almost entrepreneurial organisation with power at the centre. This enables organisation to move very quickly.

The circle type is relatively slow in communication; the Y is relatively fast in communication.

When you finished this chapter you should attempt the online AB MCQ Test

ECONOMICS AND MARKETING

Chapter 19

MACROECONOMICS

1.   Introduction to macroeconomics

The term 'macroeconomics' refers to the branch of economics that deals with **national and international economics**. 'Microeconomics', which will be dealt with later deals with the study of specific markets for products and services.

Macroeconomics therefore covers topics such as:

- How can the size of a country's economy be measured?
- How could the economy be made to grow?
- What are the unemployment rate and what affects this?
- What causes inflation and how can that be controlled?
- What determines currency exchange rates?
- How to imports compare to exports?

2.   Government influence on business

Governments can have a huge influence on businesses:

Policy	Affects:
Overall economic policy	Demand, taxation, cost of finance (interest rates
Industry policy	Regulation, planning, grants, tariffs/quotas, free trade
Environmental and infrastructure policy	Planning, costs (eg carbon or pollution tax), transport costs and efficiency
Social policy	Education, retirement, pensions, employment protection
Foreign policy	EU compliance, World Trade Organisation, foreign trade, banned exports and imports

3. National income

National income is a measure of the size of a country's economy. National income can be defined as:

the total value a country's final output of all new goods and services produced in a year

The word 'final' is important. If Company A sold goods to consumers, then the value of those sales would be part of national income. However, if Company A sold to Company B and Company B sold to the public for the same price, then the sales revenue would appear in both company's accounts and there would be double-counting if both amounts were included in national income. To avoid this, only Company B's sales would be included in national income.

The higher the national income, the more income is available for a country's population

If an item is sold for €50, then that amount appears in two places:

◉   The amount spent by the consumer (consumption or expenditure)

◉   The amount received by the seller (income)

The consumption (expenditure) and income must be equal.

Of course, there is another set of flows. For example, companies employ people and pay wages whilst employees can use their wages to buy goods from companies. Recognition of these two sets of flows (wages/labour, sales of goods/purchases of goods) gives rise to the circular flow of income.

There are two main measures of national income:

◉   Gross domestic product (GDP)

◉   Gross national product (GNP)

A country's gross domestic product refers to the total value of income or production taking place in that country. It is calculated as:

GDP =	**Household spending**	+	**Capital investment spending**	+	**Government spending**	+	**Exports of goods and services**	−	**Imports of goods and services**

A country's gross national product takes into account income earned from abroad and also profits earned in a country being sent to foreign investors. The difference between income being earned abroad and profits being remitted to overseas investors is called the net property income from abroad. So

GNP =	**GDP**	+	**Net profit income from abroad**

# 4. The circular flow of income

Households provide: labour, land, capital (together known as factors of production)

In exchange for:

Firm providing: wages, rent, interest

Firms: produce goods or provide services

Households: pay for the goods and services
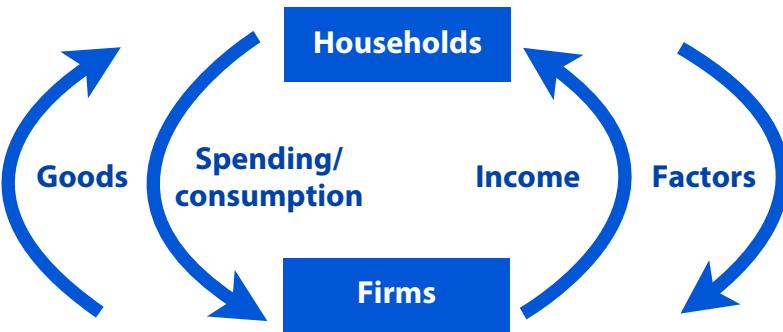
As well as money, goods, services and factors of production moving between firms and households, there are injections and withdrawals (or leakages) from the system.

Injections:

- Government spending
- Exports (money comes from abroad)
- Investment (this is expenditure on goods in addition to household spending).

Withdrawals:

- Taxation
- Savings (for example, money is earned, but simply kept and accumulated)
- Imports (money goes abroad)

Injections will increase the circular flow of income (for example, money flowing into the country from the sale of exports). Similarly, withdrawals will decrease the circular flow (for example, more people deciding to save).

If an economy is in equilibrium (meaning that the circular flows are constant) then injections into the economy must be equal to each other. For example, if the government suddenly printed more money and injected it into the economy by giving each person €10 to spend, then that additional money could be spent on goods and services, increasing both consumption and the supply of goods. To supply more goods, more factors of production would be bought, increasing the population's income until a new equilibrium point is reached.

5. Aggregate supply and demand

Although money spend by consumers (consumption or expenditure) must equal the value of goods sold by suppliers (income) this does not mean that the demand for goods will always equate to the supply of goods. A product could be very popular but suppliers are not able to keep up with that demand. The imbalance between supply and demand can occur at the macro-economic level also:

◉ Aggregate demand: the total demand in the economy for goods and services; it is the total desired demand.

◉ Aggregate supply: the total supply of goods and services in the economy.

Aggregate demand would increase as prices decrease: lower prices stimulates demand. Aggregate supply increases as prices increase: higher prices will encourage firms to produce more.

An equilibrium (or balance) is reached when aggregate demand and aggregate supply are equal: enough is produced to exactly meet demand.

Let's see what happens if these are not equal. Assume that because the economic situation had been a little uncertain, consumers had decided to save some of their income in case of redundancy. Then the economy picks up and consumers have more confidence to spend their savings. Suddenly aggregate demand would have increased, but the supply of goods might lag behind this sudden increase in demand. The likely effect is that there will be price rises as consumers are willing to pay more to satisfy their increased demand; production will be increased so that, once again supply will satisfy demand – but at a slightly higher price

The following graph shows what happens:

Prices
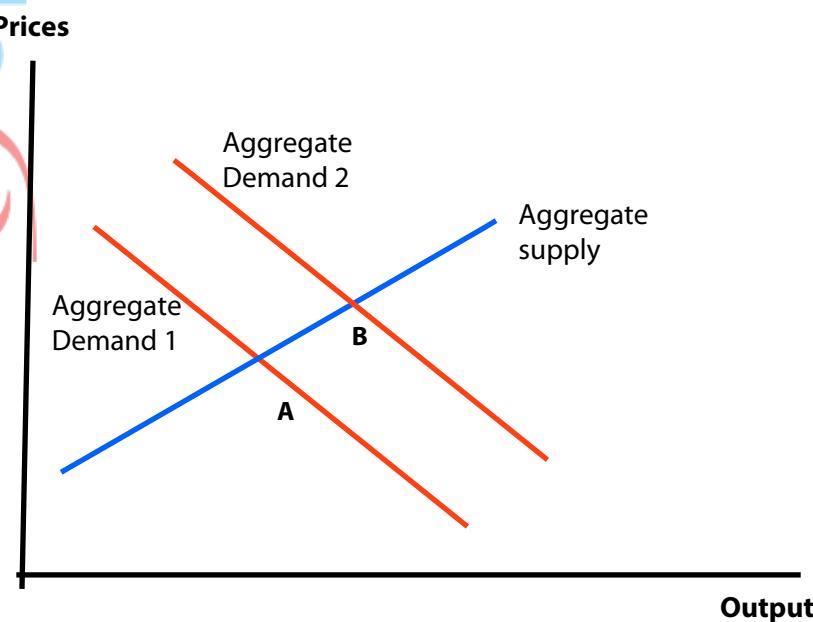
We start at point A. Aggregate supply and aggregate demand meet at this point: the quantity supplied matches the quantity of goods demanded.

When confidence in the economy rises and people are willing to spend more money, the aggregate demand shifts to the right from aggregate demand line 1 to line 2. This means that more goods are demanded at a given price.

The extra demand will stimulate producers to supply more and the equilibrium point moves from A to B. Prices are slightly higher. Of course, as production increases, employment will increase, so governments can increase employment by stimulating aggregate demand. Demand can be stimulated by measures such as:

◉ Decreasing tax so that consumers are left with more to spend

⦿   Increasing government expenditure (eg the government borrows and spends)

⦿   Decreasing interest rates so that it is cheaper for consumers to borrow and spend

Of course, aggregate supply has limits. For example, once everyone is in employment it is difficult to satisfy further demand. Output has reached its limit

Prices

Aggregate Demand 2

Aggregate supply, showing where full employment is reached and no more goods can be made.

Aggregate Demand 1

B

A
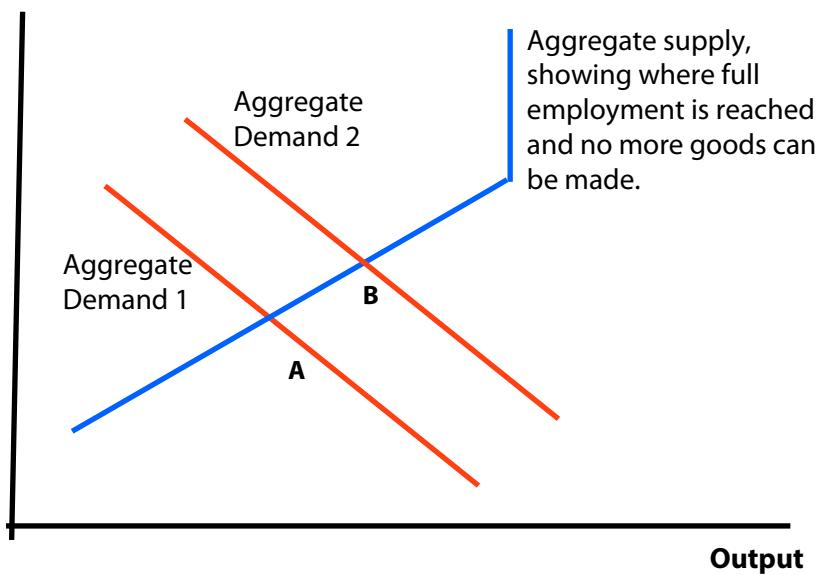
Output

If no further goods can be made, yet demand keeps increasing, there will be a strong upward inflationary pressure on the economy as output cannot adjust to meet demand. On the other hand, if demand is lower than could be met by maximum demand, there is likely to be unemployment.

Prices

Full employment

Aggregate Demand 2

B

C

Aggregate Demand 1

A

Aggregate supply

Output
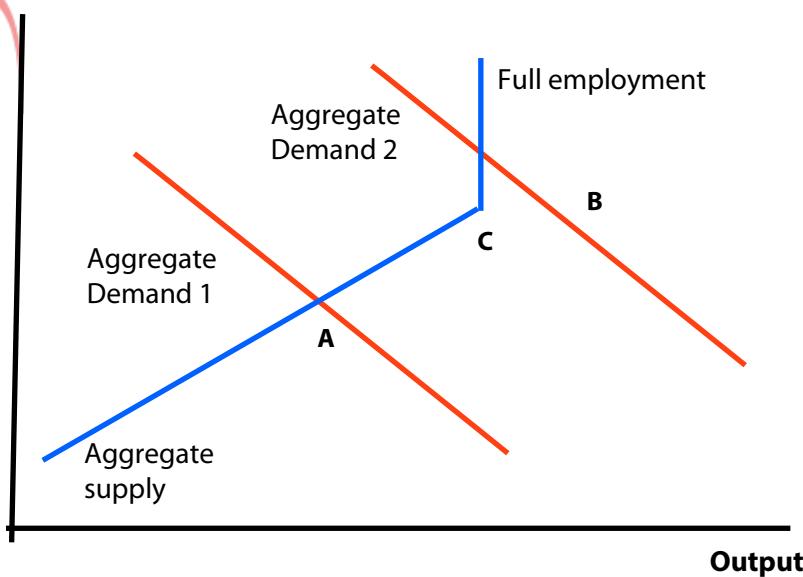
At equilibrium point A, aggregate demand is equal to aggregate supply but there is spare productive capacity and there will be unemployment. The line showing aggregate Demand 1 would have to move to the right until it went through point C where full employment would be reached. The rightward move in aggregate demand needed to achieve full employment is known as the **deflationary gap**.

At equilibrium point B, aggregate demand is higher than the maximum supply available. Output can't increase so prices rise steeply as a way of making demand and supply match. The line showing aggregate Demand 2 would have to move leftward to go through point C and to achieve matched demand and supply. The distance aggregate demand would have to reduce to achieve the match at point C is known as the **inflationary gap**.

6. Shifts in the aggregate demand curve

This section is not talking about movement *along* an aggregate demand curve. Such movements are causes by changes in prices that will increase or decrease demand. We are looking at what causes demand curves to shift to the right (eg Demand line 1 moving to Demand line 2) or to the left.

Shifts to the right increase aggregate demand and is equivalent to an economy growing. Similarly, shifts to the left imply the economy is contracting. Controlling economic growth or contraction will be a key concern of all governments: fast growth can lead to inflation and can suck in imports to meet demand; fast decline can lead to mass unemployment.

Rightward shifts are caused by:

◉   An increase in disposable income. This can be caused by, for example, lower taxes, lower interest rates, increased welfare payments.

◉   Consumers deciding to save less (known as a lower marginal propensity to save).

◉   Increased government spending

◉   A more relaxed monetary policy (for example, the government simply printing more money

◉   A change in net exports. When a country's exchange rate weakens, its exports become cheaper to foreign buyers and this stimulates demand in the economy as more goods are demanded by overseas buyers.

Leftward shifts are caused by:

◉   The opposite of each of the above influences

7. Inflation - causes

We need to look at the terminologies associated with two pieces of macroeconomics – inflation and unemployment.

First, inflation. What causes inflation?

◉   Demand pull. This is where there is a lot of money in the economy, lots of people who want to spend money, and because demand is high, prices are pulled upward.

◉   Cost push. An example of cost push inflation is where people in the manufacturing industry, let's say coal mining, have a large wage rise. Inevitably that wage rise is passed on and will find itself reflected in the cost, say, of electricity. The cost of electricity goes up and that's an example of cost push inflation.

◉   Import cost inflation. A good example of that was the huge increase in the cost of oil that happened towards the end of 2008.

◉   Expectation. This is where people expect there to be inflation and because they expect inflation, they make higher wage demands and the higher wage demands inevitably push up the price of goods that are going to be sold.

◉   Increase in the money supply. An increase in the money supply will stimulate demand. More people have money to buy goods and this will cause demand pull inflation.

8.   Unemployment

The second collection of terminology we need to look at is unemployment. What types of unemployment are there?

Real wage unemployment. This is where people are effectively being paid too much. Employers can't afford to keep them on and therefore they lose their jobs. They've priced themselves out of their markets. That tends to be self-correcting because once there is a large number of people looking for job with particular skills that will tend to bring down the real wage price.

Frictional unemployment refers to the temporary unemployment of people as they move from one job to another. There will always be some frictional unemployment and it's not terribly important socially because it is temporary.

Seasonal unemployment is obvious. It will refer to unemployment patterns in sectors such as building and agriculture where there tends to be high unemployment during the winter.

Structural unemployment is more permanent. It occurs where the structure of the industry has changed. An example of structural unemployment can be seen in the UK where we have closed most of our coal mines. It was thought to be cheaper to import coal from abroad.

Technological unemployment speaks for itself. It is unemployment brought about by changes in technology so the old skills and jobs disappeared.

Cyclical unemployment is a very long cycle of employment and unemployment as economies rise and fall. Towards the end of 2008 most of the world entered a recession. The recession is likely to last for some years and this causes high cyclical unemployment.

9.   Monetary and fiscal policy

Governments have two main ways in which to control or regulate their economies:

◉   monetary policy, and

◉   fiscal policy.

Fiscal policy

First we'll look at fiscal policy. And the word "fisc" is an old word which referred to the king's purse. Where does the state get the money from? Where does it spend it? If the state wants to spend money it either has to raise income through taxes or borrow money. If it wants to reduce taxes it either has to reduce expenditure or borrow money. The three have to be in balance.

In the current recession governments are seeking to spend more money. This is a way of putting money into the economy to try to stimulate it. However, if they spend more by raising taxes they may actually not end up putting very much more money into the economy. They are taking with one hand and giving away with the other. So what most governments are doing is increasing government borrowing. Keep taxes the same; borrow money, spend it, once it's spent it will be earned by people who will spend it again. And that's the way in which governments hope the recession will be brought to an end.

Monetary policy

The second way in which governments attempt to control their economies is by their monetary policy: managing the supply of money in the economy. The more money in the economy the more economies are likely to be stimulated. There are two main weapons.

◉ **Interest rates.** If interest rates are very high people will tend not to want to borrow money. If you don't borrow money you can't spend it, and if you can't spend it then, for example, demand pull inflation will be relatively low. If however you greatly reduce the interest rates more people will be encouraged to borrow. They spend that borrowed money on televisions, cars, houses, whatever. And once it's spent the money is in the economy, other people earn it, demand goes up, and the economy is stimulated.

◉ **Credit controls**. This is a control over institutions, typically banks, on how much they are allowed to lend. So for example if you put $1,000 into a bank and the reserve requirement was only 10%, that means that the bank could lend $900 out of the $1,000 deposited. That $900 could be deposited again and the bank could lend on $810 and so on. So the initial deposit of $1,000 can create a much higher amount of money in the economy. Say however that the reserve requirement was 50% - $1,000 in the bank; the bank only lend on $500. That $500 is put into another account, the bank can lend on only $250 and so on. You can see that at the end of the cycles a much smaller amount of money will be created in the economy.

10. Functions of taxation

Taxation has many functions. We've already pointed out that it raises revenues for the government but it's also used for other purposes. For example, to discourage certain activities regarded as being undesirable. And a good example here would be a tax on cigarettes.

It can also be used to cause certain products to be priced to take into account their social costs. There is increasing talk for example about a carbon tax of some sort because it is argued that if you drive a car or fly in a plane the release of carbon has a social cost that ought to be paid for.

Obviously, tax can be used to redistribute income and wealth. Frequently people with higher income and more wealth are taxed more highly and that is redistributed through government expenditure to people who have less wealth.

It can be used to protect home industries from foreign competition; examples are import duties, import tariffs where imports have a tax attached to them to make them more expensive relative to the home-produced products.

Finally it can provide a stabilising effect on national income. Governments are often committed to long-term expenditure plans but if the economy falls somewhat governments might seek to increase the tax take so that the national income stays up and they don't have to borrow any more.

11. Types of taxation

Taxes can be described as:

◉ regressive,

◉ proportional, or

◉ progressive.

A **regressive tax** takes a higher proportion of a poor person's salary than it does for a rich person. A simple example is VAT. If the VAT rate is 20% it doesn't matter whether you are rich or poor you still pay 20% and that is proportionally more taken from a poor person's pay than it is from a rich person's income.

A **proportional tax** takes exactly the same proportion of income tax from all levels of income. So you could have a flat rate tax which taxes everyone at say 10% from the very first dollar earned, up to millions of dollars.

A **progressive tax** takes a higher proportion of income as income rises. So maybe for the first $1,000 of income the tax rate is zero, for the next $4,000 of income the tax rate is 20%, and anything beyond that is taxed at say 40%. A progressive tax would obviously be more effective at redistributing wealth and income than either a regressive or a proportional tax.

Couple of more terms on tax.

◉ A direct tax is paid directly by a person to the revenue authority. A good example there would be income tax. A certain proportion of your income goes directly to the revenue authority.

◉ An indirect tax is collected by the revenue authority from an intermediary, normally a supplier of some sort. A good example of an indirect tax is VAT. You buy something, you pay over the total purchase price, and then the seller passes some of that on to the government.

◉ Some taxes are charged a fixed sum per unit sold. So if you were to buy a bottle of wine it doesn't matter whether it costs $5, $10 or $25; a fixed sum will go to the government.

◉ An **ad valorem** tax is charged as a fixed percentage of the price of the good. A good example of an ad valorem tax is VAT.
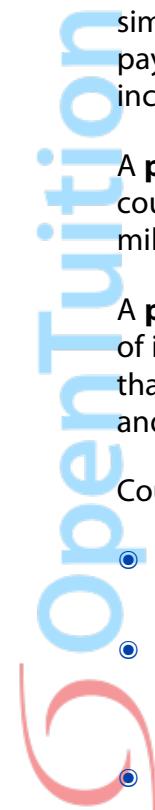
Chapter 20

MICROECONOMICS

1. Introduction

Deals with the price and cost of manufacturing of goods, and with the reactions of suppliers of customers.

2. The demand curve
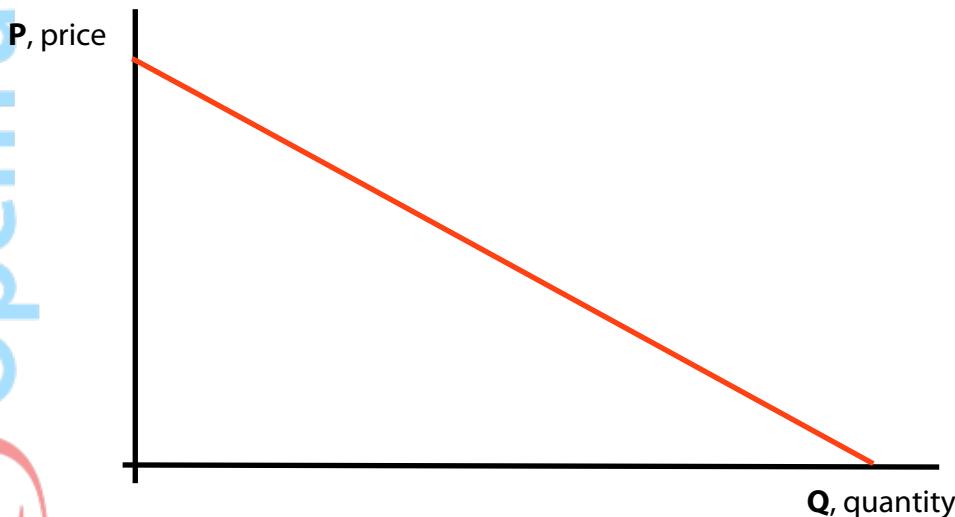
For most goods, as price increases the quantity demanded will reduce. This diagram shows a linear decrease; in practice the demand curve is likely to be curved.

The position and slope of the demand curve depend on:

◉   Price of goods

◉   Consumers' income. Very high income might imply that a change in price will not make much difference to demand.

◉   Substitutes and complements. A substitute product is one that can be bought as an alternative. For example, olive oil and sunflower oil are substitutes for some purposes. If the price of olive oil increases, the demand to sunflower oil is likely to increase as consumers switch. Complementary products are often bought together. For example, cars and petrol. If the price of cars reduces, more are bought, but more petrol will also be bought even though its price has not changed.

◉   Fashion and taste. A fashionable item will have high demand and consumers may be prepared to pay a high price.

◉   Whether the goods are essential or luxury. If goods are essentials (like basic food) then higher prices will not affect demand greatly. If goods are luxuries (or at least purchase of them is discretionary), then a rise in price can cause a steep fall in demand. For example, the purchase of foreign holidays is markedly affected by the price of those holidays.

◉   Expectation of future price changes. If consumers think the price will rise, then current demand is increased as they stock-up on the goods.
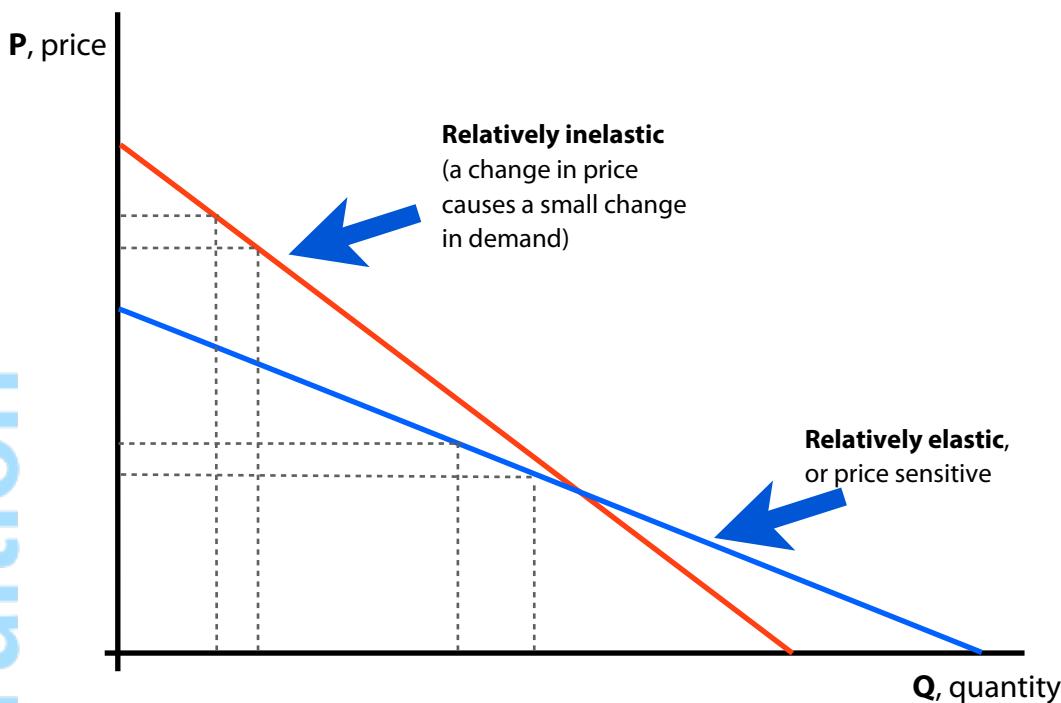
If demand is elastic, then demand for the good is price sensitive and a small change in price will cause a relatively large change in demand. That is shown by the less steep line above.

If demand is inelastic, then demand for the good is relatively price insensitive and a change in price will have a relatively small effect on demand.

The price elasticity of demand is defined as: $\dfrac{\text{The proportional (or percentage) change in demand}}{\text{The proportional (or percentage) change in price}}$

Because an increase in price will normally cause a decrease in demand, technically this measure is negative, but the negative sign is usually ignored.

Price elasticity of demand >1 means that a relatively small change in price will cause a relatively large change in demand, so demand is **elastic**.

This has the consequent that revenue will increase if prices are reduced because the increase in demand more than compensates for the fall in price.

Price elasticity of demand 0 < 1 means that a relatively small change in price will cause a relatively small change in demand, so demand is **inelastic**.

This has the consequent that revenue will decrease if prices are reduced because the increase in demand will not compensate for the fall in price.

Price elasticity of demand = 1 means that revenue will be constant if the price is changed slightly.

3. Calculation of the price elasticity of demand
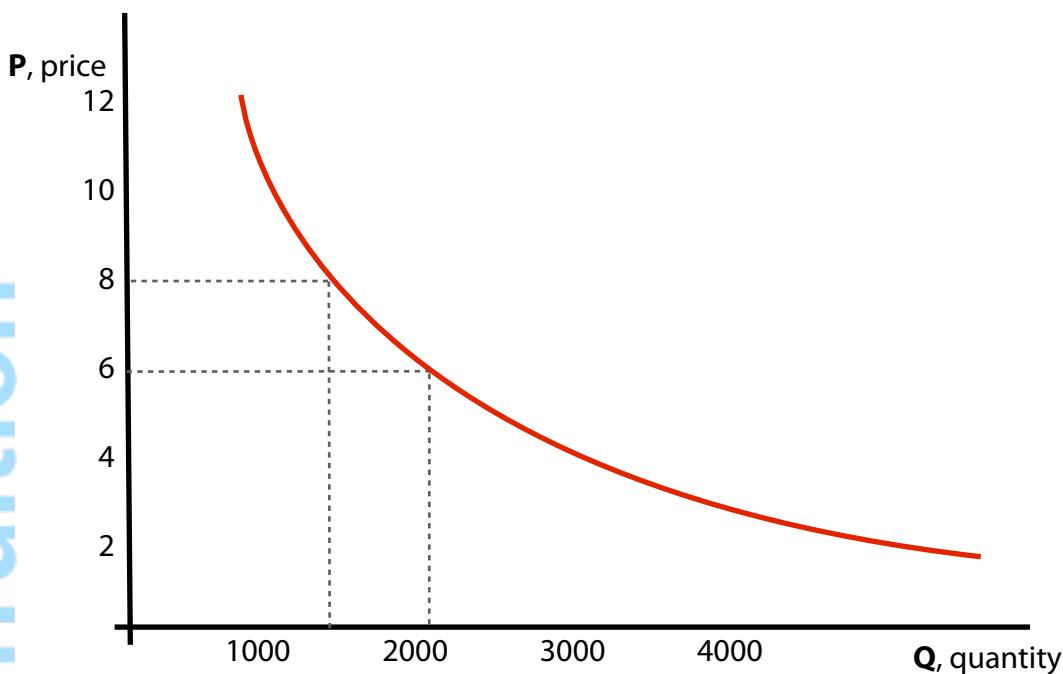
In the above diagram, say that at a price of $8, demand is 1,200 and that at a price of 6, demand is 2,200.

There are two approaches to calculating the elasticity:

Arc elasticity uses the mid point of the two quantities and prices as the basis point ie 1,700 (= (2,200 + 1,200)/2) for quantity and 7 for price.

Proportional change in demand = (2,200 − 1,200)/1700 = 0.588 or 58.8%

Proportional change in price = (8 − 6)/7 = 0.286 or 28.6%

Price elasticity of demand = 58.8/28.6 = 2

Point elasticity uses the starting points eg start price at 8 and demand at 1,200

Proportional change in demand = (2,200 − 1,200)/1200 = 0.833 or 833%

Proportional change in price = (8 − 6)8 = 0.25% or 25%

Price elasticity of demand = 83.3/25 = 3.3

Note that elasticity of demand change constantly along a demand curve, even if the demand curve is a straight line. For example, in the table below, demand increases by 1,000 units for each $1 decrease in price:

Price ($)	Demand (units)
12	5,000
11	6,000
10	7,000
9	8,000
8	9,000
7	10,000
6	11,000
5	12,000
4	13,000
3	14,000
2	15,000
1	16,000

The arc price elastic of demand from $12 to $11 is:

$$\frac{(6{,}000 - 5{,}000)\ 5{,}500}{(12 - 11)/11.5} = 0.18/0.087 = 2 \quad \text{(very elastic)}$$

The arc elasticity of demand between $3 and $2 is:

$$\frac{(15{,}000 - 14{,}000)/14{,}500}{(3 - 2)/2.5} = 0.069/0.4 = 0.175 \text{ (very inelastic)}$$

Income elasticity of demand

This measures how demand varies with income:

$$\text{Income elasticity of demand} = \frac{\text{Proportional change in demand}}{\text{Proportional change in income}}$$

The change in demand is represented by a shift in the demand curve: same quantity demanded at a higher price or higher quantity demanded at the same price.

If the **income elasticity of demand is negative** then the goods are known as **inferior goods** because as income rises consumers change to better brands. For example, changing from inter-city bus services (cheap, but slow) to intercity trains (more expensive but faster).

Inelastic: 0 – 1: necessities. The goods were bought even when income was low.

Elastic: >1: luxuries. More goods are bought when there is 'spare' income.

4. Demand and supply curves
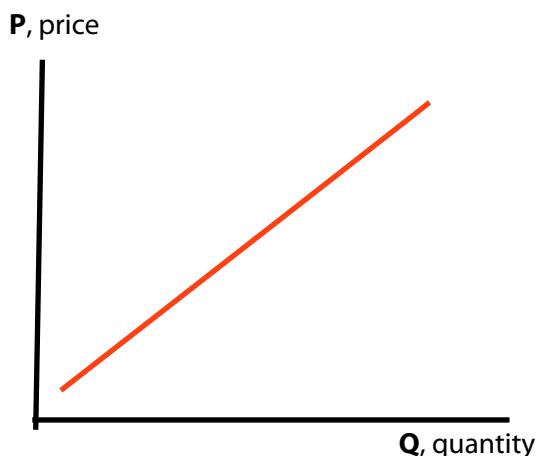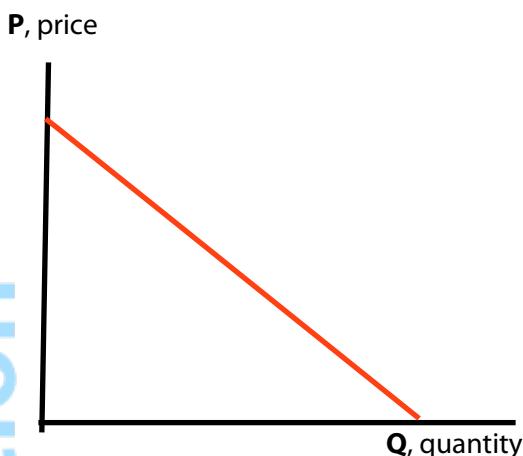
In the demand curve as the price increases, demand falls off. In the supply curve, as the price increases, production will increase because higher prices mean that there is the opportunity of more profits.

However, profits will only be made if the goods produced actually sell and an equilibrium point will be reached at a price where demand is matched by supply. The equilibrium point is the market price of the product.
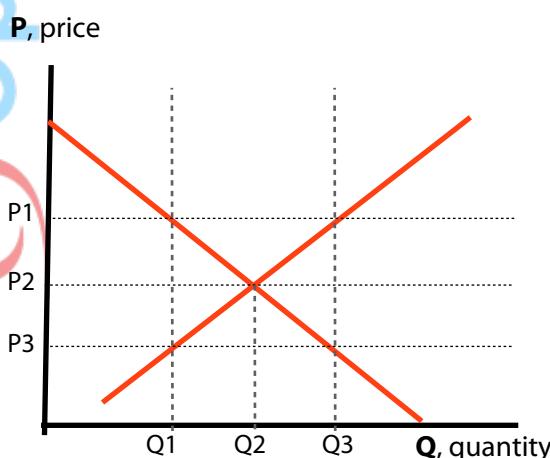

At a price of P1, Q3 will be made, but only Q1 demanded. There is excess supply and this will drive down the selling price, increasing demand. Prices will stabilise at a price of P2 and demand of Q2 where supply and demand match.

At a price of P3, Q3 is demanded but only Q1 supplied. There is excess demand and this will push up the price of goods until, again, demand and supply match at the price of P2.

5.   Shifting the demand and supply curves

The diagram below shows a rightward shift in the demand curve.

P, price

Q, quantity
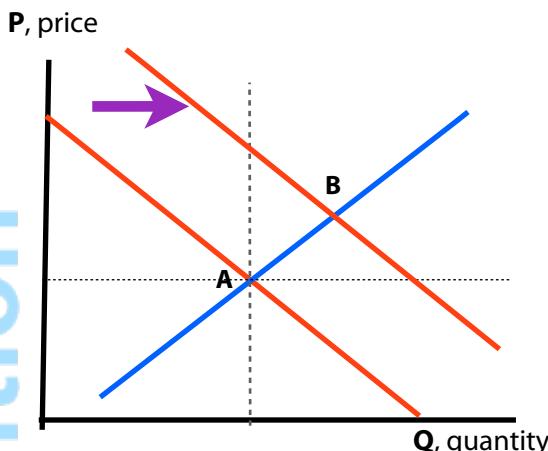
A rightward shift in a demand curve can be caused by:

◉   Rise in income (more income implies more demand at a given price)

◉   Rise in the price of substitutes (will increase the attractiveness of this product)

◉   Rise in the expected price of the product (stocking-up now)

◉   Reduction in the price of complements (as more complements are bought so more of the product is bought)

◉   Change in tastes (an item can become fashionable or otherwise popular)

◉   Population increase (more people pursuing the goods).

As the demand curve shifts to the right more goods are demanded at the same price or the same quantity would demanded at a higher price. Once again supply will adjust so that a new equilibrium point is reached where demand and supply match. The equilibrium point moves from A to B above in the above diagram.

The diagram below shows a rightward shift in the supply curve, meaning that more goods will be produced at the same price or the same number of goods will be produced at a lower price.

P, price

Q, quantity
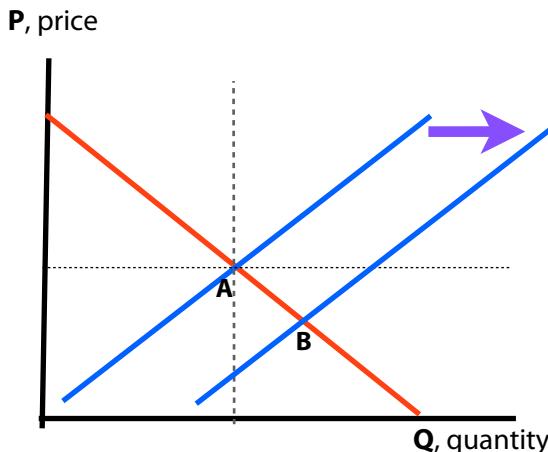
A rightward shift in a supply curve can be caused by:

◉   Fall in cost of production

◉   Fall in the price of other goods

◉   Technology changes

◉   Improved efficiency

◉   Subsidies

◉   Lower taxes

If more goods are produced then to sell them the price will have to fall until equilibrium is reached again. The equilibrium point moves from A to B in the diagram above.

6.   Cost curves

There are two types of cost:

Fixed costs: do not vary in the short run as production increases.

   For example, factory rent.

Variable costs: increase with production volume.

                   For example, labour costs.

As production costs increase, the average fixed cost (the fixed cost per unit) will decrease because the constant fixed costs are being spread over more units. A graph of fixed cost per unit against output would look like:

Average fixed cost

Q, quantity
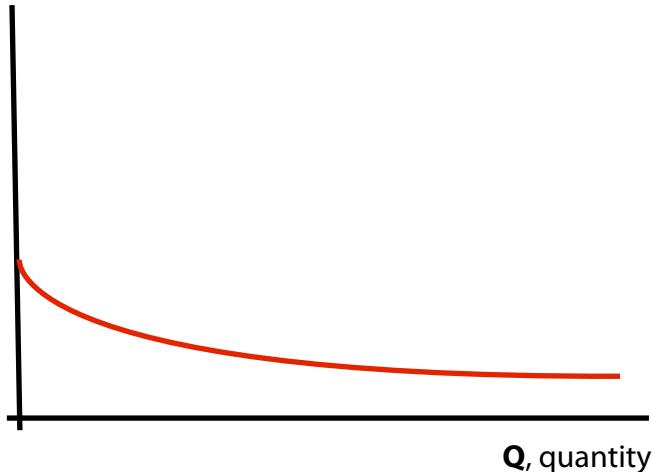
Initially variable costs per unit will fall as the producer gains advantages from greater efficiencies as more units are produced. Eventually the variable cost per unit increases because of the law of diminishing returns. For example, as machines are run harder more repairs are needed and the machine efficiency decreases. This is the law of diminishing returns.

A graph of variable cost per unit will look like:

Average variable cost

Q, quantity
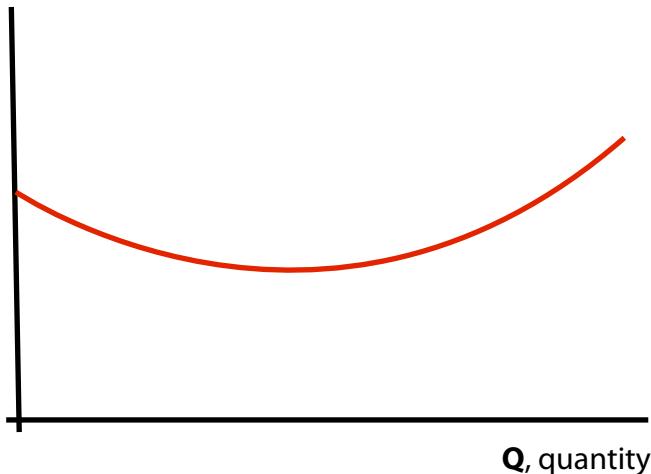
Combining the graphs will produce:

Costs

Average total cost

Average variable cost

Average fixed cost

Q, quantity
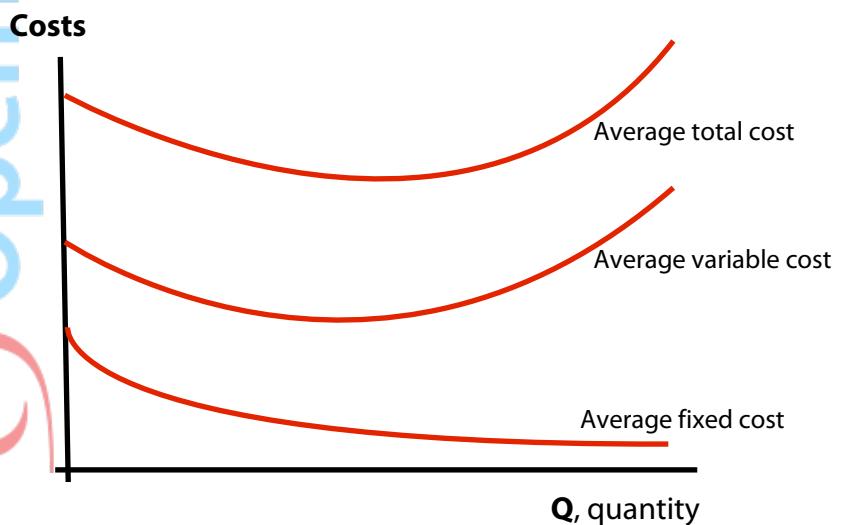
Provided the selling price is above the average variable cost the firm will produce even if the price is below the average total cost. For example, it would be worth producing and item for an additional cost of $7 if it sold for $10. The $3 difference helps towards covering fixed costs.

The marginal cost is the cost of producing an extra unit.

If average total costs are falling, the marginal cost must be less than the prevailing average so that the average cost is pulled down. If average total costs are rising, marginal costs must be greater than the prevailing average to increase the average. The marginal cost line will therefore go through the minimum point of the average total cost line. Similarly for average variable costs.

Costs
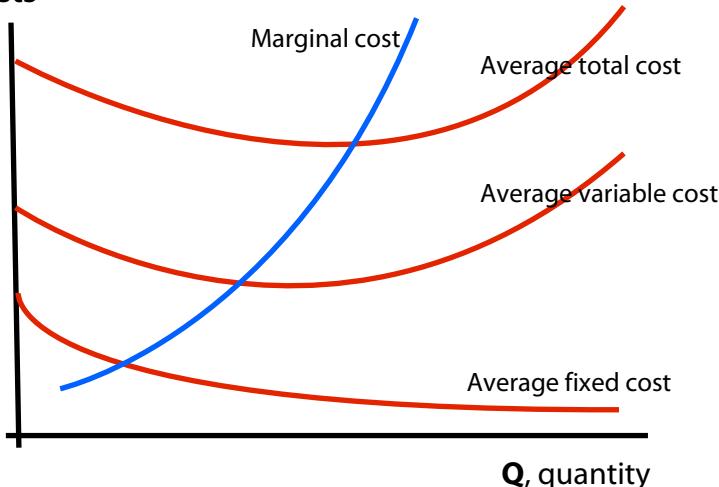
In the long run, all costs are variable and fixed capacity can be increased so that the law of diminishing returns will no longer apply. Indeed, increased capacity could bring economies of scale so that the supply curve could even be downward sloping.

7. Types of competition

Perfect competition

Many small buyers and sellers, none of which is large enough to affect the market or the market price.

Free entry and exit from the market.

Buyers and sellers are 'price-takers': the market price rules ie the equilibrium price. If a supplier raises its price, no-one will buy form that source as there a plenty of other suppliers. There is no point in lowering selling price because the seller sells all that can be made at the market price.Every buyer can buy what they want at the market price.

Imperfect competition

◉   **Monopolist**: only one supplier. The price can be set at any level to maximise revenue or profits, but volume demanded will change. Profits are, of course, not guaranteed as the monopolist might be selling something no-one wants.

◉   **Oligopoly**: a small number of suppliers (eg petrol companies). If a supplier raises prices, the others will win market share by sticking at the old price. If a buyer lowers the price the other have to follow to maintain market share.

◉   **Monopolistic competition (non-price competition):** where firms seek to increase demand for their products using something other than price. For example, brand and reputation can be used. An example is found in the car industries. Ford, General Motors, Nissan and VW all sell 'family sized' cars so are competing with each other. However, their prices differ so they are using factors other than price to generate sales. For example, VW will emphasise the engineering quality of its cars.

When you finished this chapter you should attempt the online AB MCQ Test

Chapter 21

MARKETING

1. What is marketing?

Kotler defines **marketing** as "the science and art of exploring, creating, and delivering value to satisfy the needs of a target **market** at a profit. **Marketing** identifies unfulfilled needs and desires. It defines, measures and quantifies the size of the identified **market** and the profit potential."

To understand the marketing concept or the marketing approach it's useful to contrast this with certain other approaches that might be available.

The product-led approach. For this, imagine a company which was started by a couple of engineers, clever and successful people, who are very interested in the technical qualities and the cleverness of the products they produce. They get enormous satisfaction in well-engineered, clever innovative products. Unfortunately, just because the product is well-engineered, innovative and clever doesn't mean that product will sell. No matter how much those engineers appreciate the fine details of that product it may be a product that no one wants, or a product which is too expensive.

The sales-led approach may sound okay, but what it means is great emphasis on selling what you have, even if customers don't really want it. The sales-led company will have a very high powered sales team, skilled in the arts of persuasion and getting people to sign contracts which they may later regret.

The marketing-led concept is quite different. What's important about that is that it is very outward looking. It looks to see:

◉ What will potential customers want?

◉ What do they appreciate?

◉ What amount of money do they think it's worth paying for the product or service we are providing?

Through market research we will establish the needs of potential customers and then develop an appropriate product to match those needs. It will stress to those customers the ability of the product or service to satisfy their needs and it will profit through customer satisfaction because it fulfils the needs of the customers.

In many ways it's a very humble approach. It's saying that the customer knows best: the marketing concept means finding out what do customers want and developing products or services to fulfil customer's needs.

2. Market segmentation

We have said that marketing is finding out what customers want and designing products and services to meet customers' needs. The first stage to find out whether all potential customers wanted the same thing or can the market be broken into different sections or segments. Market segmentation looks in how a market can be split up.

Commonly it can be split up according to age, sex, lifestyle, wealth, and geography. For example in the fashion market, there are quite different fashions which are bought by younger and older people. Obviously there are different fashions depending whether you are selling to male or female. Lifestyle is important: are we addressing the leisure market or are we addressing a more formal market? Wealth and disposable income are important, and it's normal for most ranges of fashions to have cheaper 'value goods' and also the more expensive luxury goods.

The idea of segmentation is that if you break the market up into smaller sections and you design products or services which specifically address the needs of each segment of the market

3. Market targeting and the marketing mix

After investigating market segmentation, the next stage is market targeting, that is deciding which segments of the market to attack. Most companies have a range of products each of which targets a particular segment. Targeting each segment, known as **product positioning,** is carried out by adjusting the **marketing mix.**

Originally there were four variables or levers that could be used. These were known as McCarthy's marketing mix or the Four Ps. Now seven Ps are often shown:

- Product
- Price
- Promotion
- Place
- People
- Process
- Physical evidence

The first four (product, price, promotion, and place) were the original components of the marketing mix and apply to the marketing of physical products. The three last ones (people, process, and physical evidence) are *additional* variables specifically to do with positioning services. When services are provided it is important to have the right people with the right attitude, whereas in manufacturing, customers might never meet employee. The process by which it is provided, and the physical evidence that something has actually happened are also important. For example, if you are booking an airline flight, you may ring up the airline and you expect to be dealt with in a helpful and friendly way by the representative. The process has to be convenient to you, you don't want to be waiting too long before your phone call is answered. Finally you expect some sort of physical evidence, such as an e-mail, to show you that the service is actually going to be provided.

3.1 Product

The first of the Four Ps is product, and this includes:

The features of the product (what it does)

- Quality,
- Design,
- Brand,
- Packaging.

3.2 Pricing

The second of the Four Ps is price. This includes not only the price itself (the price level or price point), but also discounts for bulk buying which is particularly important in business-to-business sales. Price also includes the terms, that is how long a customer has to pay. There are also various types of strategic pricing, described below.

Pricing often has to take into account the price of competing products.

3.3 Promotion

There are four main types of promotion:

⊙   Advertising

⊙   Sales promotion

⊙   Personal selling

⊙   Public relations.

We are all familiar with advertising: TV, magazines and, increasingly, the Internet. Marketing can be very expensive, so setting a marketing budget is very important

Sales promotion is something which happens very close to the point-of-sale. You may have been in supermarkets where staff offer small portions of cheese or small glasses of wine for you to try in a hope that you will then go and purchase. Buy-one-get-one-free offers and coupons which give you money off the next purchase are also forms of sales promotion.

Personal selling is when a salesman or saleswomen, a sales representative in other words, goes around spending time with customers or potential customers trying to persuade them to buy. This is very important in business-to-business sales and, of course, it is economically justified there because often the orders placed in business-to-business sales are quite large and valuable.

Public relations usually means good mentions in the press. Sometimes there are charitable endeavours where a local firm has made some sort of donation or lent some sort of equipment. Corporate social responsibility and good ethics play important roles in public relations.

⊙   Push promotion

⊙   Pull promotion

Imagine a new product is about to be launched. Push promotion is concerned with getting the product into the shops and would use, for example, personal selling. Pull promotion is getting the public to demand that product, to go into shops and ask to buy it. That promotion could be done by advertising. For the whole promotional campaign to be successful, you need both push promotion and pull promotion to match up.

3.4 Place

The last of the four Ps is 'Place', meaning the place you go to buy or acquire the product. It really means distribution. Considerations to bear in mind there are:

⊙   The length of the distribution chain. For example direct marketing where products go directly from manufacturer to consumer compared to manufacturer, wholesaler, retailer chains.

⊙   Suitability of the outlet. For example, high fashion goods   are better sold through exclusive shops, not supermarkets.

4.   Link of marketing and strategy

A strategic plan, typically for five years, shows where the company will be at the end of the period: products being sold, countries of operations, manufacturing/sub-contracting, country of manufacture etc.

The key to any business's success is sales, whether sales of products or services and, obviously, a strategic plan must be linked to the marketing plan. The marketing plan shows the products offered, their price the markets they are being sold into and this determines a large part of any strategic plan.