Introduction to Business

Adapted for Seneca College, BAM101

By Michael Wade

Seneca

Acknowledgements

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Front cover photo by Adeolu Eletu on Unsplash.

Table of Contents

Acknowledgments

Chapter 1: Introduction to Business

Chapter 2: Business Ethics

Chapter 3: Competing in the Global Marketplace

Chapter 4: Forms of Business Ownership

Chapter 5: Entrepreneurship: Starting and Managing Your Own Business

Chapter 6: Management

Chapter 7: Money and Banking

Chapter 8: Financial Management and Securities Markets

References

Chapter 1 Introduction to Business

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. How do businesses and not-for-profit organizations help create our standard of living?
2. What are the sectors of the business environment, and how do changes in them influence business decisions?
3. What are the primary features of the world's economic systems, and how are the three sectors of the Canadian economy linked?
4. How do economic growth, full employment, price stability, and inflation indicate a nation's economic health?
5. How does the government use monetary policy and fiscal policy to achieve its macroeconomic goals?
6. What are the basic microeconomic concepts of demand and supply, and how do they establish prices?
7. What are the four types of market structure?

1.1 The Nature of Business

How do businesses and not-for-profit organizations help create our standard of living?

Take a moment to think about the many different types of businesses you come into contact with on a typical day. As you drive to class, you may stop at a gas station that is part of a major national oil company and grab lunch from a fast food chain such as Taco Bell, McDonald's, or the neighbourhood pizza place. Need more cash? You can do your banking on a smartphone or another device via mobile apps. You don't even have to visit the store anymore: online shopping brings the stores to you, offering everything from clothes to food, furniture, and concert tickets.

A **business** is an organization that strives for a profit by providing goods and services desired by its customers. Businesses meet the needs of consumers by providing medical care, automobiles, and countless other goods and services. **Goods** are tangible items manufactured by businesses, such as laptops. **Services** are intangible offerings of businesses that can't be held, touched, or stored. Physicians, lawyers, hairstylists, car washes, and airlines all provide services. Businesses also serve other organizations, such as hospitals, retailers, and governments, by providing machinery, goods for resale, computers, and thousands of other items.

Thus, businesses create the goods and services that are the basis of our standard of living. The **standard of living** of any country is measured by the output of goods and services people can buy with the money they have. Canada has one of the highest standards of living in the world. Although several countries, such as Switzerland and Germany, have higher average wages than Canada, their standards of living aren't higher, because prices are also much higher. As a result, the same amount of money buys less in those countries. For example, in the United States, we can buy an Extra Value Meal at McDonald's for less than $5, while in another country, a similar meal might cost as much as $10.

Businesses play a key role in determining our quality of life by providing jobs, goods, and services to society. **Quality of life** refers to the general level of human happiness based on factors including life expectancy, educational standards, health, sanitation, and leisure time. Building a high quality of life is a combined effort between businesses, government, and not-for-profit organizations. In 2017, Vienna, Austria ranked highest in quality of life, followed by Zurich, Switzerland; Auckland, New Zealand; and Munich, Germany. Seven of the top 10 locations are in western Europe, two are in Australia/New Zealand, and only one is in Canada, Vancouver. At the other end of the scale, Baghdad, Iraq is the city scoring the lowest on the annual survey.[1] Creating a quality of life is not without risks, however. **Risk** is the potential to lose time and money or otherwise not be able to accomplish an organization's goals. Without enough blood donors, for example, the Canadian Red Cross faces the risk of not meeting the demand for blood by victims of disaster. Businesses such as Microsoft face the risk of falling short of their revenue and profit goals. **Revenue** is the money a company receives by providing services or selling goods to customers. **Costs** are expenses including rent, salaries, supplies, transportation, and many other expenses a company incurs from creating and selling goods and services. For example, some of the costs Microsoft incurred by developing its software include salaries, facilities, and advertising. If Microsoft has money left over after it pays all costs, it has a **profit**. A company whose costs are greater than revenues shows a loss.

When a company such as Microsoft uses its resources intelligently, it can often increase sales, hold costs down, and earn a profit. Not all companies earn profits, but that is the risk of being in business. In Canadian business today, there is generally a direct relationship between risks and profit: the greater the risks, the greater the potential for profit (or loss). Companies that take too conservative a stance may lose out to more nimble competitors who react quickly to the changing business environment.

Take Sony, for example. The Japanese electronics giant, once a leader with its Walkman music player and Trinitron televisions, steadily lost ground—and profits—over the past two decades to other companies by not embracing new technologies such as the digital music format and flat-panel TV screens. Sony misjudged what the market wanted and stayed with proprietary technologies rather than create cross-platform options for consumers. Apple, at the time an upstart in personal music devices, quickly grabbed the lion's share of the digital music market with its iPods and iTunes music streaming service. By 2016, Sony restructured its business portfolio and has experienced substantial success with its PlayStation 4 gaming console and original gaming content.[2]

Not-for-Profit Organizations

Not all organizations strive to make a profit. A **not-for-profit organization** is an organization that exists to achieve some goal other than the usual business goal of profit. Charities such as Habitat for Humanity, the United Way, the Canadian Cancer Society, and the World Wildlife Fund are not-for-profit organizations, as are most hospitals, zoos, arts organizations, civic groups, and religious organizations. Over the last 20 years, the number of nonprofit organizations—and the employees and volunteers who work for them—has increased considerably. Government is our largest and most pervasive not-for-profit group.

Like their for-profit counterparts, these groups set goals and require resources to meet those goals. However, their goals are not focused on profits. For example, a not-for-profit organization's goal might be feeding the poor, preserving the environment, increasing attendance at the ballet, or preventing drunk driving. Not-for-profit organizations do not compete directly with one another in the same manner as, for example, Ford and Honda, but they do compete for talented employees, people's limited volunteer time, and donations.

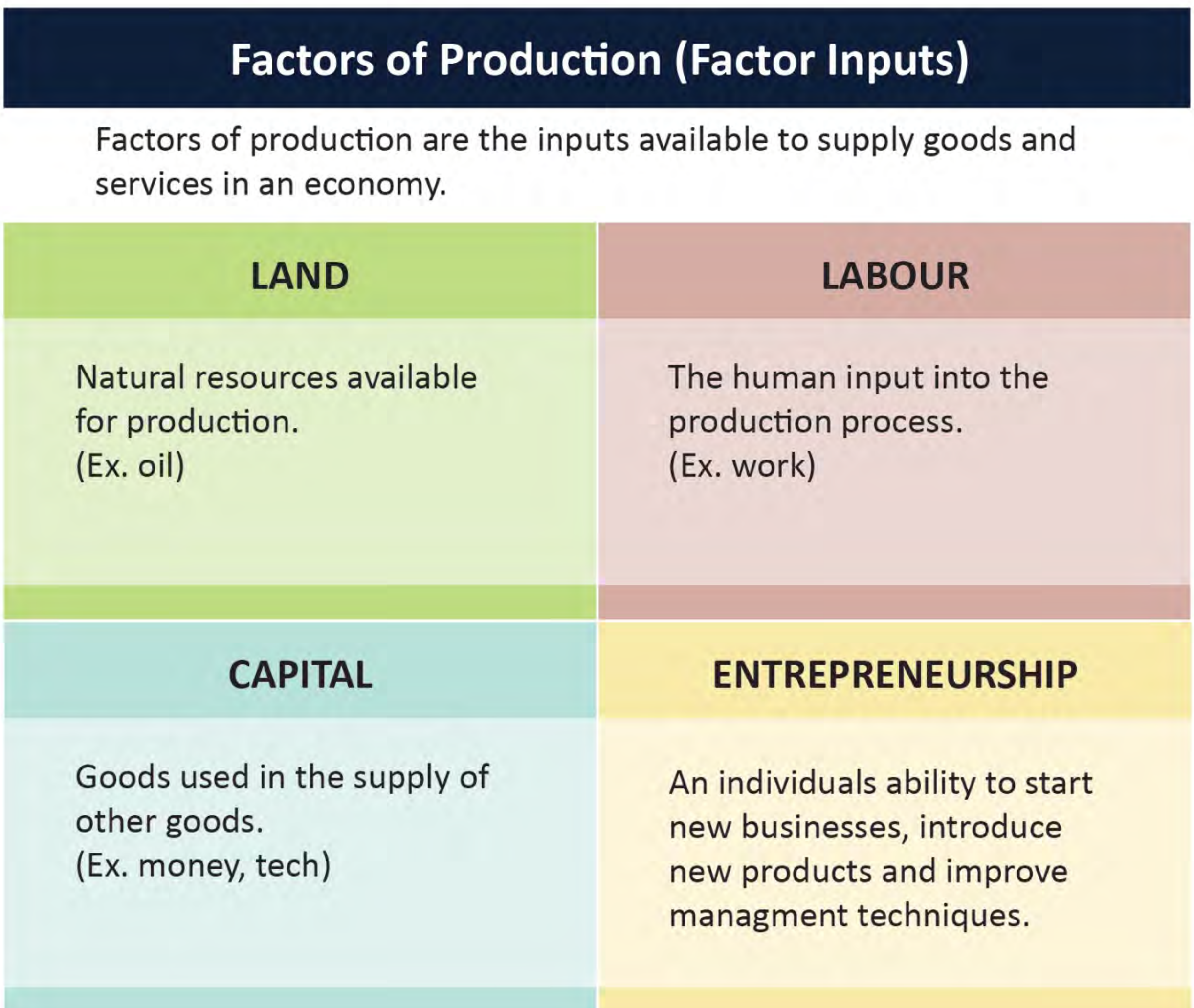
The boundaries that formerly separated not-for-profit and for-profit organizations have blurred, leading to a greater exchange of ideas between the sectors. As discussed in detail in the ethics chapter, for-profit businesses are now addressing social issues. Successful not-for-profits apply business principles to operate more effectively. Not-for-profit managers are concerned with the same concepts as their colleagues in for-profit companies: developing strategy, budgeting carefully, measuring performance, encouraging innovation, improving productivity, demonstrating accountability, and fostering an ethical workplace environment.

In addition to pursuing a museum's artistic goals, for example, top executives manage the administrative and business side of the organization: human resources, finance, and legal concerns. Ticket revenues cover a fraction of the museum's operating costs, so the director spends a great deal of time seeking major donations and memberships. Today's museum boards of directors include both art patrons and business executives who want to see sound fiscal decision-making in a not-for-profit setting. Therefore, a museum director must walk a fine line between the institution's artistic mission and financial policies. According to a survey by *The Economist*, over the next several years, major art museums will be looking for new directors, as more than a third of the current ones are approaching retirement.[4]

Factors of Production: The Building Blocks of Business

To provide goods and services, regardless of whether they operate in the for-profit or not-for-profit sector, organizations require inputs in the form of resources called **factors of production**. Four traditional factors of production are common to all productive activity: *natural resources*, *labour (human resources)*, *capital*, and *entrepreneurship*. Many experts now include *knowledge* as a fifth factor, acknowledging its key role in business success. By using the factors of production efficiently, a company can produce more goods and services with the same resources.

Commodities that are useful inputs in their natural state are known as natural resources. They include farmland, forests, mineral and oil deposits, and water. Sometimes natural resources are simply called land, although the term means more than just land. Companies use natural resources in different ways. International Paper Company uses wood pulp to make paper, and Pacific Gas & Electric Company may use water, oil, or coal to produce electricity. Today urban sprawl, pollution, and limited resources have raised questions about resource use. Conservationists, environmentalists, and government bodies are proposing laws to require land-use planning and resource conservation.



Labour, or human resources, refers to the economic contributions of people working with their minds and muscles. This input includes the talents of everyone—from a restaurant cook to a nuclear physicist—who performs the many tasks of manufacturing and selling goods and services.

The tools, machinery, equipment, and buildings used to produce goods and services and get them to the consumer are known as **capital**. Sometimes the term *capital* is also used to refer to the money that buys machinery, factories, and other production and distribution facilities. However, because money itself produces nothing, it is not one of the basic inputs. Instead, it is a means of acquiring the inputs. Therefore, in this context, capital does not include money.

Entrepreneurs are the people who combine the inputs of natural resources, labour, and capital to produce goods or services with the intention of making a profit or accomplishing a not-for-profit goal. These people make the decisions that set the course for their businesses; they create products and production processes or develop services. Because they are not guaranteed a profit in return for their time and effort, they must be risk-takers. Of course, if their companies succeed, the rewards may be great.

Today, many individuals want to start their own businesses. They are attracted by the opportunity to be their own boss and reap the financial rewards of a successful firm. Many start their first business from their dorm rooms, such as Mark Zuckerberg of Facebook, or while living at home, so their costs remain low. Entrepreneurs include people such as Microsoft cofounder Bill Gates, who was named the richest person in the world in 2017, as well as Google founders Sergey Brin and Larry Page.[5] Many thousands of individuals have started companies that, while remaining small, make a major contribution to the Canadian economy.

Factors of production video:
https://youtu.be/2a91BFui5Fc

1.2 Understanding the Business Environment

What are the sectors of the business environment, and how do changes in them influence business decisions?

Businesses do not operate in a vacuum but rather in a dynamic environment that has a direct influence on how they operate and whether they will achieve their objectives. This external business environment is composed of numerous outside organizations and forces that we can group into seven key subenvironments, as **Exhibit 1.1** illustrates: economic, political and legal, demographic, social, competitive, global, and technological. Each of these sectors creates a unique set of challenges and opportunities for businesses.

Business owners and managers have a great deal of control over the internal environment of business, which covers day-to-day decisions. They choose the supplies they purchase, which employees they hire, the products they sell, and where they sell those products. They use their skills and resources to create goods and services that will satisfy existing and prospective customers. However, the external environmental conditions that affect a business are generally beyond the control of management and change constantly. To compete successfully, business owners and managers must continuously study the environment and adapt their businesses accordingly.

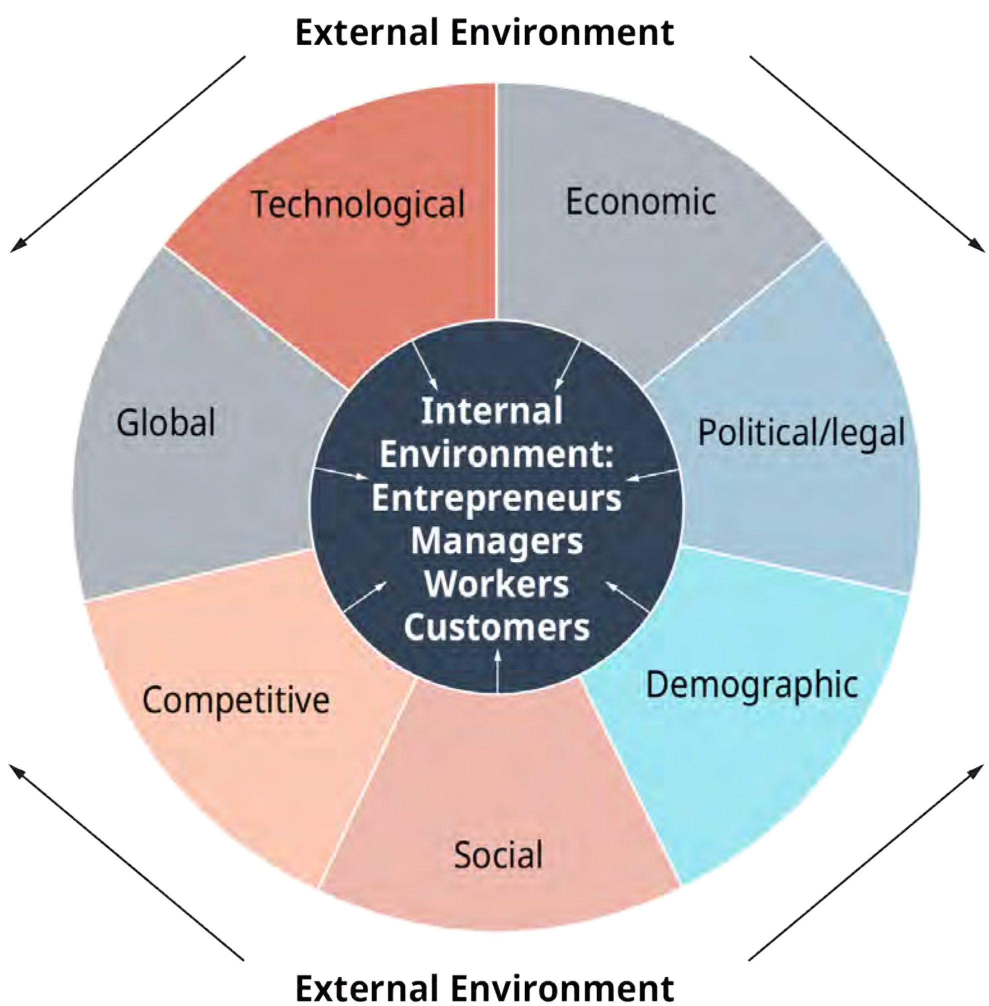


Exhibit 1.1 The Dynamic Business Environment (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

Other forces, such as natural disasters, can also have a major impact on businesses. While still in the rebuilding stage after Hurricane Katrina hit in 2005, the U.S. Gulf Coast suffered another disaster in April 2010 as a result of an explosion on the Deepwater Horizon oil-rig, which killed 11 workers and sent more than 3 million barrels of oil into the Gulf of Mexico. This event, which played out for more than 87 days, severely affected the environment, businesses, tourism, and people's livelihoods. Global oil conglomerate BP, which was responsible for the oil spill, has spent more than $60 billion in response to the disaster and cleanup. Seven years after the explosion, tourism and other businesses are slowly recovering, although scientists are not certain about the long-term environmental consequences of the oil spill.[7]

No one business is large or powerful enough to create major changes in the external environment. Thus, managers are primarily adapters to, rather than agents of change. Global competition is basically an uncontrollable element in the external environment. In some situations, however, a firm can influence external events through its strategies. For example, major U.S. pharmaceutical companies have been successful in getting the Food and Drug Administration (FDA) to speed up the approval process for new drugs.[8] In recent years, the five largest companies in the S&P Index—Google, Facebook, Amazon, Microsoft, and Apple—have spent close to $50 million on lobbying activities in the nation's capital in an effort to help policy makers understand the tech industry and the importance of innovation and an "open" internet.[9] Let's now take a brief look at these varied environmental influences.

Economic Influences

This category is one of the most important external influences on businesses. Fluctuations in the level of economic activity create business cycles that affect businesses and individuals in many ways. For example, when the economy is growing, unemployment rates are low which lead to overall increase in consumer incomes. Inflation and interest rates are other areas that change according to economic activity. The government may attempt to stimulate or curtail the level of economic activity through policies that affect taxes and interest rate levels. In addition, the forces of supply and demand determine how prices and quantities of goods and services behave in a free market.

Political and Legal Influences

The political climate of a country is another critical factor for managers to consider in day-to-day business operations. The amount of government activity, the types of laws it passes, and the general political stability of a government are three components of political climate. For example, a multinational company such as General Electric will evaluate the political climate of a country before deciding to locate a plant there. Is the government stable, or might a coup disrupt the country? How restrictive are the regulations for foreign businesses, including foreign ownership of business property and taxation? Import tariffs, quotas, and export restrictions also must be taken into account.

Demographic Factors

Demographic factors are an uncontrollable factor in the business environment and extremely important to managers. **Demography** is the study of a population's statistics, such as their age, gender, race, ethnicity, and location. Demographics help companies define the markets for their products and also determine the size and composition of the workforce.

Demographics are at the heart of many business decisions. Businesses today must deal with the unique shopping preferences of different generations, which each require targeted marketing approaches, goods, and services. For example, more than 75 million members of the millennial generation were born between 1981 and 1997. In 2017 they surpassed baby boomers as America's largest generation.[11]

The marketing impact of millennials continues to be immense. These are technologically savvy and prosperous young people, with hundreds of billions of dollars to spend. And spend they do—freely, even though they haven't yet reached their peak income and spending years.[12] Other age groups such as Generation X—people born between 1965 and 1980—and the baby boomers—born between 1946 and 1964—have their own spending patterns. Many boomers nearing retirement have money and are willing to spend it on their health, comforts, leisure pursuits, and cars. As the population ages, businesses are offering more products that appeal to middle-aged and senior markets.[13]

Social Factors

Social factors—our attitudes, values, ethics, and lifestyles—influence what, how, where, and when people purchase products or services. They are difficult to predict, define, and measure because they can be very subjective. They also change as people move through different life stages. People of all ages have a broader range of interests, defying traditional consumer profiles. People are also experiencing a "poverty of time" and seek ways to gain more control over their time. Changing roles have brought more women into the workforce. This development is increasing family incomes, heightening demand for time-saving goods and services, changing family shopping patterns, and impacting individuals' ability to achieve a work-life balance. In addition, a renewed emphasis on ethical behavior within organizations at all levels has managers and employees alike searching for the right approach when addressing gender inequality, sexual harassment, and other social behaviors that impact the potential for a business's continued success.

Technology

The application of technology can stimulate growth under capitalism or any other economic system. **Technology** is the application of science, engineering, and knowledge to solve production and organizational problems. New equipment and software that improve productivity and reduce costs can be among a company's most valuable assets. **Productivity** is the amount of goods and services one worker can produce. Our ability as a nation to maintain and build wealth depends in large part on the speed and effectiveness with which we use technology to improve manufacturing productivity, develop new products, and process information and make it instantly available across the organization, suppliers, and customers.

Many Canadian businesses, large and small, use technology to create change, improve efficiencies, and streamline operations. For example, advances in cloud computing provide businesses with the ability to access and store data without running applications or programs housed on a physical computer or server in their offices. Such applications and programs can now be accessed through the internet. Mobile technology allows businesses to communicate with employees, customers, suppliers, and others at the swipe of a tablet or smartphone screen. Robots help businesses automate repetitive tasks that free up workers to focus on more knowledge-based tasks critical to business operations.[15]

1.3 How Business and Economics Work

What are the primary features of the world's economic systems, and how are the three sectors of the Canadian economy linked?

A business's success depends in part on the economic systems of the countries where it is located and where it sells its products. A nation's **economic system** is the combination of policies, laws, and choices made by its government to establish the systems that determine what goods and services are produced and how they are allocated. **Economics** is the study of how a society uses scarce resources to produce and distribute goods and services. The resources of a person, a firm, or a nation are limited. Hence, economics is the study of choices—what people, firms, or nations choose from among the available resources. Every economy is concerned with what types and amounts of goods and services should be produced, how they should be produced, and for whom. These decisions are made by the marketplace, the government, or both. In Canada, the government and the free-market system guide the economy together.

You probably know more about economics than you realize. Every day, many news stories deal with economic matters: a union wins wage increases at General Motors, the Bank of Canada lowers interest rates, Wall Street has a record day, the prime minister proposes a cut in income taxes, consumer spending rises as the economy grows, or retail prices are on the rise, to mention just a few examples.

Global Economic Systems

Businesses and other organizations operate according to the *economic systems* of their home countries. Today the world's major economic systems fall into two broad categories: free market, or capitalism; and planned economies, which include communism and socialism. However, in reality many countries use a mixed market system that incorporates elements from more than one economic system.
The major differentiator among economic systems is whether the government or individuals decide:

- how to allocate limited resources—the factors of production—to individuals and organizations to best satisfy unlimited societal needs.
- what goods and services to produce and in what quantities.
- how and by whom these goods and services are produced.
- how to distribute goods and services to consumers.

Managers must understand and adapt to the economic system or systems in which they operate. Companies that do business internationally may discover that they must make changes in production and selling methods to accommodate the economic system of other countries. **Table 1.1** summarizes key factors of the world's economic systems.

	Capitalism	Communism	Socialism	Mixed Economy
Ownership of Business	Businesses are privately owned with minimal government ownership or interference.	Government owns all or most enterprises.	Basic industries such as railroads and utilities are owned by government. Very high taxation as government redistributes income from successful private businesses and entrepreneurs.	Private ownership of land and businesses with government control of some enterprises. The private sector is typically large.
Control of Markets	Complete freedom of trade. No or little government control.	Complete government control of markets.	Some markets are controlled, and some are free. Significant central-government planning. State enterprises are managed by bureaucrats. These enterprises are rarely profitable.	Some markets, such as nuclear energy and the post office, are controlled or highly regulated.
Worker Incentives	Strong incentive to work and innovate because profits are retained by owners.	No incentive to work hard or produce quality products.	Private-sector incentives are the same as capitalism, and public-sector incentives are the same as a planned economy.	Private-sector incentives are the same as capitalism. Limited incentives in the public sector.
Management of Enterprises	Each enterprise is managed by owners or professional managers with little government interference.	Centralized management by the government bureaucracy. Little or no flexibility in decision-making at the factory level.	Significant government planning and regulation. Bureaucrats run government enterprises.	Private-sector management similar to capitalism. Public sector similar to socialism.
Forecast for 2020	Continued steady growth.	No growth and perhaps disappearance.	Stable with probable slight growth.	Continued growth.
Examples	United States	Cuba, North Korea	Finland, India, Israel	Great Britain, France, Sweden, Canada

Table 1.1 The Basic Economic Systems of the World

Capitalism

In recent years, more countries have shifted toward free-market economic systems and away from planned economies. Sometimes, as was the case of former East Germany, the transition to capitalism is painful but fairly quick. In other countries, such as Russia, the movement has been characterized by false starts and backsliding. **Capitalism**, also known as the *private enterprise system*, is based on competition in the marketplace and private ownership of the factors of production (resources). In a competitive economic system, a large number of people and businesses buy and sell products freely in the marketplace. In pure capitalism, all the factors of production are owned privately, and the government does not try to set prices or coordinate economic activity.

A capitalist system guarantees certain economic rights: the right to own property, the right to make a profit, the right to make free choices, and the right to compete. The right to own property is central to capitalism. The main incentive in this system is profit, which encourages entrepreneurship. Profit is also necessary for producing goods and services, building manufacturing plants, paying dividends and taxes, and creating jobs. The freedom to choose whether to become an entrepreneur or to work for someone else means that people have the right to decide what they want to do on the basis of their own drive, interest, and training. The government does not create job quotas for each industry or give people tests to determine what they will do.

Capitalism video:
https://youtu.be/89H6BGdUyx0

Competition is good for both businesses and consumers in a capitalist system. It leads to better and more diverse products, keeps prices stable, and increases the efficiency of producers. Companies try to produce their goods and services at the lowest possible cost and sell them at the highest possible price. But when profits are high, more businesses enter the market to seek a share of those profits. The resulting competition among companies tends to lower prices. Companies must then find new ways of operating more efficiently if they are to keep making a profit—and stay in business.

Exhibit 1.2 McDonald's China Since joining the World Trade Organization in 2001, China has continued to embrace tenets of capitalism and grow its economy. China is the world's largest producer of mobile phones, PCs, and tablets, and the country's over one billion people constitute a gargantuan market. The explosion of McDonald's and KFC franchises epitomizes the success of American-style capitalism in China, and Beijing's bid to host the 2022 Winter Olympics is a symbol of economic openness. This McCafe is an example of changing Western products to suit Chinese tastes. *Do you think China's capitalistic trend can continue to thrive under the ruling Chinese Communist Party that opposes workers' rights, free speech, and democracy?* (Credit: Marku Kudjerski/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Communism

The complete opposite of capitalism is **communism**. In a communist economic system, the government owns virtually all resources and controls all markets. Economic decision-making is centralized: the government, rather than the competitive forces in the marketplace, decides what will be produced, where it will be produced, how much will be produced, where the raw materials and supplies will come from, who will get the output, and what the prices will be. This form of centralized economic system offers little if any choice to a country's citizens. Early in the 20th century, countries that chose communism, such as the former Soviet Union and China, believed that it would raise their standard of living. In practice, however, the tight controls over most aspects of people's lives, such as what careers they can choose, where they can work, and what they can buy, led to lower productivity. Workers had no reasons to work harder or produce quality goods, because there were no rewards for excellence. Errors in planning and resource allocation led to shortages of even basic items.

These factors were among the reasons for the 1991 collapse of the Soviet Union into multiple independent nations. Recent reforms in Russia, China, and most of the eastern European nations have moved these economies toward more capitalistic, market-oriented systems. North Korea and Cuba are the best remaining examples of communist economic systems. Time will tell whether Cuba takes small steps toward a market economy now that the United States re-established diplomatic relations with the island country a few years ago.[16]

Socialism

Socialism is an economic system in which the basic industries are owned by the government or by the private sector with strong government control. A socialist state controls critical, large-scale industries such as transportation, communications, and utilities. Smaller businesses and those considered less critical, such as retail, may be privately owned. To varying degrees, the state also determines the goals of businesses, the prices and selection of goods, and the rights of workers. Socialist countries typically provide their citizens with a higher level of services, such as health care and unemployment benefits, than do most capitalist countries. As a result, taxes and unemployment may also be higher in socialist countries. For example, in 2017, the top individual tax rate in France was 45 percent, compared to 39.6 percent in the United States. With both countries electing new presidents in 2017, tax cuts may be a campaign promise that both President Macron and President Trump take on as part of their overall economic agendas in the coming years.[17]

Many countries, including the United Kingdom, Denmark, India, and Israel, have socialist systems, but the systems vary from country to country. In Denmark, for example, most businesses are privately owned and operated, but two-thirds of the population is sustained by the state through government welfare programs.

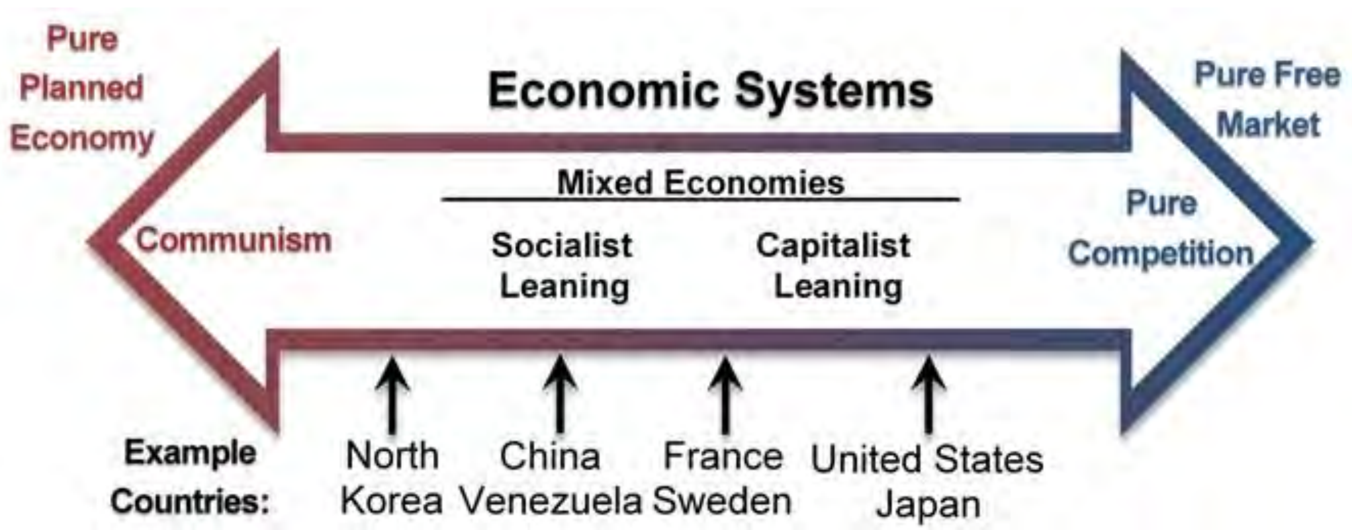
Video on economic systems:
https://youtu.be/B43YEW2FvDs

Mixed Economic Systems

Pure capitalism and communism are extremes; real-world economies fall somewhere between the two. The U.S. economy leans toward pure capitalism, but it uses government policies to promote economic stability and growth. Also, through policies and laws, the government transfers money to the poor, the unemployed, the elderly, and the disabled. American capitalism has produced some very powerful organizations in the form of large corporations, such as General Motors and Microsoft. To protect smaller firms and entrepreneurs, the government has passed legislation that requires that the giants compete fairly against weaker competitors.

Canada, Sweden, and the UK, among others, are also called **mixed economies**; that is, they use more than one economic system. Sometimes, the government is basically socialist and owns basic industries. In Canada, the government owns the communications, transportation, and utilities industries, as well as some of the natural-resource industries. It also provides health care to its citizens. But most other activity is carried on by private enterprise, as in a capitalist system. In 2016, UK citizens voted for Britain to leave the European Union, a move that will take two or more years to finalize. It is too early to tell what impact the Brexit decision will have on the UK economy and other economies around the world.[18]

The few factors of production owned by the government in a mixed economy include some public lands, the postal service, and some water resources. But the government is extensively involved in the economic system through taxing, spending, and welfare activities. The economy is also mixed in the sense that the country tries to achieve many social goals—income redistribution and retirement pensions, for example—that may not be attempted in purely capitalist systems.



Macroeconomics and Microeconomics

The state of the economy affects both people and businesses. How you spend your money (or save it) is a personal economic decision. Whether you continue in school and whether you work part-time are also economic decisions. Every business also operates within the economy. Based on their economic expectations, businesses decide what products to produce, how to price them, how many people to employ, how much to pay these employees, how much to expand the business, and so on.

Economics has two main subareas. **Macroeconomics** is the study of the economy as a whole. It looks at aggregate data for large groups of people, companies, or products as a whole. In contrast, **microeconomics** focuses on individual parts of the economy, such as households or firms.

Micro vs Macro video:
https://youtu.be/w8tUIq7Blsg

Both macroeconomics and microeconomics offer a valuable outlook on the economy. For example, Ford might use both to decide whether to introduce a new line of vehicles. The company would consider such macroeconomic factors as the national level of personal income, the unemployment rate, interest rates, fuel costs, and the national level of sales of new vehicles. From a microeconomic viewpoint, Ford would judge consumer demand for new vehicles versus the existing supply, competing models, labour and material costs and availability, and current prices and sales incentives.

Economics as a Circular Flow

Another way to see how the sectors of the economy interact is to examine the **circular flow** of inputs and outputs among households, businesses, and governments as shown in **Exhibit 1.3**. Let's review the exchanges by following the red circle around the inside of the diagram. Households provide inputs (natural resources, labour, capital, entrepreneurship, knowledge) to businesses, which convert these inputs into outputs (goods and services) for consumers. In return, households receive income from rent, wages, interest, and ownership profits (blue circle). Businesses receive revenue from consumer purchases of goods and services.

The other important exchange in **Exhibit 1.3** takes place between governments (federal, provincial, and local) and both households and businesses. Governments supply many types of publicly provided goods and services (highways, schools, police, courts, health services, unemployment insurance, social security) that benefit consumers and businesses. Government purchases from businesses also contribute to business revenues. When a construction firm repairs a local stretch of state highway, for example, government pays for the work. As the diagram shows, government receives taxes from households and businesses to complete the flow.

Changes in one flow affect the others. If government raises taxes, households have less to spend on goods and services. Lower consumer spending causes businesses to reduce production, and economic activity declines; unemployment may rise. In contrast, cutting taxes can stimulate economic activity. Keep the circular flow in mind as we continue our study of economics. The way economic sectors interact will become more evident as we explore macroeconomics and microeconomics.

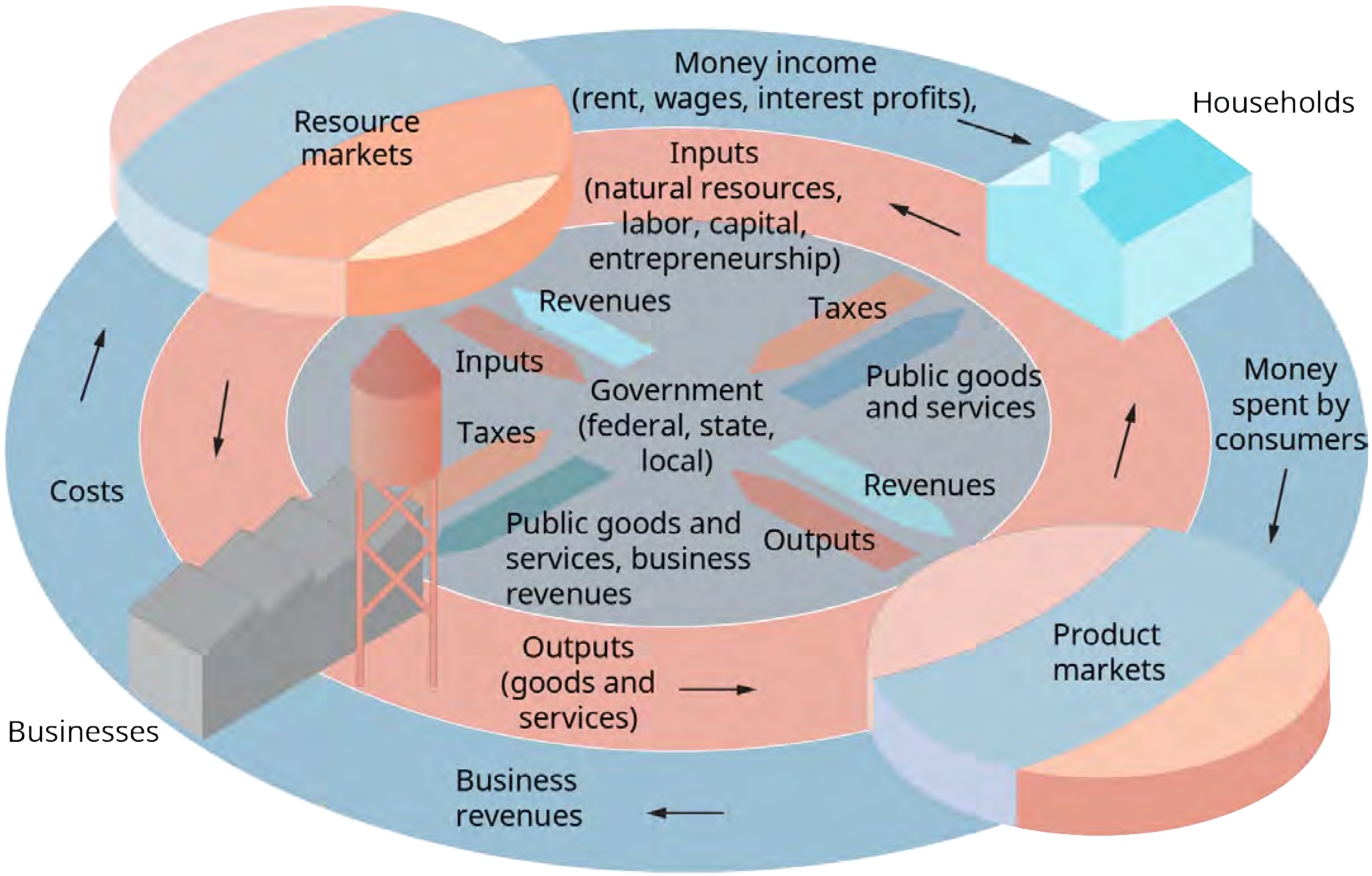


Exhibit 1.3 Economics as a Circular Flow (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

1.4 Macroeconomics: The Big Picture

How does economic growth, full employment, price stability, and inflation indicate a nation's economic health?

Have you ever looked at the news on a mobile device or turned on the radio and heard something like, "Today Statistics Canada reported that for the second straight month unemployment declined?" Statements like this are macroeconomic news. Understanding the national economy and how changes in government policies affect households and businesses is a good place to begin our study of economics. Let's look first at macroeconomic goals and how they can be met. Canada and most other countries have three main macroeconomic goals: economic growth, full employment, and price stability. A nation's economic well-being depends on carefully defining these goals and choosing the best economic policies to achieve them.

Striving for Economic Growth

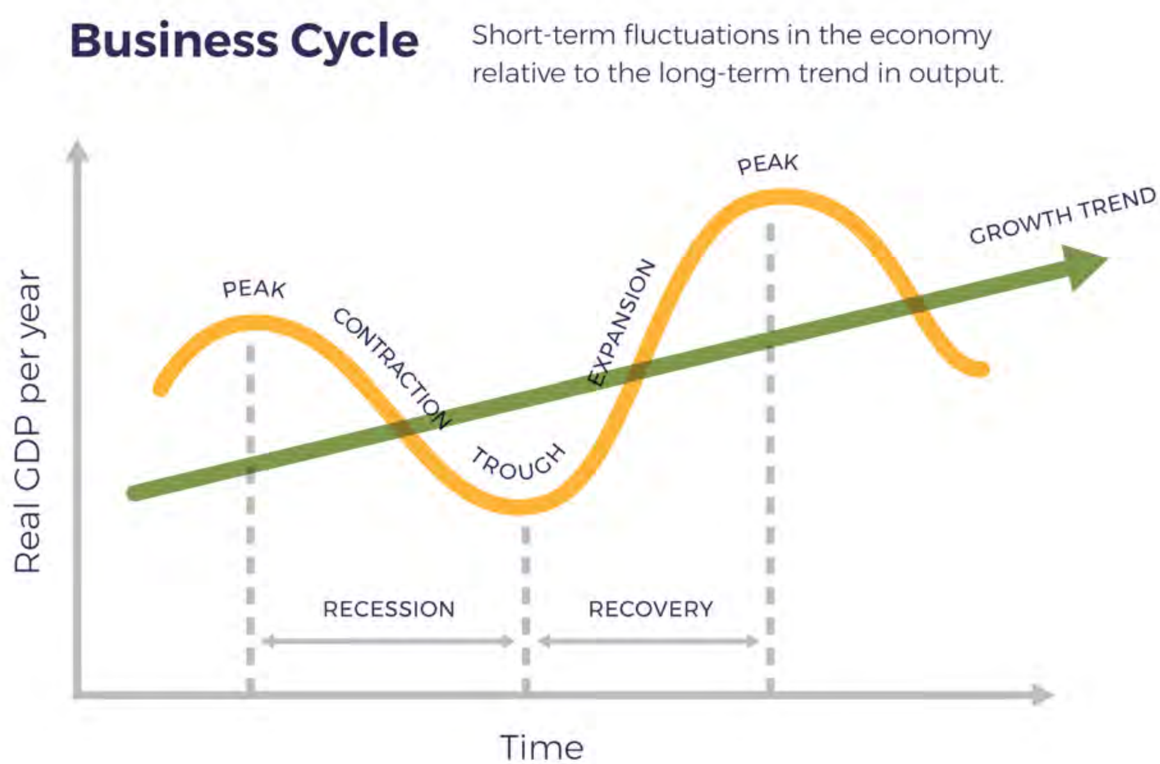
Perhaps the most important way to judge a nation's economic health is to look at its production of goods and services. The more the nation produces, the higher its standard of living. An increase in a nation's output of goods and services is **economic growth**.

The most basic measure of economic growth is the **gross domestic product (GDP)**. GDP is the total market value of all final goods and services produced within a nation's borders each year. Statistics Canada publishes quarterly GDP figures that can be used to compare trends in national output. When GDP rises, the economy is growing.

The rate of growth in real GDP (GDP adjusted for inflation) is also important. Recently, the Canadian economy has been growing at a slow but steady rate. This growth rate has meant a steady increase in the output of goods and services and relatively low unemployment. When the growth rate slides toward zero, the economy begins to stagnate and decline.

One country that continues to grow more rapidly than most is China, whose GDP has been growing at 6 to 7 percent per year. Today few things in the global marketplace are not or cannot be made in China. The primary contributor to China's rapid growth has been technology. For example, most tablets and laptops are manufactured in China.

The level of economic activity is constantly changing. These upward and downward changes are called **business cycles**. Business cycles vary in length, in how high or low the economy moves, and in how much the economy is affected. Changes in GDP trace a pattern as economic activity expands and contracts. An increase in business activity results in rising output, income, employment, and prices. Eventually, these all peak, and output, income, and employment decline. A decline in GDP that lasts for two consecutive quarters (each a three-month period) is called a **recession**. It is followed by a recovery period when economic activity once again increases. The most recent recession began in December 2007 and ended in June 2009.



Businesses must monitor and react to the changing phases of business cycles. When the economy is growing, companies often have a difficult time hiring good employees and finding scarce supplies and raw materials. When a recession hits, many firms find they have more capacity than the demand for their goods and services requires.

During the most recent recession, many businesses operated at substantially lower than capacity. When plants use only part of their capacity, they operate inefficiently and have higher costs per unit produced. Let's say that Mars Corp. has a huge plant that can produce one million Milky Way candy bars a day, but because of a recession Mars can sell only half a million candy bars a day. The plant uses large, expensive machines. Producing Milky Ways at 50 percent capacity does not efficiently utilize Mars's investment in its plant and equipment.

Keeping People on the Job

Another macroeconomic goal is **full employment** or having jobs for all who want to and can work. Full employment doesn't actually mean 100 percent employment. Some people choose not to work for personal reasons (attending school, raising children) or are temporarily unemployed while they wait to start a new job. Thus, the government defines full employment as the situation when about 94 to 96 percent of those available to work actually have jobs.

Maintaining low unemployment levels is of concern not just to Canada but also to countries around the world. For example, high youth unemployment rates (for workers 25 years of age and younger) in Spain, Italy, and Greece continue to cause protests in these European countries as elected officials struggle with how to turn around their respective economies and put more people, particularly young people, back to work. The UK's impending exit from the European Union may also have an effect on unemployment rates, as global companies move jobs out of Britain to central European countries such as Poland.[20]

Measuring Unemployment

To determine how close we are to full employment, the government measures the **unemployment rate**. This rate indicates the percentage of the total labour force that is not working but is actively looking for work. It excludes "discouraged workers," those not seeking jobs because they think no one will hire them. Each month Statistics Canada releases statistics on employment. These figures help us understand how well the economy is doing.

Types of Unemployment

Economists classify unemployment into four types: frictional, structural, cyclical, and seasonal. The categories are of small consolation to someone who is unemployed, but they help economists understand the problem of unemployment in our economy.

Frictional unemployment is short-term unemployment that is not related to the business cycle. It includes people who are unemployed while waiting to start a better job, those who are re-entering the job market, and those entering for the first time, such as new college graduates. This type of unemployment is always present and has little impact on the economy.

Structural unemployment is also unrelated to the business cycle but is involuntary. It is caused by a mismatch between available jobs and the skills of available workers in an industry or a region. For example, if the birthrate declines, fewer teachers will be needed. Or the available workers in an area may lack the skills that employers want. Retraining and skill-building programs are often required to reduce structural unemployment.

Cyclical unemployment, as the name implies, occurs when a downturn in the business cycle reduces the demand for labour throughout the economy. In a long recession, cyclical unemployment is widespread and even people with good job skills can't find jobs. The government can partly counteract cyclical unemployment with programs that boost the economy.

In the past, cyclical unemployment affected mainly less-skilled workers and those in heavy manufacturing. Typically, they would be rehired when economic growth increased. Since the 1990s, however, competition has forced many Canadian companies to downsize so they can survive in the global marketplace. These job reductions affected workers in all categories, including middle management and other salaried positions. Firms continue to re-evaluate workforce requirements and downsize to stay competitive to compete with Asian, European, U.S. and other Canadian firms. After a strong rebound from the global recession of 2007–2009, when the auto industry slashed more than 200,000 hourly and salaried workers from their payrolls, the automakers are now taking another close look at the size of their global workforces. For example, as sales steadily rose after the recession, Ford Motor Company's workforce in North America increased by 25 percent over the past five years. As car sales plateaued in 2017, the company recently announced it would cut approximately 10 percent of its global workforce in an effort to reduce costs, boost profits, and increase its stock value for shareholders.[21]

The last type is **seasonal unemployment**, which occurs during specific times of the year in certain industries. Employees subject to seasonal unemployment include retail workers hired for the holiday shopping season, fruit pickers in British Columbia, and restaurant employees in ski country during the summer.

Types of unemployment video:
https://youtu.be/ZckAN1KYB5I

Keeping Prices Steady

The third macroeconomic goal is to keep overall prices of goods and services fairly steady. The situation in which the average of all prices of goods and services is rising is called **inflation**. Inflation's higher prices reduce **purchasing power**, the value of what money can buy. Purchasing power is influenced by two things: inflation and income. If incomes rise at the same rate as inflation, there is no change in purchasing power. If prices go up but income doesn't rise or rises at a slower rate, a given amount of income buys less, and purchasing power falls. For example, if the price of a basket of groceries rises from $30 to $40 but your salary remains the same, you can buy only 75 percent as much groceries ($30 ÷ $40) for $30. Your purchasing power declines by 25 percent ($10 ÷ $40). If incomes rise at a rate faster than inflation, then purchasing power increases. You can, in fact, have rising purchasing power even if inflation is increasing. Typically, however, inflation rises faster than incomes, leading to a decrease in purchasing power.

Inflation affects both personal and business decisions. When prices are rising, people tend to spend more—before their purchasing power declines further. Businesses that expect inflation often increase their supplies, and people often speed up planned purchases of cars and major appliances.
Some nations have had high double and even triple-digit inflation in recent years. As of early 2017, the monthly inflation rate in Venezuela was an astounding 741 percent, followed by the African country of South Sudan at 273 percent.[23]

Exhibit 1.4 Nespresso Buyers of Nespresso coffee, KitKat chocolate bars, and Purina pet food are paying more for these items as global food giant Nestlé raises prices. Increasing input costs, such as costs of raw materials, have been hard on food businesses, raising the price of production, packaging, and transportation. *How might fluctuations in the producer price index (PPI) affect the consumer price index (CPI) and why?* (Credit: Kārlis Dambrāns/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Types of Inflation

There are two types of inflation. **Demand-pull inflation** occurs when the demand for goods and services is greater than the supply. Would-be buyers have more money to spend than the amount needed to buy available goods and services. Their demand, which exceeds the supply, tends to pull prices up. This situation is sometimes described as “too much money chasing too few goods.” The higher prices lead to greater supply, eventually creating a balance between demand and supply.

Cost-push inflation is triggered by increases in production costs, such as expenses for materials and wages. These increases push up the prices of final goods and services. Wage increases are a major cause of cost-push inflation, creating a “wage-price spiral.” For example, assume the Canadian Auto Workers union negotiates a three-year labour agreement that raises wages 3 percent per year and increases overtime pay. Carmakers will then raise car prices to cover their higher labour costs. Also, the higher wages will give autoworkers more money to buy goods and services, and this increased demand may pull up other prices. Workers in other industries will demand higher wages to keep up with the increased prices, and the cycle will push prices even higher.

How Inflation Is Measured

The rate of inflation is most commonly measured by looking at changes in the **consumer price index (CPI)**, an index of the prices of a "market basket" of goods and services purchased by typical urban consumers. It is published monthly by Statistics Canada. Major components of the CPI, which are weighted by importance, are food and beverages, clothing, transportation, housing, medical care, recreation, and education. There are special indexes for food and energy.

CPI video:
https://youtu.be/qfKmJe3CK6E

Changes in wholesale prices are another important indicator of inflation. The **producer price index (PPI)** measures the prices paid by producers and wholesalers for various commodities, such as raw materials, partially finished goods, and finished products.

The Impact of Inflation

Inflation has several negative effects on people and businesses. For one thing, inflation penalizes people who live on fixed incomes. Let's say that a couple receives $2,000 a month retirement income beginning in 2018. If inflation is 10 percent in 2019, then the couple can buy only about 91 percent (100 ÷ 110) of what they could purchase in 2018. Similarly, inflation hurts savers. As prices rise, the real value, or purchasing power, of a nest egg of savings deteriorates.

Changes in wholesale prices are another important indicator of inflation. The **producer price index (PPI)** measures the prices paid by producers and wholesalers for various commodities, such as raw materials, partially finished goods, and finished products.

1.5 Achieving Macroeconomic Goals

How does the government use monetary policy and fiscal policy to achieve its macroeconomic goals?

To reach macroeconomic goals, countries must often choose among conflicting alternatives. Sometimes political needs override economic needs. For example, bringing inflation under control may call for a politically difficult period of high unemployment and low growth. Or, in an election year, politicians may resist raising taxes to curb inflation. Still, the government must try to guide the economy to a sound balance of growth, employment, and price stability. The two main tools it uses are monetary policy and fiscal policy.

Monetary Policy

Monetary policy is exercised by The Bank of Canada, which is empowered to take various actions that decrease or increase the money supply and raise or lower short-term interest rates, making it harder or easier to borrow money. When The Bank of Canada believes that inflation is a problem, it will use contractionary policy to decrease the money supply and raise interest rates. When rates are higher, borrowers have to pay more for the money they borrow, and banks are more selective when making loans. Because money is "tighter"—more expensive to borrow—demand for goods and services will go down, and so will prices. In any case, that's the theory. The Bank of Canada will typically tighten or decrease the money supply during inflationary periods, making it harder to borrow money.

To counter a recession, The Bank of Canada uses expansionary policy to increase the money supply and reduce interest rates. With lower interest rates, it's cheaper to borrow money, and banks are more willing to lend it. We then say that money is "easy." Attractive interest rates encourage businesses to borrow money to expand production and encourage consumers to buy more goods and services especially more expensive things like cars and houses which require them to borrow money. In theory, both sets of actions will help the economy escape or come out of a recession.

Fiscal Policy

Fiscal policy relies on the government's powers of spending and taxation. Both taxation and government spending can be used to reduce or increase the total supply of money in the economy—the total amount, in other words, that businesses and consumers have to spend. When the country is in a recession, government policies typically increase spending, reduce taxes, or both. Such expansionary actions will put more money in the hands of businesses and consumers, encouraging businesses to expand and consumers to buy more goods and services. Expansionary fiscal policy is used to increase government expenditures and/or decrease taxes which causes the government's budget deficit to increase or its budget surplus to decrease. When the economy is experiencing inflation, the opposite policy is adopted. Contractionary fiscal policy is used to decrease government expenditures and/or increase taxes which causes the government's budget deficit to decrease or its budget surplus to increase. Because such contractionary measures reduce spending by businesses and consumers, prices come down and inflation eases.

The National Debt

If, in any given year, the government takes in more money (through taxes) than it spends on goods and services (for things such as defence, transportation, and social services), the result is a **budget surplus**. If, on the other hand, the government spends more than it takes in, we have a **budget deficit**. Historically, deficits have occurred much more often than surpluses; typically, the government spends more than it takes in. Consequently, the Canadian government now has a total national debt of more than $1.4 trillion. Just like you as a student, if you spend more each month than you bring in from a part-time job, you will build up debt.

This number is moving too quickly for the authors to keep the graph current – you can see the current debt at https://www.nationaldebtclocks.org/debtclock/canada.

1.6 Microeconomics: Zeroing in on Businesses and Consumers

What are the basic microeconomic concepts of demand and supply, and how do they establish prices?

Now let's shift our focus from the whole economy to *microeconomics,* the study of households, businesses, and industries. This field of economics is concerned with how prices and quantities of goods and services behave in a free market. It stands to reason that people, firms, and governments try to get the most from their limited resources. Consumers want to buy the best quality at the lowest price. Businesses want to keep costs low and revenues high to earn larger profits. Governments also want to use their revenues to provide the most effective public goods and services possible. These groups choose among alternatives by focusing on the prices of goods and services.

As consumers in a free market, we influence what is produced. If Mexican food is popular, the high demand attracts entrepreneurs who open more Mexican restaurants. They want to compete for our dollars by supplying Mexican food at a lower price, of better quality, or with different features, such as Santa Fe Mexican food rather than Tex-Mex. This section explains how business and consumer choices influence the price and availability of goods and services.

Supply and demand video:
https://youtu.be/AHh_toZGypw

Exhibit 1.5 Galaxy Note 7 Samsung's strategy to take on Apple's iPhone domination hit a terrible snag in 2016, when its Galaxy Note 7 mobile phone was recalled and the product eliminated. Defective batteries in the Note 7 made them catch fire and cause serious damage. Samsung eventually killed the entire line of Note 7 phones, recalling nearly 3 million phones, which cost the company more than $5 billion. *How do businesses determine the optimum quantity of products or services to make available to consumers?* (Credit: Paul Sullivan/ flickr/ Attribution- NoDerivs 2.0 Generic (CC BY-ND 2.0))

The Nature of Demand

Demand is the quantity of a good or service that people are willing to buy at various prices. The higher the price, the lower the quantity demanded, and vice versa. A graph of this relationship is called a **demand curve**.

Let's assume you own a store that sells jackets for snowboarders. From past experience, you know how many jackets you can sell at different prices. The demand curve in **Exhibit 1.6** depicts this information. The *x*-axis (horizontal axis) shows the quantity of jackets, and the *y*-axis (vertical axis) shows the related price of those jackets. For example, at a price of $100, customers will buy (demand) 600 snowboard jackets.

In the graph, the demand curve slopes downward and to the right because as the price falls, people will want to buy more jackets. Some people who were not going to buy a jacket will purchase one at the lower price.

Also, some snowboarders who already have a jacket will buy a second one. The graph also shows that if you put a large number of jackets on the market, you will have to reduce the price to sell all of them. Understanding demand is critical to businesses. Demand tells you *how much you can sell* and *at what price*—in other words, how much money the firm will earn to cover costs and hopefully earn a profit. Gauging demand is difficult even for large corporations, but particularly for small firms.

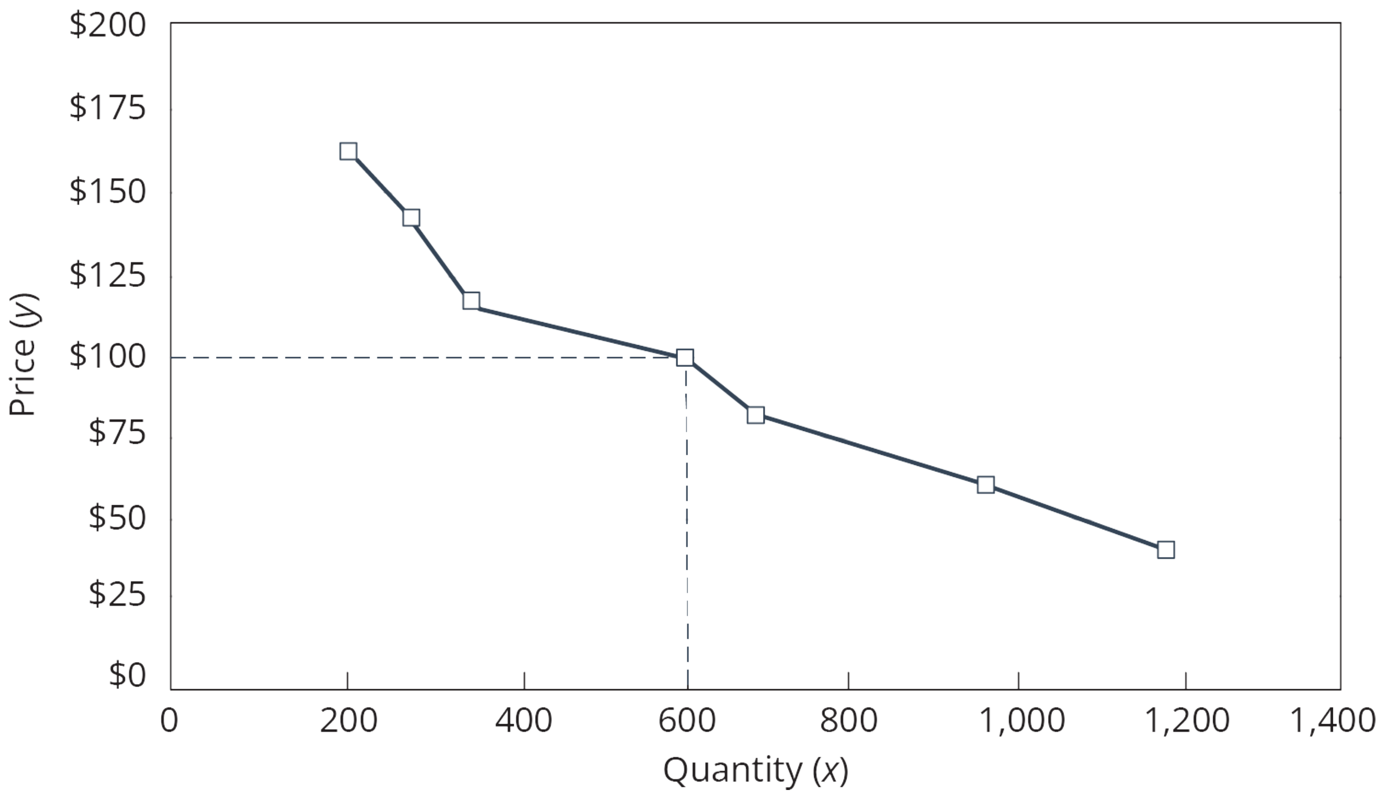


Exhibit 1.6 Demand Curve for Snowboarding Jackets (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

The Nature of Supply

Demand alone is not enough to explain how the market sets prices. We must also look at **supply**, the quantity of a good or service that businesses will make available at various prices. The higher the price, the greater the number of jackets a supplier will supply, and vice versa. A graph of the relationship between various prices and the quantities a business will supply is a **supply curve**.

We can again plot the quantity of jackets on the *x*-axis and the price on the *y*-axis. As **Exhibit 1.7** shows, 800 jackets will be available at a price of $100. Note that the supply curve slopes upward and to the right, the opposite of the demand curve. If snowboarders are willing to pay higher prices, suppliers of jackets will buy more inputs (for example, Gore-Tex® fabric, dye, machinery, labour) and produce more jackets. The quantity supplied will be greater at higher prices because manufacturers can earn higher profits.

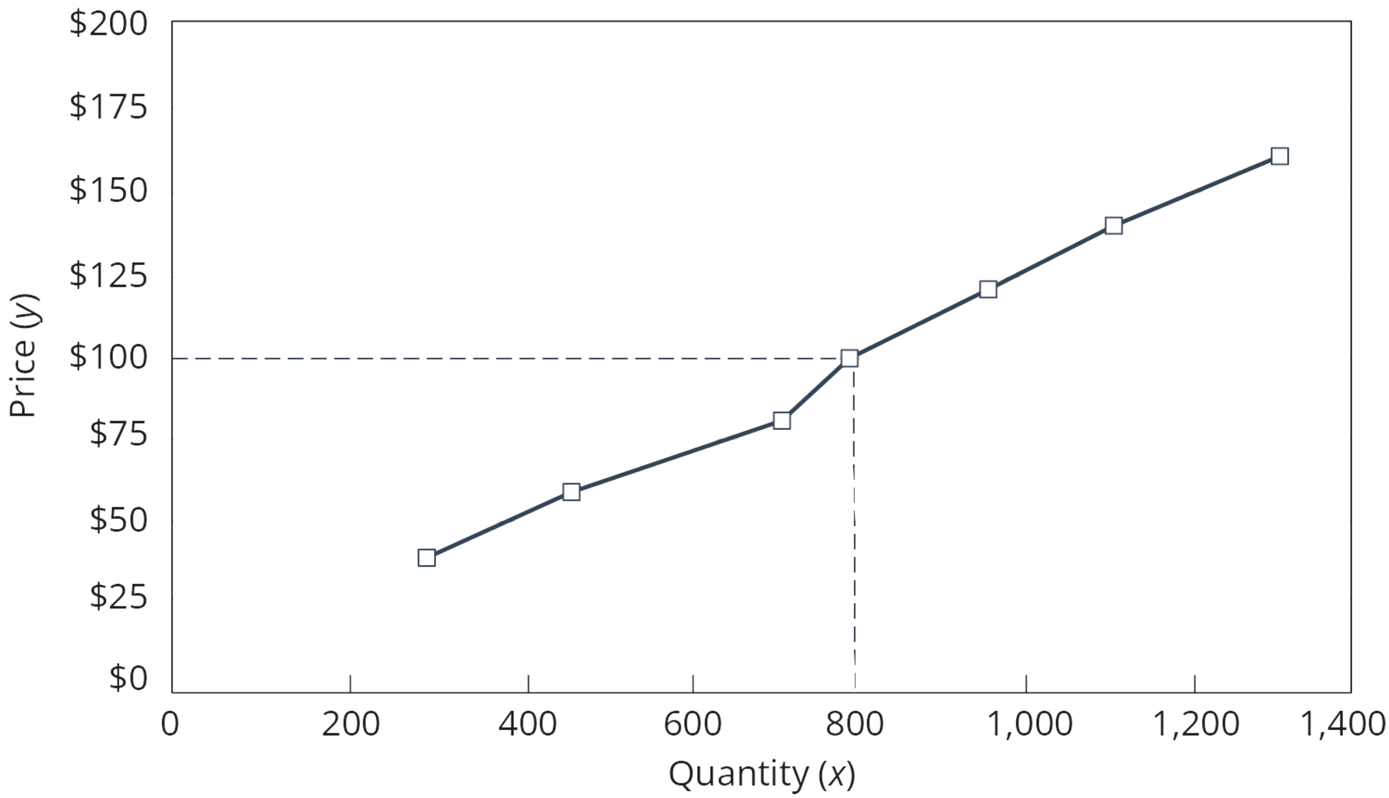


Exhibit 1.7 Supply Curve for Snowboarding Jackets (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

How Demand and Supply Interact to Determine Prices

In a stable economy, the number of jackets that snowboarders demand depends on the jackets' price. Likewise, the number of jackets that suppliers provide depends on price. But at what price will consumer demand for jackets match the quantity suppliers will produce?

To answer this question, we need to look at what happens when demand and supply interact. By plotting both the demand curve and the supply curve on the same graph in Exhibit 1.8, we see that they cross at a certain quantity and price. At that point, labeled E, the quantity demanded equals the quantity supplied. This is the point of **equilibrium**. The equilibrium price is $80 and the equilibrium quantity is 700 jackets. At that point, there is a balance between the quantity consumers will buy and the quantity suppliers will make available.

Market equilibrium is achieved through a series of quantity and price adjustments that occur automatically. If the price increases to $160, suppliers produce more jackets than consumers are willing to buy, resulting in a surplus. To sell more jackets, prices will have to fall. Thus, a surplus pushes prices downward until equilibrium is reached. When the price falls to $60, the quantity of jackets demanded rises above the available supply. The resulting shortage forces prices upward until equilibrium is reached at $80.

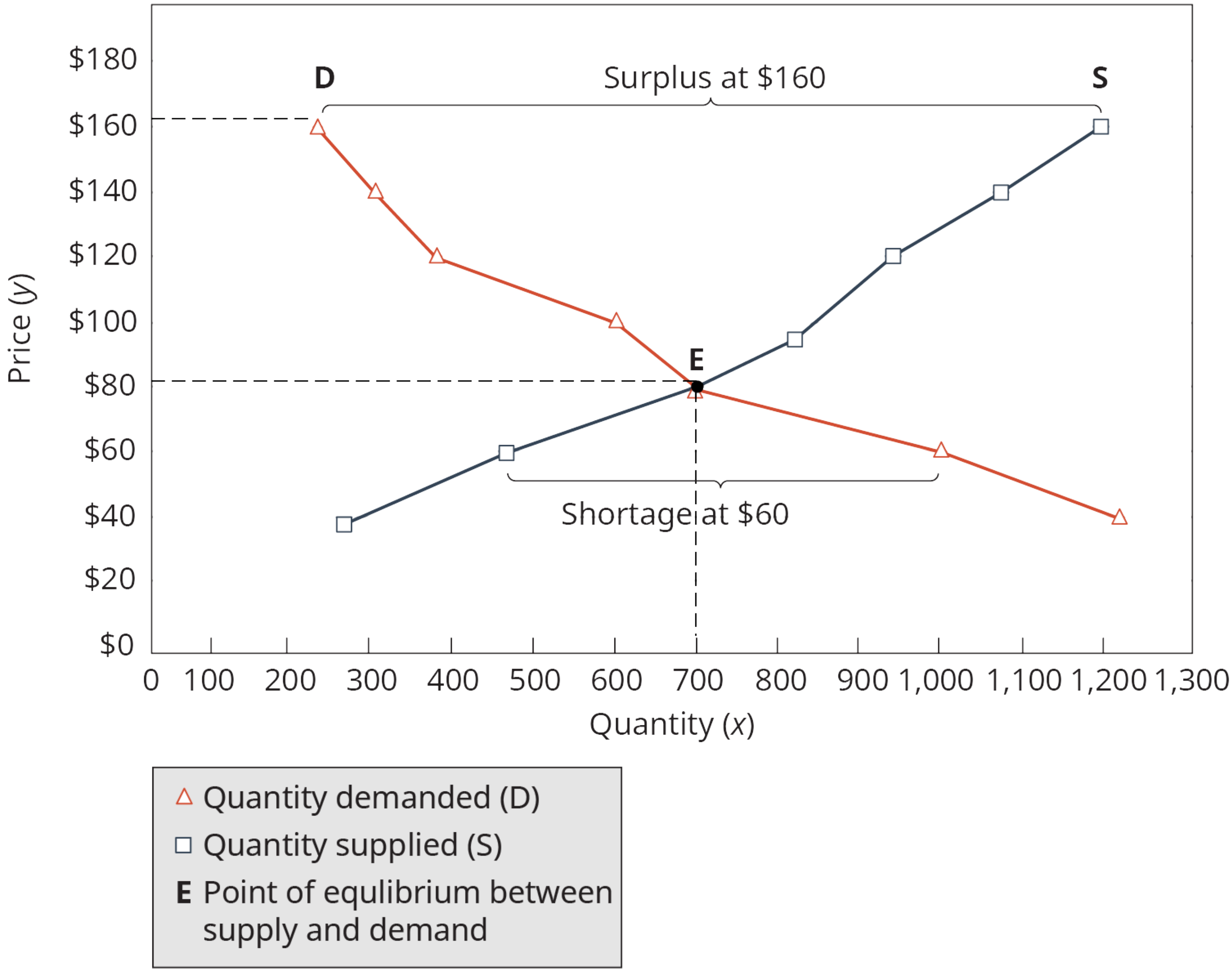


Exhibit 1.8 Equilibrium Price and Quantity of Snowboarding Jackets (Attribution: Copyright Rice University, OpenStax, under CC-BY 4.0 license)

1.7 Competing in a Free Market

What are the four types of market structure?

One of the characteristics of a free-market system is that suppliers have the right to compete with one another. The number of suppliers in a market defines the **market structure**. Economists identify four types of market structures: perfect competition, pure monopoly, monopolistic competition, and oligopoly.

Table 1.2 summarizes the characteristics of each of these market structures.

Perfect Competition

Characteristics of **perfect (pure) competition** include:

- A large number of small firms are in the market.
- The firms sell similar products; that is, each firm's product is very much like the products sold by other firms in the market.
- Buyers and sellers in the market have good information about prices, sources of supply, and so on.

It is easy to open a new business or close an existing one.

Characteristics	Perfect Competition	Pure Monopoly	Monopolistic Competition	Oligopoly
Number of firms in market	Many	One	Many, but fewer than perfect competition	Few
Firm's ability to control price	None	High	Some	Some
Barriers to entry	None	Subject to government regulation	Few	Many
Product differentiation	Very little	No products that compete directly	Emphasis on showing perceived differences in products	Some differences
Examples	Farm products such as wheat and corn	Utilities such as gas, water, cable television	Retail specialty clothing stores	Steel, automobiles, airlines, aircraft manufacturers

Table 1.2 Characteristics of the Four Market Structures

In a perfectly competitive market, firms sell their products at prices determined solely by forces beyond their control. Because the products are very similar and each firm contributes only a small amount to the total quantity supplied by the industry, price is determined by supply and demand. A firm that raised its price even a little above the going rate would lose customers. In the wheat market, for example, the product is essentially the same from one wheat producer to the next. Thus, none of the producers has control over the price of wheat.

Perfect competition is the ideal market structure for both businesses and consumers. No industry has perfect competition, but the stock market and some agricultural markets, such as wheat and corn, come closest. Farmers, for example, can sell all of their crops through national commodity exchanges at the current market price.

Pure Monopoly

At the other end of the spectrum is **pure monopoly**, the market structure in which a single firm accounts for all industry sales of a particular good or service. The firm *is* the industry. This market structure is characterized by **barriers to entry**—factors that prevent new firms from competing equally with the existing firm. Often the barriers are technological or legal conditions. Polaroid, for example, held major patents on instant photography for years. When Kodak tried to market its own instant camera, Polaroid sued, claiming patent violations. Polaroid collected millions of dollars from Kodak. Another barrier may be one firm's control of a natural resource. DeBeers Consolidated Mines Ltd., for example, controls most of the world's supply of uncut diamonds.

Public utilities, such as gas and water companies, are pure monopolies. Some monopolies are created by the government to outlaw competition. Canada Post is currently one such monopoly.

Monopolistic Competition

Three characteristics define the market structure known as **monopolistic competition**:

- Many firms are in the market.
- The firms offer products that are close substitutes but still differ from one another.
- It is relatively easy to enter the market.

Under monopolistic competition, firms take advantage of product differentiation. Industries where monopolistic competition occurs include clothing, food, and similar consumer products. Firms under monopolistic competition have more control over pricing than do firms under perfect competition because consumers do not view the products as perfect substitutes. Nevertheless, firms must demonstrate product differences to justify their prices to customers. Consequently, companies use advertising to distinguish their products from others. Such distinctions may be significant or superficial. For example, Nike says "Just Do It," and Tylenol is advertised as being easier on the stomach than aspirin.

Oligopoly

An **oligopoly** has two characteristics:

- A few firms produce most or all of the output.
- Large capital requirements or other factors limit the number of firms.

Boeing and Airbus Industries (aircraft manufacturers) and Apple and Google (operating systems for smartphones) are major players in different oligopolistic industries. With so few firms in an oligopoly, what one firm does has an impact on the other firms. Thus, the firms in an oligopoly watch one another closely for new technologies, product changes and innovations, promotional campaigns, pricing, production, and other developments. Sometimes they go so far as to coordinate their pricing and output decisions, which is illegal.

Key Terms

barriers to entry	Factors, such as technological or legal conditions, within an industry that prevent new firms from competing equally with an existing firm.
business	An organization that strives for a profit by providing goods and services desired by its customers.
business cycles	Upward and downward changes in the level of economic activity.
capital	The inputs, such as tools, machinery, equipment, and buildings, used to produce and distribute goods and services.
capitalism	An economic system based on competition in the marketplace and private ownership of the factors of production (resources); also known as the private enterprise system.
circular flow	The movement of inputs and outputs among households, businesses, and governments; a way of showing how the sectors of the economy interact.
communism	An economic system characterized by government ownership of virtually all resources, government control of all markets, and economic decision-making by central government planning.
consumer price index (CPI)	An index of the prices of a "market basket" of goods and services purchased by typical urban consumers.
contractionary policy	The use of monetary policy by a country's central bank to tighten the money supply by selling government securities or raising interest rates.
cost-push inflation	Inflation that occurs when increases in production costs push up the prices of final goods and services.
costs	Expenses incurred from creating and selling goods and services.
crowding out	The situation that occurs when government spending replaces spending by the private sector.
cyclical unemployment	Unemployment that occurs when a downturn in the business cycle reduces the demand for labor throughout the economy.
demand	The quantity of a good or service that people are willing to buy at various prices.
demand curve	A graph showing the quantity of a good or service that people are willing to buy at various prices.
demand-pull inflation	Inflation that occurs when the demand for goods and services is greater than the supply.
demography	The study of a population's statistics, such as their age, gender, race, ethnicity, and location.
economic growth	An increase in a nation's output of goods and services.
economic system	The combination of policies, laws, and choices made by a nation's government to establish the systems that determine what goods and services are produced and how they are allocated.

Key Terms

economics	The study of how a society uses scarce resources to produce and distribute goods and services.
entrepreneurs	People who combine the inputs of natural resources, labor, and capital to produce goods or services with the intention of making a profit or accomplishing a not-for-profit goal.
equilibrium	The point at which quantity demanded equals quantity supplied.
expansionary policy	The use of monetary policy by a country's central bank to increase or loosen the growth of the money supply.
factors of production	The resources used to create goods and services.
federal budget deficit	The condition that occurs when the federal government spends more for programs than it collects in taxes.
fiscal policy	The government's use of taxation and spending to affect the economy.
frictional unemployment	Short-term unemployment that is not related to the business cycle.
full employment	The condition when all people who want to work and can work have jobs.
goods	Tangible items manufactured by businesses.
gross domestic product (GDP)	The total market value of all final goods and services produced within a nation's borders each year.
inflation	The situation in which the average of all prices of goods and services is rising.
knowledge	The combined talents and skills of the workforce.
knowledge workers	Workers who create, distribute, and apply knowledge.
macroeconomics	The subarea of economics that focuses on the economy as a whole by analyzing aggregate data for large groups of people, companies, or products.
market structure	The number of suppliers in a market.
microeconomics	The subarea of economics that focuses on individual parts of the economy, such as households or firms.
mixed economies	Economies that combine several economic systems; for example, an economy where the government owns certain industries but others are owned by the private sector..
monetary policy	A government's programs for controlling the amount of money circulating in the economy and interest rates.
monopolistic competition	A market structure in which many firms offer products that are close substitutes, and entry into the industry is relatively easy.

Key Terms

national debt	The accumulated total of all of the federal government's annual budget deficits.
not-for-profit organization	An organization that exists to achieve some goal other than gaining profit.
oligopoly	A market structure in which a few firms produce most or all of the output, and large capital requirements or other factors limit the total number of firms.
perfect (pure) competition	A market structure in which a large number of small firms sell similar products, buyers and sellers have good information, and businesses can be easily opened or closed.
producer price index (PPI)	An index of the prices paid by producers and wholesalers for various commodities, such as raw materials, partially finished goods, and finished products.
productivity	The amount of goods and services one worker can produce.
profit	The money left over after all costs are paid.
purchasing power	The value of what money can buy.
pure monopoly	A market structure in which a single firm accounts for all industry sales of a particular good or service, and there are barriers to entry.
quality of life	The general level of human happiness based on factors such as life expectancy, educational standards, health, sanitation, and leisure time.
recession	A decline in GDP that lasts for at least two consecutive quarters.
relationship management	The practice of building, maintaining, and enhancing interactions with customers and other parties to develop long-term satisfaction through mutually beneficial partnerships.
revenue	The money a company receives by providing services or selling goods to customers.
risk	The potential to lose time and money or otherwise not be able to accomplish an organization's goals.
savings bonds	Government bonds issued in relatively small denominations.
seasonal unemployment	Unemployment that occurs during specific seasons in certain industries.
services	Intangible offerings of businesses that can't be held, touched, or stored.
socialism	An economic system in which the basic industries are owned either by the government itself or by the private sector with strong government control.
standard of living	A country's output of goods and services that people can buy with the money they have.
strategic alliance	A cooperative agreement between business firms; sometimes called a strategic partnership.

Key Terms

structural unemployment	Unemployment that is caused by a mismatch between available jobs and the skills of available workers in an industry or region; not related to the business cycle.
supply	The quantity of a good or service that businesses will make available at various prices.
supply curve	A graph showing the quantity of a good or service that businesses will make available at various prices.
technology	The application of science, engineering, and knowledge to solve production and organizational problems.
unemployment rate	The percentage of the total labor force that is not working but is actively looking for work.

Summary of Learning Outcomes

1. How do businesses and not-for-profit organizations help create our standard of living?

Businesses attempt to earn a profit by providing goods and services desired by their customers. Not-for-profit organizations, though not striving for a profit, still deliver many needed services for our society. Our standard of living is measured by the output of goods and services. Thus, businesses and not-for-profit organizations help create our standard of living. Our quality of life is not simply the amount of goods and services available for consumers but rather the society's general level of happiness.

Economists refer to the building blocks of a business as the factors of production. To produce anything, one must have natural resources, labor (human resources), capital, and entrepreneurship to assemble the resources and manage the business. Today's competitive business environment is based upon knowledge and learning. The companies that succeed will be those that learn fast, use knowledge efficiently, and develop new insights.

2. What are the sectors of the business environment, and how do changes in them influence business decisions?

The external business environment consists of economic, political and legal, demographic, social, competitive, global, and technological sectors. Managers must understand how the environment is changing and the impact of those changes on the business. When economic activity is strong, unemployment rates are low, and income levels rise. The political environment is shaped by the amount of government intervention in business affairs, the types of laws it passes to regulate both domestic and foreign businesses, and the general political stability of a government. Demographics, or the statistics of a population, are at the heart of many business decisions. Businesses today must deal with the unique preferences of different generations, each of which requires different marketing approaches, goods, and services. The population is becoming increasingly diverse: minorities' buying power has increased significantly as well, and companies are developing products and marketing campaigns that target different ethnic groups. Social factors—our attitudes, values, and lifestyles—influence what, how, where, and when people purchase products. They are difficult to predict, define, and measure because they can be very subjective. They also change as people move through different life stages.

3. What are the primary features of the world's economic systems, and how are the three sectors of the Canadian economy linked?

Economics is the study of how individuals, businesses, and governments use scarce resources to produce and distribute goods and services. Today there is a global trend toward capitalism. Capitalism, also known as the private enterprise system, is based upon marketplace competition and private ownership of the factors of production. Competition leads to more diverse goods and services, keeps prices stable, and pushes businesses to become more efficient.

In a communist economy, the government owns virtually all resources, and economic decision-making is done by central government planning. Governments have generally moved away from communism because it is inefficient and delivers a low standard of living. Socialism is another centralized economic system in which the basic industries are owned by the government or by the private sector with strong government control. Other industries may be privately owned. The state is also somewhat influential in determining the goals of business, the prices and selection of products, and the rights of workers. Most national economies today are a mix of socialism and capitalism.

The two major areas in economics are macroeconomics, the study of the economy as a whole, and microeconomics, the study of households and firms. The individual, business, and government sectors of the economy are linked by a series of two-way paths. The government provides public goods and services to the other two sectors and receives income in the form of taxes. Changes in one sector affect the other sectors.

Summary of Learning Outcomes

4. How do economic growth, full employment, price stability, and inflation indicate a nation's economic health?

A nation's economy grows when the level of business activity, as measured by gross domestic product (GDP), rises. GDP is the total value of all goods and services produced in a year. The goal of full employment is to have a job for all who can and want to work. How well a nation is meeting its employment goals is measured by the unemployment rate. There are four types of unemployment: frictional, structural, cyclical, and seasonal. With price stability, the overall prices of goods and services fluctuate minimally. Inflation is the general upward movement of prices. When prices rise, purchasing power falls. The rate of inflation is measured by changes in the consumer price index (CPI) and the producer price index (PPI). There are two main causes of inflation. If the demand for goods and services exceeds the supply, prices will rise. This is called demand-pull inflation. With cost-push inflation, higher production costs, such as expenses for materials and wages, increase the final prices of goods and services.

5. How does the government use monetary policy and fiscal policy to achieve its macroeconomic goals?

Monetary policy refers to actions by the Bank of Canada to control the money supply. When the Bank of Canada restricts the money supply, interest rates rise, the inflation rate drops, and economic growth slows. By expanding the money supply, the Bank of Canada stimulates economic growth. The government also uses fiscal policy—changes in levels of taxation and spending—to control the economy. Reducing taxes or increasing spending stimulates the economy; raising taxes or decreasing spending does the opposite. When the government spends more than it receives in tax revenues, it must borrow to finance the deficit. Some economists favor deficit spending as a way to stimulate the economy; others worry about our high level of national debt.

6. What are the basic microeconomic concepts of demand and supply, and how do they establish prices?

Demand is the quantity of a good or service that people will buy at a given price. Supply is the quantity of a good or service that firms will make available at a given price. When the price increases, the quantity demanded falls, but the quantity supplied rises. A price decrease leads to increased demand but a lower supply. At the point where the quantity demanded equals the quantity supplied, demand and supply are in balance. This equilibrium point is achieved by automatic market adjustments of quantity and price.

7. What are the four types of market structure?

Market structure is the number of suppliers in a market. Perfect competition is characterized by a large number of buyers and sellers, very similar products, good market information for both buyers and sellers, and easy entry and exit from the market. In a pure monopoly, there is a single seller in a market. In monopolistic competition, many firms sell close substitutes in a market that is fairly easy to enter. In an oligopoly, a few firms produce most or all of the industry's output. An oligopoly is also difficult to enter, and what one firm does will influence others.

Chapter 2

Business Ethics

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What philosophies and concepts shape personal ethical standards?
2. How can organizations encourage ethical business behaviour?
3. What is corporate social responsibility?
4. How do businesses meet their social responsibilities to various stakeholders?
5. What are the trends in ethics and corporate social responsibility?

2.1 Understanding Business Ethics

What philosophies and concepts shape personal ethical standards?

Every day, managers and business owners make business decisions based on what they believe to be right and wrong. Through their actions, they demonstrate to their employees what is and is not acceptable behaviour and shape the moral standard of the organization. As you will see in this chapter, personal and professional ethics are important cornerstones of an organization and shape its ultimate contributions to society in the form of corporate social responsibility. First, let's consider how individual business ethics are formed.

Ethics is a set of moral standards for judging whether something is right or wrong. The first step in understanding business ethics is learning to recognize an **ethical issue**. An ethical issue is a situation where someone must choose between a set of actions that may be ethical or unethical. For example, Martin Shkreli, former CEO of Turing Pharmaceuticals, raised the price of a drug used for newborns and HIV patients by more than *5000* percent, defending the price increase as a "great business decision."[1] Few people would call that ethical behaviour. But consider the actions of the stranded, hungry people in New Orleans who lost everything in the aftermath of Hurricane Katrina. They broke into flooded stores, taking food and bottled water without paying for them. Was this unethical behaviour? Or what about the small Texas plastics manufacturer that employed over 100 people and specialized in the Latin American market? The president was distraught because he knew the firm would be bankrupt by the end of the year if it didn't receive more contracts. He knew that he was losing business because he refused to pay bribes. Bribes were part of the culture in his major markets. Closing the firm would put many people out of work. Should he start paying bribes in order to stay in business? Would this be unethical? Let's look at the next section to obtain some guidance on recognizing unethical situations.

Ethics business ethics and social responsibility video:
https://youtu.be/0KhURlAim80

Recognizing Unethical Business Activities

Researchers from Brigham Young University tell us that all unethical business activities will fall into one of the following categories:

1. **Taking things that don't belong to you:** The unauthorized use of someone else's property or taking property under false pretenses is taking something that does not belong to you. Even the smallest offense, such as using the postage meter at your office for mailing personal letters or exaggerating your travel expenses, belongs in this category of ethical violations.
2. **Saying things you know are not true:** Often, when trying for a promotion and advancement, fellow employees discredit their coworkers. Falsely assigning blame or inaccurately reporting conversations is lying. Although "This is the way the game is played around here" is a common justification, saying things that are untrue is an ethical violation.
3. **Giving or allowing false impressions:** The salesperson who permits a potential

customer to believe that cardboard boxes will hold the customer's tomatoes for long-distance shipping when the salesperson knows the boxes are not strong enough has given a false impression. A car dealer who fails to disclose that a car has been in an accident is misleading potential customers.

4. **Buying influence or engaging in a conflict of interest:** A conflict of interest occurs when the official responsibilities of an employee or government official are influenced by the potential for personal gain. Suppose a company awards a construction contract to a firm owned by the father of the provincial attorney general while the provincial attorney general's office is investigating that company. If this construction award has the potential to shape the outcome of the investigation, a conflict of interest has occurred.
5. **Hiding or divulging information:** Failing to disclose the results of medical studies that indicate your firm's new drug has significant side effects is the ethical violation of hiding information about the potential harm your product has to purchasers. Taking your firm's product development or trade secrets to a new place of employment constitutes the ethical violation of divulging proprietary information.
6. **Taking unfair advantage:** Many current consumer protection laws were passed because so many businesses took unfair advantage of people who were not educated or were unable to discern the nuances of complex contracts. Credit disclosure requirements, truth-in-lending provisions, and new regulations on auto leasing all resulted because businesses misled consumers who could not easily follow the jargon of long, complex agreements.
7. **Committing improper personal behaviour:** Although the ethical aspects of an employee's right to privacy are still debated, it has become increasingly clear that personal conduct outside the job can influence performance and company reputation. Thus, a company driver must abstain from substance abuse because of safety issues. Even the traditional company holiday party and summer picnic have come under scrutiny due to the possibility that employees at and following these events might harm others through alcohol-related accidents.
8. **Abusing power and mistreating individuals:** Suppose a manager sexually harasses an employee or subjects employees to humiliating corrections or reprimands in the presence of customers. In some cases, laws protect employees. Many situations, however, are simply interpersonal abuse that constitutes an ethical violation.
9. **Permitting organizational abuse:** Many Canadian firms with operations overseas, such as Apple, Nike, and Levi Strauss, have faced issues of organizational abuse. The unfair treatment of workers in international operations appears in the form of child labour, demeaning wages, and excessive work hours. Although a business cannot change the culture of another country, it can perpetuate—or stop—abuse through its operations there.
10. **Violating rules:** Many organizations use rules and processes to maintain internal

control or respect the authority of managers. Although these rules may seem burdensome to employees trying to serve customers, a violation may be considered an unethical act.

11. **Condoning unethical actions:** What if you witnessed a fellow employee embezzling company funds by forging her signature on a check? Would you report the violation? A winking tolerance of others' unethical behaviour is itself unethical.[2]

After recognizing that a situation is unethical, the next question is what do you do? The action that a person takes is partially based upon his or her ethical philosophy. The environment in which we live and work also plays a role in our behaviour. This section describes personal philosophies and legal factors that influence the choices we make when confronting an ethical dilemma.

Justice—The Question of Fairness

Another factor influencing individual business ethics is **justice**, or what is fair according to prevailing standards of society. We all expect life to be reasonably fair. You expect your exams to be fair, the grading to be fair, and your wages to be fair based on the type of work being done.

Today we take justice to mean an equitable distribution of the burdens and rewards that society has to offer. The distributive process varies from society to society. Those in a democratic society believe in the "equal pay for equal work" doctrine, in which individuals are rewarded based on the value the free market places on their services. Because the market places different values on different occupations, the rewards, such as wages, are not necessarily equal. Nevertheless, many regard the rewards as just. A politician who argued that a supermarket clerk should receive the same pay as a physician, for example, would not receive many votes from the Canadian people. At the other extreme, communist theorists have argued that justice would be served by a society in which burdens and rewards were distributed to individuals according to their abilities and their needs, respectively.

Individual Rights

In our society, individuals and groups have certain rights that exist under certain conditions regardless of any external circumstances. These rights serve as guides when making individual ethical decisions. The term *human rights* implies that certain rights—to life, to freedom, to the pursuit of happiness—are bestowed at birth and cannot be arbitrarily taken away. Denying the rights of an individual or group is considered to be unethical and illegal in most, though not all, parts of the world. Certain rights are guaranteed by the government and its laws, and these are considered *legal rights.*

2.2 How Organizations Influence Ethical Conduct

How can organizations encourage ethical business behaviour?

People choose between right and wrong based on their personal code of ethics. They are also influenced by the ethical environment created by their employers. Consider the following headlines:

- Investment advisor Bernard Madoff sentenced to 150 years in prison for swindling clients out of more than $65 billion.
- Former United Airlines CEO Jeff Smisek leaves the company after a federal investigation into whether United tried to influence officials at the Port Authority of New York.
- Renaud Laplanche, the founder of Lending Club, loses his job because of faulty practices and conflicts of interest at the online peer-to-peer lender.
- Wells Fargo CEO John Stumpf fired after company employees opened more than 2 million fake accounts to meet aggressive sales targets.[3]

As these actual stories illustrate, poor business ethics can create a very negative image for a company, can be expensive for the firm and/or the executives involved, and can result in bankruptcy and jail time for the offenders. Organizations can reduce the potential for these types of liability claims by leading through example, through various informal and formal programs, and by educating their employees about ethical standards.

Leading by Example

Employees often follow the examples set by their managers. Leaders and managers establish patterns of behaviour that determine what's acceptable and what's not within the organization. While Ben Cohen was president of Ben & Jerry's ice cream, he followed a policy that no one could earn a salary more than seven times that of the lowest-paid worker. He wanted all employees to feel that they were equal. At the time he resigned, company sales were $140 million, and the lowest-paid worker earned $19,000 per year. Ben Cohen's salary was $133,000, based on the "seven times" rule. A typical top executive of a $140 million company might have earned 10 times Cohen's salary. Ben Cohen's actions helped shape the ethical values of Ben & Jerry's.

Offering Ethics Training Programs

In addition to providing a system to resolve ethical dilemmas, organizations also provide formal training to develop an awareness of questionable business activities and practice appropriate responses. Many companies have some type of ethics training program. The ones that are most effective, like those created by Levi Strauss, American Express, and Campbell Soup Company, begin with techniques for solving ethical dilemmas such as those discussed earlier. Next, employees are presented with a series of situations and asked to come up with the "best" ethical solution. According to a recent survey by the Ethics Resource Center, more than 80 percent of U.S. companies provide some sort of ethics training for employees, which may include online activities, videos, and even games.[4]

Establishing a Formal Code of Ethics

Most large companies and thousands of smaller ones have created, printed, and distributed codes of ethics. In general, a **code of ethics** provides employees with the knowledge of what their firm expects in terms of responsibilities and behaviour toward fellow employees, customers, and suppliers. Some ethical codes offer a lengthy and detailed set of guidelines for employees. Others are not really codes at all but rather summary statements of goals, policies, and priorities. Some companies have their codes framed and hung on office walls, included as a key component of employee handbooks, and/or posted on their corporate websites.

Examples of company codes of ethics:

- **Costco:** http://phx.corporate-ir.net/phoenix.zhtml?c=83830&p=irol-govhighlights
- **Starbucks:** https://www.starbucks.com/about-us/company-information/business-ethics-and-compliance
- **AT&T:** https://www.att.com/gen/investor-relations?pid=5595

Do codes of ethics make employees behave in a more ethical manner? Some people believe that they do. Others think that they are little more than public relations gimmicks. If senior management abides by the code of ethics and regularly emphasizes the code to employees, then it will likely have a positive influence on behaviour.

The "100 Best Corporate Citizens" as ranked by *Corporate Responsibility* magazine are selected based on seven categories, including employee relations, human rights, corporate governance (including code of ethics), philanthropy and community support, financial performance, environment, and climate change.[5] The top corporate citizens in 2017 were:

1. Hasbro, Inc.
2. Intel Corp.
3. Microsoft Corp.
4. Altria Group, Inc.
5. Campbell Soup Company
6. Cisco Systems, Inc.
7. Accenture
8. Hormel Foods Corp.
9. Lockheed Martin Corp.
10. Ecolab, Inc.

Making the Right Decision

In many situations, there may be no simple right or wrong answers. Yet there are several questions you can ask yourself, and a couple of self-tests you can do, to help you make the right ethical decision. First, ask yourself, "Are there any legal restrictions or violations that will result from the action?" If so, take a different course of action. If not, ask yourself, "Does it violate my company's code of ethics?" If so, again find a different path to follow. Third, ask, "Does this meet the guidelines of my own ethical philosophy?" If the answer is "yes," then your decision must still pass two important tests.

The Feelings Test

You must now ask, "How does it make me feel?" This enables you to examine your comfort level with a particular decision. Many people find that, after reaching a decision on an issue, they still experience discomfort that may manifest itself in a loss of sleep or appetite. Those feelings of conscience can serve as a future guide in resolving ethical dilemmas.

The Newspaper or Social Media Test

The final test involves the front page of the newspaper or social media posts. The question to be asked is how an objective reporter would describe your decision in a front-page newspaper story, an online media site, or a social media platform such as Twitter or Facebook. Some managers rephrase the test for their employees: How will the headline read if I make this decision, or what will be the reaction of my social media followers? This test is helpful in spotting and resolving potential conflicts of interest.

Exhibit 2.1 Making an ethical decision might come down to how you feel about the decision or to the newspaper or social media post test. The question to ask yourself is how the decision would make you feel if an objective reporter described the decision on the front page of a newspaper or via a social media post on Twitter or Facebook—all of which would be viewed by many, many people. Speaking of social media, it plays a pivotal role in ethical decision-making today, when people use the medium to share critical comments about friends as well as employers, business colleagues, and competitors. *Should companies view employees' social media pages on a regular basis, or is that information off-limits to employers?* (Credit: Mike MacKenzie/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

2.3 Managing a Socially Responsible Business

What are the trends in ethics and corporate social responsibility?

Acting in an ethical manner is one of the four components of the pyramid of **corporate social responsibility (CSR),** which is the concern of businesses for the welfare of society as a whole. It consists of obligations beyond those required by law or union contract. This definition makes two important points. First, CSR is voluntary. Beneficial action required by law, such as cleaning up factories that are polluting air and water, is not voluntary. Second, the obligations of corporate social responsibility are broad. They extend beyond investors in the company to include workers, suppliers, consumers, communities, and society at large.

Exhibit 2.2 portrays economic responsibility as the foundation of the other three responsibilities. While a business pursues profits (economic responsibility), it is expected to obey the law (legal responsibility); to do what is right, just, and fair (ethical responsibility); and to be a good corporate citizen (philanthropic responsibility). These four components are distinct but together constitute the whole. Still, if the company doesn't make a profit, then the other three responsibilities won't matter.

Many companies continue to work hard to make the world a better place to live. Recent data suggests that Fortune 500 companies spend more than $15 billion annually on CSR activities. Consider the following examples:

- Starbucks has donated more than one million meals to local communities via its FoodShare program and alliance with Feeding America, giving 100 percent of leftover food from their seven thousand U.S. company-owned stores.
- Salesforce encourages its employees to volunteer in community activities and pays them for doing so, up to 56 paid hours every year. For employees who participate in seven days of volunteerism in one year, Salesforce also gives them a $1,000 grant to donate to the employee's nonprofit of choice.
- Employees who work for Deloitte, a global audit, consulting, and financial services organization, can get paid for up to 48 hours of volunteer work each year. In a recent year, more than 27,000 Deloitte professionals contributed more than 353,000 volunteer hours to their communities around the world.[6]

Understanding Social Responsibility

Peter Drucker, the late globally respected management expert, said that we should look first at what an organization does *to* society and second at what it can do *for* society. This idea suggests that social responsibility has two basic dimensions: legality and responsibility.

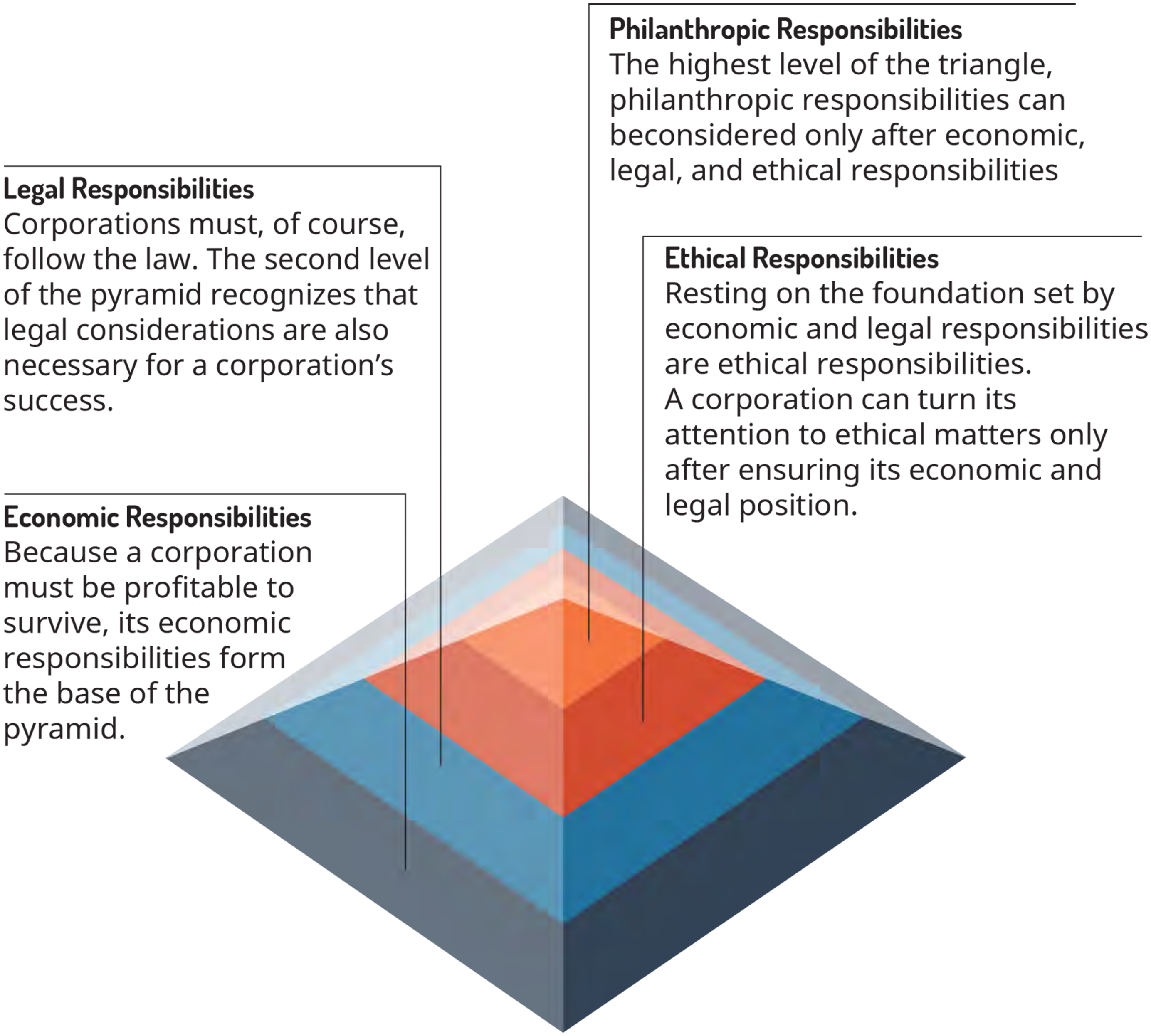


Exhibit 2.2 The Pyramid of Corporate Social Responsibility (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Illegal and Irresponsible Behaviour

The idea of corporate social responsibility is so widespread today that it is hard to conceive of a company continually acting in illegal and irresponsible ways. Nevertheless, such actions do sometimes occur, which can create financial ruin for organizations, extreme financial hardships for many former employees, and general struggles for the communities in which they operate in. Unfortunately, top executives still walk away with millions. Some, however, will ultimately pay large fines and spend time in prison for their actions. Federal, provincial, and local laws determine whether an activity is legal or not. The laws that regulate business are discussed later in this module.

Irresponsible but Legal Behaviour

Sometimes companies act irresponsibly, yet their actions are legal. For example, the Minnesota-based company that makes MyPillow was recently fined $1 million by the state of California for making unsubstantiated claims that the "most comfortable pillow you'll ever own" could help alleviate medical conditions such as snoring, fibromyalgia, migraines, and other disorders. The company's CEO countered that the claims were actually made by customers; these testimonials were posted on the company's website but later removed. In addition to the fine, the company faced several class-action lawsuits, and the Better Business Bureau has revoked MyPillow's accreditation.[7]

Legal and Responsible Behaviour

The vast majority of business activities fall into the category of behaviour that is both legal and responsible. Most companies act legally, and most try to be socially responsible. Research shows that consumers, especially those under 30, are likely to buy brands that have excellent ethical track records and community involvement. Outdoor specialty retailer REI, for example, recently announced that it gave back nearly 70 percent of its profits to the outdoor community. A member cooperative, the company invested a record $9.3 million in its nonprofit partners in 2016.[8]

2.4 Responsibilities to Stakeholders

How do businesses meet their social responsibilities to various stakeholders?

What makes a company be admired or perceived as socially responsible? Such a company meets its obligations to its stakeholders. Stakeholders are the individuals or groups to whom a business has a responsibility to. The stakeholders of a business are its employees, its customers, the general public, and its investors.

Responsibility to Employees

An organization's first responsibility is to provide a job to employees. Keeping people employed and letting them have time to enjoy the fruits of their labour is the finest thing business can do for society. Beyond this fundamental responsibility, employers must provide a clean, safe working environment that is free from all forms of discrimination. Companies should also strive to provide job security whenever possible.

Enlightened firms also empower employees to make decisions on their own and suggest solutions to company problems. Empowerment contributes to an employee's self-worth, which, in turn, increases productivity and reduces absenteeism.

Each year, in collaboration with Great Place to Work®, *Fortune* conducts an extensive employee survey of the best places to work in the United States. For 2017, the top companies included Google, Wegmans Food Markets, Edward Jones, Genentech, Salesforce, Acuity, and Quicken Loans. Some companies offer unusual benefits to their employees. For example, biotech company Genentech offers employee compensation for taking alternative methods of transportation to work at its South San Francisco campus. Employees can earn $12 per day for walking or biking to work, and those who drive a carpool or vanpool can earn $8 and $16, respectively. In addition, the company offers free commuter bus service for all employees via 27 routes around the Bay Area.[9]

Responsibility to Customers

To be successful in today's business environment, a company must satisfy its customers. A firm must deliver what it promises, as well as be honest and forthright in everyday interactions with customers, suppliers, and others. Recent research suggests that many consumers, particularly millennials, prefer to do business with companies and brands that communicate socially responsible messages, utilize sustainable manufacturing processes, and practice ethical business standards.[10]

Responsibility to Society

A business must also be responsible to society. A business provides a community with jobs, goods, and services. It also pays taxes that support schools, hospitals, and better roads. Some companies have taken an additional step to demonstrate their commitment to stakeholders and society as a whole by becoming Certified Benefit Corporations, or B Corps for short. Verified by B Lab, a global nonprofit organization, B Corps meet the highest standards of social and environmental performance, public transparency, legal accountability, and strive to use the power of business to solve social and environmental problems via an impact assessment that rates each company on a possible score of 200 points. To become certified as a Benefit Corporation, companies need to reach a score of at least 80 and must be recertified every two years. There are more than 2,000 companies worldwide that have been certified as B Corps, including Method, W.S. Badger Company, Fishpeople Seafood, LEAP Organics, New Belgium Brewing Company, Ben & Jerry's, Cabot Creamery Co-op, Comet Skateboards, Etsy, Patagonia, Plum Organics, and Warby Parker.[11]

Environmental Protection

Business is also responsible for protecting and improving the world's fragile environment. The world's forests are being destroyed fast. Every second, an area the size of a football field is laid bare. Plant and animal species are becoming extinct at the rate of 17 species per hour. A continent-size hole is opening up in the earth's protective ozone shield. Each year we throw out 80 percent more refuse than we did in 1960; as a result, more than half of the nation's landfills are filled to capacity.

To slow the erosion of the world's natural resources, many companies have become more environmentally responsible. For example, Toyota now uses renewable energy sources such as solar, wind, geothermal, and water power for electricity to run its facilities. When its new $1 billion North American headquarters opened in Plano, Texas, in May 2017, Toyota said the 2.1 million square-foot campus would eventually be powered by 100% clean energy, helping the auto giant move closer to its goal of eliminating carbon emissions in all of its operations.[12]

Corporate Philanthropy

Companies also display their social responsibility through corporate philanthropy. **Corporate philanthropy** includes cash contributions, donations of equipment and products, and support for the volunteer efforts of company employees. American Express is a major supporter of the Red Cross. The organization relies almost entirely on charitable gifts to carry out its programs and services, which include disaster relief, armed-forces emergency relief, blood and tissue services, and health and safety services. The funds provided by American Express have enabled the Red Cross to deliver humanitarian relief to victims of numerous disasters around the world.[13] When Hurricane Katrina hit the Gulf Coast, Bayer sent 45,000 diabetes blood glucose monitors to the relief effort. Within weeks of the disaster, Abbott, Alcoa, Dell, Disney, Intel, UPS, Walgreens, Walmart, and others contributed more than $550 million for disaster relief.[14]

Exhibit 2.3 Hybrid cars and all-electric vehicles such as Tesla models are turning heads and changing the way the world drives. Electric vehicles are more eco-friendly, but they are also more expensive to own. Analysts project that after charging, insurance, and maintenance costs, electric cars cost thousands of dollars more than conventional vehicles. *Do the environmental benefits associated with electric cars justify the higher cost of ownership?* (Credit: Steve Jurvetson/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Responsibilities to Investors

Companies' relationships with investors also entail social responsibility. Although a company's economic responsibility to make a profit might seem to be its main obligation to shareholders, some investors are increasingly emphasizing other aspects of social responsibility.

Some investors are limiting their investments to securities (e.g., stocks and bonds) that coincide with their beliefs on ethical and social responsibility. This is called **social investing**. For example, a social investment fund might eliminate from consideration the securities of all companies that make tobacco products, liquor, weapons, or have a history of being environmentally irresponsible. Not all social investment strategies are alike. Some ethical mutual funds will not invest in government securities because they help to fund the military; others freely buy government securities, with managers noting that federal funds also support the arts and pay for AIDS research. Today, assets invested using socially responsible strategies total more than $7 trillion.[15]

Perhaps partly due to the global recession of 2007–2009, over the last several years, companies have tried to meet their responsibilities to investors as well as to their other stakeholders. Recent research suggests that now more than ever, CEOs are being held to higher standards by boards of directors, investors, governments, media, and even employees when it comes to corporate accountability and ethical behaviour. A recent global study by PwC reveals that over the last several years, there has been a large increase in the number of CEOs being forced out due to some sort of ethical lapse in their organizations. Strategies to prevent such missteps should include establishing a culture of integrity to prevent anyone from breaking the rules, making sure company goals and metrics do not create undue pressure on employees to cut corners, and implementing effective processes and controls to minimize the opportunity for unethical behaviour.[16]

2.5 Trends in Ethics and Corporate Social Responsibility

What are the trends in ethics and corporate social responsibility?

Three important trends related to ethics and corporate social responsibility are strategic changes in corporate philanthropy, a new social contract between employers and employees, and the growth of global ethics and corporate social responsibility.

Changes in Corporate Philanthropy

Historically, corporate philanthropy has typically involved companies seeking out charitable groups and giving them money or donating company products or services. Today, the focus has shifted to **strategic giving**, which ties philanthropy and corporate social responsibility efforts closely to a company's mission or goals and targets donations to the communities where a company does business. Some of the top businesses recognized for their efforts in giving back to the communities in which they operate include technology giant Salesforce, NuStar Energy, insurance and financial services firm Veterans United, and software leader Intuit.[17]

Cause related marketing video:
https://youtu.be/C1s65IGuRMM

A Social Contract between Employer and Employee

Another trend in social responsibility is the effort by organizations to redefine their relationship with their employees. Many people have viewed social responsibility as a one-way street that focuses on the obligations of business to society, employees, and others. Now, companies recognize that the social contract between employer and employee is an important aspect of the workplace and that both groups have to be committed to working together in order for the organization to prosper. The social contract can be defined in terms of four important aspects: compensation, management, culture, and learning and development.[18]

When it comes to compensation, companies today must recognize that most employees do not stay with one organization for decades. Thus, companies need to change their compensation structure to acknowledge the importance of short-term performance and to update their methods for determining compensation, including benefits and other nontraditional perks such as paid leave and telecommuting options.

In the current workplace environment, where employees are likely to jump to new jobs every couple years, managers need to take a more active and engaged approach to supervising employees and perhaps change the way they think about loyalty, which may be difficult for managers who are used to supervising the same group of employees for a long period of time. Engaging employees on a regular basis, setting realistic expectations, and identifying specific development paths may help retain key employees.

Thanks to today's tight labour market, some employees feel empowered to demand more from their employer and its overall culture via strategies such as increased flexibility, transparency, and fairness. This increased importance of the employee's role in the company's culture helps workers stay engaged in the mission of the organization and perhaps makes them less likely to look elsewhere for employment.

Finally, rapidly changing technology used in today's workplace continues to shift the learning and development of the employer-employee contract, causing immense challenges to both companies and workers. It may be more difficult to identify the employee skills that will be critical over the next several years, causing employers either to increase training of current workers or to look outside the organization for other individuals who already possess the technical skills needed to get the job done.

Global Ethics and Social Responsibility

When Canadian businesses expand into global markets, they must take their codes of ethics and policies on corporate social responsibility with them. As a citizen of several countries, a multinational corporation has several responsibilities. These include respecting local practices and customs, ensuring that there is harmony between the organization's staff and the host population, providing management leadership, and developing a solid group of local managers who will be a credit to their community. When a multinational firm makes an investment in a foreign country, it should commit to a long-term relationship. That means involving all stakeholders in the host country in decision-making. Finally, a responsible multinational will implement ethical guidelines within the organization in the host country. By fulfilling these responsibilities, the company will foster respect for both local and international laws.

Multinational corporations often must balance conflicting interests of stakeholders when making decisions regarding social responsibilities, especially in the area of human rights. Questions involving child labour, forced labour, minimum wages, and workplace safety can be particularly difficult. Recently Gap, Inc. decided to publish the list of its global factories in an effort to provide transparency about its suppliers and the efforts the company continues to make to improve working conditions around the world. The company has partnered with Verité, a nongovernmental organization focused on ensuring that people work under safe, fair, and legal conditions. By soliciting feedback from factory workers who make its products, Gap is hoping to improve working conditions and help these factories become leaders in their local communities.[19]

Sustainability

Sustainability has become such an important concept that it is frequently used interchangeably with CSR. Indeed, for some companies it seems that CSR is sustainability. This is perhaps not surprising, given the growing media attention on issues related to sustainability.

Sustainability is a concept derived from environmentalism; it originally referred to the ability of a society or company to continue to operate without compromising the planet’s environmental condition in the future. In other words, a sustainable corporation is one that can sustain its current activities without adding to the world’s environmental problems. Sustainability is therefore a very challenging goal, and many environmentalists maintain that no corporation today operates sustainably, since all use energy (leading to the gradual depletion of fossil fuels while emitting greenhouse gases) and all produce waste products like garbage and industrial chemicals. Whether or not true sustainability will be attainable in the near future, the development and promotion of sustainability strategies has become an obsession for most large corporations today, as demonstrated by their websites’ inevitable reference to the corporation’s sincere commitment to sustainability and responsible environmental practices. No corporation or corporate executive today will be caught saying they do not really care about the environment. However, if we observe their actions rather than their words, we may have cause for doubt.

Corporate social responsibility and sustainability video:
https://youtu.be/xoE8XlcDUI8

Whistleblowing

A **whistleblower** is a person who exposes any kind of information that reveals illegal, unethical, or not correct activities within an organization that is either private or public. Many whistleblowers have stated that they were motivated to take action and put an end to unethical practices after witnessing injustices in their businesses or organizations. In addition to ethics, social and organizational pressures are also motivating forces. A 2012 study found that individuals are more likely to blow the whistle when several others know about the wrongdoing, because they would otherwise fear consequences for keeping silent.

The motivation for whistleblowing isn't always virtuous, and the outcome isn't always positive either. There are cases involving employees who blew the whistle as an act of revenge against their employer or supervisor, for instance. While it's possible for the whistleblower to be viewed as a "hero" for his/her courage and truth telling, it's also possible to be seen as a traitor or tattletale—as just one of the many disgruntled employees who are simply trying to get even for a perceived but imaginary injustice. One of the barriers to whistleblowing is the belief—widespread in the professional world—that individuals are bound to secrecy within their work sector. Accordingly, whistleblowing becomes a moral choice that pits the employee's loyalty to an employer against the employee's responsibility to serve the public interest. As a result, in Canada, whistleblower protection laws and regulations have been enacted to guarantee freedom of speech for workers and contractors in certain situations. Whistleblowers have the right to file complaints that they believe give reasonable evidence of a violation of a law, rule, or regulation; gross mismanagement; gross waste of funds; an abuse of authority; or a substantial and specific danger to public health or safety.

Key Terms

code of ethics	A set of guidelines prepared by a firm to provide its employees with the knowledge of what the firm expects in terms of responsibilities and behaviour toward fellow employees, customers, and suppliers.
corporate philanthropy	The practice of charitable giving by corporations; includes contributing cash, donating equipment and products, and supporting the volunteer efforts of company employees.
corporate social responsibility (CSR)	The concern of businesses for the welfare of society as a whole; consists of obligations beyond those required by law or contracts.
ethical issue	A situation where a person must choose from a set of actions that may be ethical or unethical.
ethics	A set of moral standards for judging whether something is right or wrong.
justice	What is considered fair according to the prevailing standards of society; an equitable distribution of the burdens and rewards that society has to offer.
social investing	The practice of limiting investments to securities of companies that behave in accordance with the investor's beliefs on ethical and social responsibility to encourage businesses to be more socially responsible.
stakeholders	Individuals or groups to whom a business has a responsibility to; including employees, customers, the general public, and investors.
strategic giving	The practice of tying philanthropy and corporate social responsibility efforts closely to a company's mission or goals and targeting donations to the communities where a company does business.
Sustainability	The ability of a society or company to continue to operate without compromising the planet's environmental condition in the future.
Whistleblower	A person who exposes any kind of information that reveals illegal, unethical, or not correct activity within an organization that is either private or public.

Summary of Learning Outcomes

1. What philosophies and concepts shape personal ethical standards?

Ethics is a set of moral standards for judging whether something is right or wrong. An approach to ethical decision-making is justice, or what is fair according to accepted standards.

2. How can organizations encourage ethical business behaviour?

Top management must shape the ethical culture of the organization. They should lead by example, offer ethics-training programs, and establish a formal code of ethics.

3. What is corporate social responsibility?

Corporate social responsibility is the concern of businesses for the welfare of society as a whole. It consists of obligations beyond just making a profit and goes beyond what is required by law or union contract.

Companies may engage in illegal and irresponsible behaviour, irresponsible but legal behaviour, or legal and responsible behaviour. The vast majority of organizations act legally and try to be socially responsible.

4. How do businesses meet their social responsibilities to various stakeholders?

Stakeholders are individuals or groups to whom a business has a responsibility to. Businesses are responsible to employees. They should provide a clean, safe working environment. Organizations can build employees' self-worth through empowerment programs. Businesses also have a responsibility to customers to provide good, safe products and services. Organizations are responsible to the general public to be good corporate citizens. Firms must help protect the environment and provide a good place to work. Companies also engage in corporate philanthropy, which includes contributing cash, donating goods and services, and supporting the volunteer efforts of employees. Finally, companies are responsible to investors. They should earn a reasonable profit for company owners.

5. What are the trends in ethics and corporate social responsibility?

Today, corporate philanthropy is shifting away from simply giving to needy groups and is focusing instead on strategic giving, in which philanthropic efforts relate more closely to the corporate mission or goals and targets donations to areas where the firm operates.

A second trend is the development of a new social contract between employer and employee. Instead of resting the responsibility of maintaining jobs solely on the employer, now the employee must assume part of the burden and find ways to add value to the organization.

As the world increasingly becomes a global community, multinational corporations are now expected to assume a global set of ethics and responsibility. Global companies must understand local customs. They should also involve local stakeholders in decision-making. Multinationals must also make certain that their suppliers are not engaged in human rights violations.

Chapter 3 Competing in the Global Marketplace

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. Why is global trade important to Canada, and how is it measured?
2. Why do nations trade?
3. What are the barriers to international trade?
4. How do governments and institutions foster world trade?
5. What are international economic communities?
6. How do companies enter the global marketplace?
7. What threats and opportunities exist in the global marketplace?
8. What are the advantages of multinational corporations?
9. What are the trends in the global marketplace?

This chapter examines the business world of the global marketplace. It focuses on the processes of taking a business global, such as licensing agreements and franchisees; the challenges that are encountered; and the regulatory systems governing the world market of the 21st century.

Today, global revolutions are under way in many areas of our lives: management, politics, communications, and technology. The word global has assumed a new meaning, referring to a boundless mobility and competition in social, business, and intellectual arenas. The purpose of this chapter is to explain how global trade is conducted. We also discuss the barriers to international trade and the organizations that foster global trade. The chapter concludes with trends in the global marketplace.

3.1 Global Trade in Canada

Why is global trade important to Canada, and how is it measured?

No longer just an option, having a global vision has become a business imperative. Having a **global vision** means recognizing and reacting to international business opportunities, being aware of threats from foreign competitors in all markets, and effectively using international distribution networks to obtain raw materials and move finished products to the customer.

Canadian managers must develop a global vision if they are to recognize and react to international business opportunities, as well as remain competitive at home. Often a Canadian firm's toughest domestic competition comes from foreign companies. Moreover, a global vision enables a manager to understand that customer and distribution networks operate worldwide, blurring geographic and political barriers and making them increasingly irrelevant to business decisions. Over the past three decades, world trade has climbed from $200 billion a year to more than $1.4 trillion.[1]

Go into a Paris McDonald's and you may not recognize where you are. There are no Golden Arches or utilitarian chairs and tables and other plastic features. The restaurants have exposed brick walls, hardwood floors, and armchairs. Some French McDonald's even have faux marble walls. Most restaurants have TVs with continuous music videos. You can even order an espresso, beer, and a chicken on focaccia bread sandwich. It's not America.

The Impact of Terrorism on Global Trade

The terrorist attacks on America on September 11, 2001, and the Charlie Hebdo terrorist attacks in Paris in 2015 have changed the way the world conducts business. The immediate impacts of these events have included a short-term shrinkage of global trade. Globalization, however, will continue because the world's major markets are too vitally integrated for globalization to stop. Nevertheless, terrorism has caused the growth to be slower and costlier.[2]

Companies are paying more for insurance and security for overseas staff and property. Heightened border inspections slow movements of cargo, forcing companies to stock more inventory. Tighter immigration policies curtail the liberal inflows of skilled and blue-collar workers that allowed companies to expand while keeping wages in check. The impact of terrorism may lessen over time, but multinational firms will always be on guard.[3]

Measuring Trade between Nations

International trade improves relationships with friends and allies; helps ease tensions among nations; and bolsters economies by raising people's standard of living, providing jobs, and improving the quality of life. The value of international trade is over $16 trillion a year and growing. This section takes a look at some key measures of international trade: exports and imports, the balance of trade, the balance of payments, and exchange rates.

Exports and Imports

The developed nations (those with mature communication, financial, educational, and distribution systems) are the major players in international trade. They account for about 70 percent of the world's exports and imports. **Exports** are goods and services made in one country and sold to others. **Imports** are goods and services that are bought from other countries.

Balance of Trade

The difference between the value of a country's exports and the value of its imports during a specific time is the country's **balance of trade**. A country that exports more than it imports is said to have a favourable balance of trade, called a **trade surplus**. A country that imports more than it exports is said to have an unfavourable balance of trade, or a **trade deficit**. When imports exceed exports, more money from trade flows out of the country than flows into it.

Balance of Trade video:
https://youtu.be/GK66uQHVjlU

Balance of Payments

Another measure of international trade is called the **balance of payments**, which is a summary of a country's international financial transactions showing the difference between the country's total payments to and its total receipts from other countries. The balance of payments includes imports and exports (balance of trade), long-term investments in overseas plants and equipment, government loans to and from other countries, gifts and foreign aid, military expenditures made in other countries, and money transfers in and out of foreign banks.

Balance of payments video:
https://youtu.be/GK66uQHVjlU

The Changing Value of Currencies

The exchange rate is the price of one country's currency in terms of another country's currency. If a country's currency appreciates, less of that country's currency is needed to buy another country's currency. If a country's currency depreciates, more of that currency will be needed to buy another country's currency.

As the dollar depreciates, the prices of Japanese goods rise for Canadian residents, so they buy fewer Japanese goods—thus, Canadian imports decline. At the same time, as the dollar depreciates relative to the yen, the yen appreciates relative to the dollar. This means prices of Canadian goods fall for the Japanese, so they buy more Canadian goods—and Canadian exports rise.

Currency markets operate under a system called **floating exchange rates**. Prices of currencies "float" up and down based upon the demand for and supply of each currency. Global currency traders create the supply of and demand for a particular currency based on that currency's investment, trade potential, and economic strength. If a country decides that its currency is not properly valued in international currency markets, the government may step in and adjust the currency's value. In a **devaluation**, a nation lowers the value of its currency relative to other currencies. This makes that country's exports cheaper and should, in turn, help the balance of payments.

3.2 Why Nations Trade

What are the advantages of trading?

One might argue that the best way to protect workers and the domestic economy is to stop trade with other nations. Then the whole circular flow of inputs and outputs would stay within our borders. But if we decided to do that, how would we get resources like bananas and coffee beans? Canada simply can't produce some things, and it can't manufacture some products, such as toys and most clothing, at the low costs we're used to. The fact is that nations—like people—are good at producing different things: you may be better at balancing a ledger than repairing a car. In that case you benefit by "exporting" your bookkeeping services and "importing" the car repairs you need from a good mechanic. Economists refer to specialization like this as advantage.

Absolute Advantage

A country has an **absolute advantage** when it can produce and sell a product at a lower cost than any other country or when it is the only country that can provide a product. Suppose that Canada has an absolute advantage in air traffic control systems for busy airports and that Brazil has an absolute advantage in coffee. Canada does not have the proper climate for growing coffee, and Brazil lacks the technology to develop air traffic control systems. Both countries would gain by exchanging air traffic control systems for coffee.

Absolute and comparative advantage video:
https://youtu.be/hnGCjwRWtcw

Comparative Advantage

Even if Canada had an absolute advantage in both coffee and air traffic control systems, it should still specialize and engage in trade. Why? The reason is the **principle of comparative advantage**, which says that each country should specialize in the products that it can produce most readily and cheaply, and trade those products for goods that foreign countries can produce most readily and cheaply. This specialization ensures greater product availability and lower prices.

For example, India and Vietnam have a comparative advantage in producing clothing because of lower labour costs. Japan has long held a comparative advantage in consumer electronics because of technological expertise.

Thus, comparative advantage acts as a stimulus to trade. When nations allow their citizens to trade whatever goods and services they choose without government regulation, free trade exists. **Free trade** is the policy of permitting the people and businesses of a country to buy and sell where they please without restrictions. The opposite of free trade is **protectionism**, in which a nation protects its home industries from outside competition by establishing artificial barriers such as tariffs and quotas. In the next section, we'll look at the various barriers, some natural and some created by governments, that restrict free trade.

Protectionism video:
https://youtu.be/Rylkrzn7A9g

The Fear of Trade and Globalization

The continued protests during meetings of the World Trade Organization and the convocations of the World Bank and the International Monetary Fund (the three organizations are discussed later in the chapter) show that many people fear world trade and globalization. What do they fear? The negatives of global trade are as follows:

- Millions of Canadians have lost jobs due to imports or production shifting abroad. Most find new jobs, but often those jobs pay less.
- Millions of others fear losing their jobs, especially at those companies operating under competitive pressure.
- Employers often threaten to export jobs if workers do not accept pay cuts.
- Service and white-collar jobs are increasingly vulnerable to operations moving offshore.

Sending domestic jobs to another country is called **outsourcing**, a topic you can explore in more depth. Many Canadian companies have set up call service centers in India, the Philippines, and other countries. Now even engineering and research and development jobs are being outsourced.

Benefits of Globalization

A closer look reveals that globalization has been the engine that creates jobs and wealth. Benefits of global trade include the following:

- Productivity grows more quickly when countries produce goods and services in which they have a comparative advantage. Living standards can increase faster. One problem is that big **G20** countries have added more than 1,200 restrictive export and import measures since 2008.
- Global competition and cheap imports keep prices down, so inflation is less likely to stop economic growth. However, in some cases this is not working because countries manipulate their currency to get a price advantage.
- An open economy spurs innovation with fresh ideas from abroad.
- Through infusion of foreign capital and technology, global trade provides poor countries with the chance to develop economically by spreading prosperity.
- More information is shared between two trading partners that may not have much in common initially, including insight into local cultures and customs, which may help the two nations expand their collective knowledge and learn ways to compete globally.[4]

3.3 Barriers to Trade

What are the barriers to international trade?

International trade is carried out by both businesses and governments—as long as no one puts up trade barriers. In general, trade barriers keep firms from selling to one another in foreign markets. The major obstacles to international trade are natural barriers, tariff barriers, and nontariff barriers.

Natural Barriers

Natural barriers to trade can be either physical or cultural. For instance, even though raising cattle in the relative warmth of Argentina may cost less than raising cattle in the bitter cold of Siberia, the cost of shipping the beef from South America to Siberia might drive the price too high. Distance is thus one of the natural barriers to international trade.

Language is another natural trade barrier. People who can’t communicate effectively may not be able to negotiate trade agreements.

Tariff Barriers

A **tariff** is a tax imposed by a nation on imported goods. It may be a charge per unit, such as per barrel of oil or per new car; it may be a percentage of the value of the goods, such as 5 percent of a $500,000 shipment of shoes; or it may be a combination. No matter how it is assessed, any tariff makes imported goods more costly, so they are less able to compete with domestic products.

Protective tariffs make imported products less attractive to buyers than domestic products.

Arguments for and against Tariffs

The main arguments for tariffs include the following:

- Tariffs protect infant industries. A tariff can give a struggling new domestic industry time to become an effective global competitor.
- Tariffs protect Canadian jobs. Unions and others say tariffs keep foreign labour from taking away Canadian jobs.
- Tariffs aid in military preparedness. Tariffs should protect industries and technology during peacetime that are vital to the military in the event of war.

The main arguments against tariffs include the following:

- Tariffs discourage free trade, and free trade lets the principle of competitive advantage work most efficiently.
- Tariffs raise prices, thereby decreasing consumers' purchasing power.

Trade Barriers video:
https://youtu.be/c6xBo0_WCYU

Nontariff Barriers

Governments also use other tools besides tariffs to restrict trade. One type of nontariff barrier is the **import quota**, or limits on the quantity of a certain good that can be imported.

A complete ban against importing or exporting a product is an **embargo**.

3.4 Fostering Global Trade

How do governments and institutions foster world trade?

Antidumping Laws

Canadian firms don't always get to compete on an equal basis with foreign firms in international trade. To level the playing field, Congress has passed antidumping laws. **Dumping** is the practice of charging a lower price for a product (perhaps below cost) in foreign markets than in the firm's home market. The company might be trying to win foreign customers, or it might be seeking to get rid of surplus goods.

When the variation in price can't be explained by differences in the cost of serving the two markets, dumping is suspected. Most industrialized countries have antidumping regulations. They are especially concerned about predatory dumping, the attempt to gain control of a foreign market by destroying competitors with impossibly low prices.

The United States recently imposed tariffs on softwood lumber from Canada. Canada was found guilty of pricing softwood lumber at between 7.72 and 4.49 percent below their costs. U.S. customs officers will now levy tariffs on Canadian timber exports with tax rates from 17.41 percent to 30.88 percent, depending on the business.[5]

From our discussion so far, it might seem that governments act only to restrain global trade. On the contrary, some governments and international financial organizations work hard to increase it, as this section explains.

Trade Negotiations and the World Trade Organization

The **Uruguay Round** of trade negotiations is an agreement that dramatically lowers trade barriers worldwide. Adopted in 1994, the agreement has been now signed by 148 nations. As the most ambitious global trade agreement ever negotiated, the Uruguay Round reduced tariffs by one-third worldwide, a move that is expected to increase global income by $235 billion annually. Perhaps the most notable aspect of the agreement is its recognition of new global realities. For the first time, an agreement covers services, intellectual property rights, and trade-related investment measures such as exchange controls.

As a follow-up to the Uruguay Round, the negotiating round started in the capital of Qatar in 2001 is called the Doha Round. To date, the round has shown little progress in advancing free trade. Developing nations are pushing for the reduction of farm subsidies in the United States, Europe, and Japan. Poor countries say that the subsidies stimulate overproduction, which drives down global agricultural prices. Because developing nations' primary exports are agricultural commodities, low prices mean that they cannot compete in the global marketplace. On the other hand, the United States and Europe are interested in bringing down trade barriers in services and manufacturing. The continuing talks have served as a lightning rod for protesters, who claim that the World Trade Organization (WTO) serves the interests of multinational corporations, promotes trade over preserving the environment, and treats poor nations unfairly.[6]

The **World Trade Organization** replaces the old General Agreement on Tariffs and Trade (GATT), which was created in 1948. The GATT contained extensive loopholes that enabled countries to evade agreements to reduce trade barriers. Today, all WTO members must fully comply with all agreements under the Uruguay Round. The WTO also has an effective dispute settlement procedure with strict time limits to resolve disputes.

The WTO has emerged as the world's most powerful institution for reducing trade barriers and opening markets. The advantage of WTO membership is that member countries lower trade barriers among themselves. Countries that don't belong must negotiate trade agreements individually with all their trading partners. Only a few countries, such as North Korea, Turkmenistan, and Eritrea, are not members of the WTO.[7]

One of the biggest disputes before the WTO involves the United States and the European Union. The United States claims that Europe has given Airbus $15 billion in aid to develop airplanes. The European

Union claims that the U.S. government has provided $23 billion in military research that has benefited Boeing's commercial aircraft business. It also claimed that Washington State (the home of Boeing manufacturing) has given the company $3.2 billion in unfair tax breaks.[8]

WTO video:
https://youtu.be/MrYMm-hq2-k

The World Bank and International Monetary Fund

Two international financial organizations are instrumental in fostering global trade. The **World Bank** offers low-interest loans to developing nations. Originally, the purpose of the loans was to help these nations build infrastructure such as roads, power plants, schools, drainage projects, and hospitals. Now the World Bank offers loans to help developing nations relieve their debt burdens. To receive the loans, countries must pledge to lower trade barriers and aid private enterprise. In addition to making loans, the World Bank is a major source of advice and information for developing nations.

The International Monetary Fund (IMF) was founded in 1945, one year after the creation of the World Bank, to promote trade through financial cooperation and eliminate trade barriers in the process. The IMF makes short-term loans to member nations that are unable to meet their budgetary expenses. It operates as a lender of last resort for troubled nations. In exchange for these emergency loans, IMF lenders frequently extract significant commitments from the borrowing nations to address the problems that led to the crises. These steps may include curtailing imports or even devaluing the currency.

Some global financial problems do not have a simple solution. One option would be to pump a lot more funds into the IMF, giving it enough resources to bail out troubled countries and put them back on their feet. In effect, the IMF would be turned into a real lender of last resort for the world economy.

The danger of counting on the IMF, though, is the "moral hazard" problem. Investors would assume that the IMF would bail them out and would therefore be encouraged to take bigger and bigger risks in emerging markets, leading to the possibility of even deeper financial crises in the future.

World Bank and IMF video:
https://youtu.be/lN3qrFA4jXc

3.5 International Economic Communities

What are international economic communities?

Nations that frequently trade with each other may decide to formalize their relationship. The governments meet and work out agreements for a common economic policy. The result is an economic community or, in other cases, a bilateral trade agreement (an agreement between two countries to lower trade barriers). For example, two nations may agree upon a **preferential tariff**, which gives advantages to one nation (or several nations) over others. When members of the British Commonwealth (countries that are former British territories) trade with Great Britain, they pay lower tariffs than do other nations. For example, Canada and Australia are former British territories but are still members of the British Commonwealth. You will note that Queen Elizabeth still appears on Canadian currency and the Union Jack is still incorporated into the Australian flag. In other cases, nations may form free-trade associations. In a **free-trade zone**, few duties or rules restrict trade among the partners, but nations outside the zone must pay the tariffs set by the individual members.

North American Free Trade Agreement (NAFTA)

The **North American Free Trade Agreement (NAFTA)** created the world's largest free-trade zone. The agreement includes Canada, the United States, and Mexico, with a combined population of 450 million and an economy of over $20.8 trillion.[9]

Canada entered a free-trade agreement with the United States in 1988. Thus, most of the new long-run opportunities opened for U.S. and Canadian business under NAFTA are in Mexico.

NAFTA video:
https://youtu.be/LaMCK-Sec7Y

Before NAFTA, tariffs on Mexican exports to the United States averaged just four percent, and most goods entered the United States duty-free, so NAFTA's primary impact was to open the Mexican market to U.S. companies. When the treaty went into effect, tariffs on about half the items traded across the Rio Grande disappeared. Since NAFTA came into effect, U.S.-Mexican trade has increased from $80 billion to $515 billion annually. The pact removed a web of Mexican licensing requirements, quotas, and tariffs that limited transactions on U.S. goods and services. For instance, the pact allows U.S. and Canadian financial-services companies to own subsidiaries in Mexico for the first time in 50 years.

The real test of NAFTA will be whether it can deliver rising prosperity on both sides of the Rio Grande. For Mexicans, NAFTA must provide rising wages, better benefits, and an expanding middle class with enough purchasing power to keep buying goods from the United States and Canada. That scenario seems to be working. At the Delphi Corp. auto parts plant in Ciudad Juárez, just across the border from El Paso, Texas, the assembly line is a cross section of working-class Mexicans. In the years since NAFTA lowered trade and investment barriers, Delphi has significantly expanded its presence in the country.

Exhibit 3.1 The softwood lumber dispute between the United States and Canada that has resulted in the U.S. imposed tariffs on Canadian softwood lumber imports is one of the longest trade disputes between the two nations. The dispute is the result of disagreements about Canadian lumber production and imports between the two nations. The main contention in the dispute is the U.S. claim that the Canadian government is unfairly subsidizing Canadian lumber production by providing access to public land while U.S. producers harvest softwood lumber on their own property. *Why do anti-free-trade groups support these tariffs when the result will be higher prices for softwood lumber?* (Credit: Jesse Wagstaff/ Flickr/ Attribution-NoDerivs 2.0 Generic (CC BY 2.0))

Today it employs 70,000 Mexicans, who receive up to 70 million U.S.-made components to assemble every day. The wages are modest by U.S. standards—an assembly-line worker with two years' experience earns about $2.30 an hour. But that's triple Mexico's minimum wage, and Delphi jobs are among the most coveted in Juárez. The United States recently notified the Canadian and Mexican governments that it intends to renegotiate aspects of the NAFTA agreement.[10]

The largest new trade agreement is **Mercosur**, which includes Peru, Brazil, Argentina, Uruguay, and Paraguay. The elimination of most tariffs among the trading partners has resulted in trade revenues that currently exceed $16 billion annually. Recent recessions in Mercosur countries have limited economic growth, even though trade among Mercosur countries has continued to grow.

Central America Free Trade Agreement

The newest free trade agreement is the Central America Free Trade Agreement (CAFTA) passed in 2005. Besides the United States, the agreement includes Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. The United States is already the principal exporter to these nations, so economists don't think that it will result in a major increase in U.S. exports. It will, however, reduce tariffs on exports to CAFTA countries. Already, some 80 percent of the goods imported into the United States from CAFTA nations are tariff-free. CAFTA countries may benefit from the new permanent trade deal if U.S. multinational firms deepen their investment in the region.

The European Union

In 1993, the member countries of the European Community (EC) ratified the Maastricht Treaty, which proposed to take the EC further toward economic, monetary, and political union. Although the heart of the treaty deals with developing a unified European Market, Maastricht was also intended to increase integration among **European Union (EU)** members.

The EU has helped increase this integration by creating a borderless economy for the 28 European nations, shown on the map in Exhibit 3.6.[11]

EU28 Member States:	Candidate Countries:
• Austria • Belgium • Bulgaria • Croatia • Cyprus • Czech Republic • Denmark • Estonia • Finland • France • Germany • Greece • Hungary • Ireland • Italy • Latvia • Lithuania • Luxembourg • Malta • The Netherlands • Poland • Portugal • Romania • Slovakia • Slovenia • Spain • Sweden • United Kingdom	• Albania • Former Yugoslav Republic of Macedonia • Montenegro • Serbia • Turkey

Table 3.1

European Union states have set up common institutions to which they delegate some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at the European level. This pooling of sovereignty is also called **European integration**. In 2016, citizens of the United Kingdom voted to leave the European Union, a plan known as Brexit, which could take several years to occur.[12]

Exhibit 3.2 The European Union Source: Adapted from https://europa.eu/european-union/about-eu/countries/member-countries_en.

One of the principal objectives of the European Union is to promote economic progress of all member countries. The EU has stimulated economic progress by eliminating trade barriers, differences in tax laws, and differences in product standards, and by establishing a common currency. A new European Community Bank was created, along with a common currency called the euro. The European Union's single market has created

2.5 million new jobs since it was founded and generated more than $1 trillion in new wealth.[13] The opening of national EU markets has brought down the price of national telephone calls by 50 percent since 1998. Under pressure of competition, the prices of airfares in Europe have fallen significantly. The removal of national restrictions has enabled more than 15 million Europeans to go to another EU country to work or spend their retirement.

The EU is a very tough antitrust enforcer; some would say it is tougher than the United States. The EU, for example, fined Google $2.7 billion for favouring some of its own services in its search results.[14] The EU can seal off corporate offices for unspecified periods to prevent destruction of evidence and enter the homes, cars, yachts, and other personal property of executives suspected of abusing their companies' market power or conspiring to fix prices.

Microsoft has been fighting the European Court since 2002, with no quick end in sight. The Court fined Microsoft for monopolizing internet access by offering Internet Explorer with its Windows software. The company is also appealing a Court decision requiring it to share code with "open source" companies. Another big U.S. company, Coca-Cola, settled a six-year antitrust dispute with the European Court by agreeing to strict limits on its sales tactics. Coke can't sign exclusive agreements with retailers that would ban competing soft drinks or give retailers rebates based on sales volume. Furthermore, it must give rivals, like Pepsi, 20 percent of the space in Coke coolers so Pepsi can stock its own brands. If Coke violates the terms of the agreement, it will be fined 10 percent of its worldwide revenue (over $2 billion).[15]

There is the possibility for an entirely different type of problem facing global businesses in this protectionist movement by the EU against outsiders. For example, European automakers have proposed holding Japanese imports at roughly their current 10 percent market share. The Irish, Danes, and Dutch don't make cars and have unrestricted home markets; they are unhappy at the prospect of limited imports of Toyotas and Hondas.

Meanwhile, France has a strict quota on Japanese cars to protect its own Renault and Peugeot. These local automakers could be hurt if the quota is raised at all.

Interestingly, a number of big U.S. companies are already considered more "European" than many European companies. Coke and Kellogg's are considered classic European brand names. Ford and General Motors compete for the largest share of auto sales in the continent. Apple, IBM, and Dell dominate European markets. General Electric, AT&T, and Westinghouse are already strong all over Europe and have invested heavily in new manufacturing facilities there.

The European Union proposed a constitution that would centralize powers at the Union level and decrease the powers of individual member countries. It also would create a single voice in world affairs by creating a post of foreign minister. The constitution also gave the EU control over political asylum, immigration, guaranteed freedom of speech, and collective labour bargaining. In order to become law, each EU country had to ratify the constitution. The two most powerful countries in the EU, France and Germany, voted "no" in the summer of 2005. Citizens of both countries were afraid that the constitution would draw jobs away from Western Europe and to the Eastern EU countries. These new members of the EU have lower wage rates and fewer regulations. Voters were also worried that the constitution would result in free-market reforms along American or British lines over France and Germany's traditional social protections. Concerns over immigration also sparked the referendum vote that is leading to the United Kingdom leaving the European Union.

3.6 Participating in the Global Marketplace

How do companies enter the global marketplace?

Companies decide to "go global" for a number of reasons. Perhaps the most urgent reason is to earn additional profits. If a firm has a unique product or technological advantage not available to other international competitors, this advantage should result in major business successes abroad. In other situations, management may have exclusive market information about foreign customers, marketplaces, or market situations. In this case, although exclusivity can provide an initial motivation for going global, managers must realize that competitors will eventually catch up. Finally, saturated domestic markets, excess capacity, and potential for cost savings can also be motivators to expand into international markets. A company can enter global trade in several ways, as this section describes.

Exporting

When a company decides to enter the global market, usually the least complicated and least risky alternative is **exporting** or selling domestically produced products to buyers in another country. A company, for example, can sell directly to foreign importers or buyers. Exporting is not limited to huge corporations such as General Motors or Apple. Indeed, small companies typically enter the global marketplace by exporting. China is the world's largest exporter, followed by the United States.[16] Many small businesses claim that they lack the money, time, or knowledge of foreign markets that exporting requires.

Entry modes video:
https://youtu.be/a2fqP5h0QuE

Licensing and Franchising

Another effective way for a firm to move into the global arena with relatively little risk is to sell a license to manufacture its product to a firm in a foreign country. **Licensing** is the legal process whereby a firm (the licensor) agrees to let another firm (the licensee) use a manufacturing process, trademark, patent, trade secret, or other proprietary knowledge. The licensee, in turn, agrees to pay the licensor a royalty or fee agreed on by both parties.

International licensing is a multibillion-dollar-a-year industry. Entertainment and character licensing, such as DVD movies and characters such as Batman, is the largest single category. Trademarks are the second-largest source of licensing revenue. Caterpillar licenses its brand for both shoes and clothing, which is very popular in Europe.

The licensor must make sure it can exercise sufficient control over the licensee's activities to ensure proper quality, pricing, distribution, and so on. Licensing may also create a new competitor in the long run if the licensee decides to void the license agreement. International law is often ineffective in stopping such actions. Two common ways that a licensor can maintain effective control over its licensees are by shipping one or more critical components from the United States and by locally registering patents and trademarks in its own name.

Franchising is a form of licensing that has grown rapidly in recent years. Many Canadian franchisors operate thousands of outlets in foreign countries. More than half of the international franchises are for fast-food restaurants and business services. McDonald’s, however, decided to sell its Chinese stores to a group of outside investors for $1.8 billion, but retained 20 percent of the equity.[17]

Having a big-name franchise doesn’t always guarantee success or mean that the job will be easy. In China, Home Depot closed its stores after opening 12 to serve the large Chinese population. Had they done market research, they would have known that the majority of urban dwellers live in recently built apartments and that DIY (Do It Yourself) is viewed with disdain in Chinese society, where it is seen as a sign of poverty.[18] When Subway opened its first sandwich shop in China, locals stood outside and watched for a few days. Patrons were so confused that the franchisee had to print signs explaining how to order. Customers didn’t believe the tuna salad was made from a fish because they couldn’t see the head or tail. And they didn’t like the idea of touching their food, so they would hold the sandwich vertically, peel off the paper wrap, and eat it like a banana. Most of all, the Chinese customers didn’t want sandwiches.

It’s not unusual for Western food chains to adapt their strategies when selling in China. McDonald’s, aware that the Chinese consume more chicken than beef, offered a spicy chicken burger. KFC got rid of coleslaw in favour of seasonal dishes such as shredded carrots or bamboo shoots.

Licensing video:
https://youtu.be/TwdLXgIhXJA

Contract Manufacturing

In **contract manufacturing**, a foreign firm manufactures private-label goods under a domestic firm’s brand. Marketing may be handled by either the domestic company or the foreign manufacturer. Levi Strauss, for instance, entered into an agreement with the French fashion house of Cacharel to produce a new Levi’s line, Something New, for distribution in Germany.

The advantage of contract manufacturing is that it lets a company test the water in a foreign country. By allowing the foreign firm to produce a certain volume of products to specification and put the domestic firm’s brand name on the goods, the domestic firm can broaden its global marketing base without investing in overseas plants and equipment. After establishing a solid base, the domestic firm may switch to a joint venture or direct investment, explained below.

Joint Ventures

Joint ventures are similar to licensing agreements. In a **joint venture**, the domestic firm buys part of a foreign company or joins with a foreign company to create a new entity. A joint venture is a quick and relatively inexpensive way to enter the global market. It can also be very risky. Many joint ventures fail. Others fall victim to a takeover, in which one partner buys out the other.

Some countries require foreign companies to form local partnerships in order to establish a business in their country. China, for example, had this requirement in a number of industries until recently. Thus, a joint venture was the only way to enter the Chinese market. Joint ventures help reduce risks by sharing costs and technology. Often joint ventures will bring together different strengths from each member. In the General Motors-Suzuki joint venture in Canada, for example, both parties have contributed and gained. The alliance, CAMI Automotive, was formed to manufacture low-end cars for the U.S. market. The plant, which was run by Suzuki management, produces the Chevrolet Equinox and the Pontiac Torrent, as well as the new Suzuki SUV. Through CAMI, Suzuki has gained access to GM's dealer network and an expanded market for parts and components. GM avoided the cost of developing low-end cars and obtained models it needed to revitalize the lower end of its product line and its average fuel economy rating. After the successful joint venture, General Motors gained full control of the operation in 2011. The CAMI factory may be one of the most productive plants in North America. There GM learned how Japanese automakers use work teams, run flexible assembly lines, and manage quality control.[19]

Direct Foreign Investment

Active ownership of a foreign company or overseas manufacturing or marketing facilities is called **direct foreign investment**. Direct investors have either a controlling interest or a large minority interest in the firm. Thus, they stand to receive the greatest potential reward but also face the greatest potential risk. A firm may make a direct foreign investment by acquiring an interest in an existing company or by building new facilities. It might do so because it has trouble transferring some resources to a foreign operation or obtaining that resource locally. One important resource is personnel, especially managers. If the local labour market is tight, the firm may buy an entire foreign firm and retain all its employees instead of paying higher salaries than competitors.

Sometimes firms make direct investments because they can find no suitable local partners. Also, direct investments avoid the communication problems and conflicts of interest that can arise with joint ventures. IBM, in the past, insisted on total ownership of its foreign investments because it did not want to share control with local partners.

General Motors has done very well by building a $4,400 (RMB 29,800) minivan in China that gets 43 miles per gallon in city driving. The Wuling Sunshine has a quarter of the horsepower of U.S. minivans, weak acceleration, and a top speed of 81 miles per hour. The seats are only a third of the thickness of seats in Western models, but look plush compared to similar Chinese cars. The minivans have made GM the largest automotive seller in China, and have made China a large profit center for GM.[20]

Walmart now has over 6,000 stores located outside the United States. In 2016, international sales were over $116 billion. About one-third of all new Walmart stores are opened in global markets.[21]

Not all of Walmart's global investments have been successful. In Germany, Walmart bought the 21-store Wertkauf hypermarket chain and then 74 unprofitable and often decrepit Interspar stores. Problems in integrating and upgrading the stores resulted in at least $200 million in losses. Like all other German stores, Walmart stores were required by law to close at 8 p.m. on weekdays and 4 p.m. on Saturdays, and they could not open at all on Sundays. Costs were astronomical. As a result, Walmart left the German retail market.

Walmart has turned the corner on its international operations. It is pushing operational authority down to country managers in order to respond better to local cultures. Walmart enforces certain core principles such as everyday low prices, but country managers handle their own buying, logistics, building design, and other operational decisions.

Global firms change their strategies as local market conditions evolve. For example, major oil companies like Shell Oil and ExxonMobil had to react to dramatic changes in the price of oil due to technological advances such as more efficient automobiles, fracking, and horizontal drilling.

Foreign Direct Investment video:
https://youtu.be/5DUyGWmcGVA

Countertrade

International trade does not always involve cash. Today, countertrade is a fast-growing way to conduct international business. In **countertrade**, part or all of the payment for goods or services is in the form of other goods or services. Countertrade is a form of barter (swapping goods for goods), an age-old practice whose origins have been traced back to cave dwellers. Recently, the Malaysian government bought 20 diesel-powered locomotives from China and paid for them with palm oil.

3.7 Threats and Opportunities in the Global Marketplace

What threats and opportunities exist in the global marketplace?

To be successful in a foreign market, companies must fully understand the foreign environment in which they plan to operate. Politics, cultural differences, and the economic environment can represent both opportunities and pitfalls in the global marketplace.

Political Considerations

We have already discussed how tariffs, exchange controls, and other governmental actions threaten foreign producers. The political structure of a country may also jeopardize a foreign producer's success in international trade.

Intense nationalism, for example, can lead to difficulties. **Nationalism** is the sense of national consciousness that boosts the culture and interests of one country over those of all other countries.

Strongly nationalistic countries, such as Iran and New Guinea, often discourage investment by foreign companies. In other, less radical forms of nationalism, the government may take actions to hinder foreign operations. France, for example, requires pop music stations to play at least 40 percent of their songs in French. This law was enacted because the French love American rock and roll. Without airtime, American music sales suffer. In another example of nationalism, U.S.-based PPG made an unsolicited bid to acquire Netherlands-based AzkoNobel NV. There was a chorus of opposition from Dutch politicians to the idea of a foreign takeover of AzkoNobel, the Dutch paint manufacturer. The government warned that it would move to defend AzkoNobel from a hostile takeover attempt. AzkoNobel played up the sentiment, tweeting about its rejection of the hostile takeover with the hashtag #DutchPride.[22]

In a hostile climate, a government may expropriate a foreign company's assets, taking ownership and compensating the former owners. Even worse is confiscation, when the owner receives no compensation. This happened during rebellions in several African nations during the 1990s and 2000s.

Cultural Differences

Central to any society is the common set of values shared by its citizens that determine what is socially acceptable. Culture underlies the family, educational system, religion, and social class system. The network of social organizations generates overlapping roles and status positions. These values and roles have a tremendous effect on people's preferences and thus on marketers' options. For example, China Walmart holds live fishing contests on the premises, and in South Korea the company hosts a food competition with variations on a popular Korean dish, kimchee.

Language is another important aspect of culture. Marketers must take care in selecting product names and translating slogans and promotional messages so as not to convey the wrong meaning. For example, Mitsubishi Motors had to rename its Pajero model in Spanish-speaking countries because the term refers to a sexual activity. Toyota Motor's MR2 model dropped the 2 in France because the combination sounds like a French swear word. The literal translation of Coca-Cola in Chinese characters means "bite the wax tadpole."

Each country has its own customs and traditions that determine business practices and influence negotiations with foreign customers. For example, attempting to do business in Western Europe during the first two weeks in August is virtually impossible. Businesses close, and everyone goes on vacation at the same time. In many countries, personal relationships are more important than financial considerations. For instance, skipping social engagements in Mexico may lead to lost sales. Negotiations in Japan often include long evenings of dining, drinking, and entertaining; only after a close personal relationship has been formed do business negotiations begin. Table 3.2 presents some cultural dos and don'ts.

Economic Environment

The level of economic development varies considerably, ranging from countries where everyday survival is a struggle, such as Sudan and Eritrea, to countries that are highly developed, such as Switzerland and Japan. In general, complex, sophisticated industries are found in developed countries, and more basic industries are found in less developed nations. Average family incomes are higher in the more developed countries than in the less developed markets. Larger incomes mean greater purchasing power and demand, not only for consumer goods and services but also for the machinery and workers required to produce consumer goods.

Business opportunities are usually better in countries that have an economic infrastructure in place.

Infrastructure is the basic institutions and public facilities upon which an economy's development depends. When we think about how our own economy works, we tend to take our infrastructure for granted. It includes the money and banking system that provide the major investment loans to our nation's businesses; the educational system that turns out the incredible varieties of skills and basic research that actually run our nation's production lines; the extensive transportation and communication systems—interstate highways, railroads, airports, canals, telephones, internet connectivity, postal systems, and television stations—that link almost every piece of our geography into one market; the energy system that powers our factories; and, of course, the market system itself, which brings our nation's goods and services into our homes and businesses.

Cultural Do's and Don'ts Guidelines and Examples	
DO:	**DON'T:**
• Always present your business card with both hands in Asian countries. It should also be right-side-up and print-side-showing so that the recipient can read it as it is being presented. If you receive a business card, accept it with gratitude and examine it carefully. Don't quickly put it into your pocket. • Use a "soft-sell" and subtle approach when promoting a product in Japan. Japanese people do not feel comfortable with America's traditional hard-selling style. • Understand the role of religion in business transactions. In Muslim countries, Ramadan is a holy month when most people fast. During this time everything slows down, particularly business. • Have a local person available to culturally and linguistically interpret any advertising that you plan to do. When American Airlines wanted to promote its new first-class seats in the Mexican market, it translated the "Fly in Leather" campaign literally, which meant "Fly Naked" in Spanish.	• Glad-hand, back-slap, and use first names on your first business meeting in Asia. If you do, you will be considered a lightweight. • Fill a wine glass to the top if dining with a French businessperson. It is considered completely uncouth. • Begin your first business meeting in Asia talking business. Be patient. Let your clients get to know you first.

Table 3.2

3.8 The Impact of Multinational Corporations

What are the advantages of multinational corporations?

Corporations that move resources, goods, services, and skills across national boundaries without regard to the country in which their headquarters are located are **multinational corporations**. Some are so rich and have so many employees that they resemble small countries. For example, the sales of both Exxon and Walmart are larger than the GDP of all but a few nations in the world. Multinational companies are heavily engaged in international trade. The successful ones take political and cultural differences into account.

Multinational Corporations video:
https://youtu.be/Wo6hobrwPJQ

Many global brands sell much more outside the United States than at home. Coca-Cola, Philip Morris's Marlboro brand, Pepsi, Kellogg, Pampers, Nescafe, and Gillette, are examples.

The Fortune 500 made over $1.5 trillion in profit in 2016. In slow-growing, developed economies like Europe and Japan a weaker dollar helps because it means cheaper products to sell into those markets, and profits earned in those markets translate into more dollars back home. Meanwhile, emerging markets in Asia, Latin America, and Eastern Europe are growing steadily. General Electric expects 60 percent of its revenue growth to come from emerging markets over the next decade. For Brown-Forman, the spirits company, a fifth of its sales growth for Jack Daniels, the Tennessee whiskey, is coming from developing markets like Mexico and Poland. IBM had rapid sales growth in emerging markets such as Russia, India, and Brazil.[23] The largest multinational corporations in the world are shown in Table 3.3. Despite the success of American multinationals abroad, there is some indication that preference for U.S. brands may be slipping.

Exhibit 3.3 As overseas investment grows, so does the need for global branding. The Wisconsin National Guard picked NBA star Giannis Antetokounmpo to be the face of its recruiting and marketing effort. Recognizable to NBA fans all around the world, Antetokounmpo personifies a youthful, dynamic spirit that transcends cultural and geographic boundaries. *Why is it increasingly important that multinational advertisers identify and sign celebrity spokespersons capable of bridging different cultures?* (Credit: Erik Drost/ Flickr/ Attribution-ShareAlike 2.0 Generic (CC BY 2.0))

The Multinational Advantage

Large multinationals have several advantages over other companies. For instance, multinationals can often overcome trade problems. Taiwan and South Korea have long had an embargo against Japanese cars for political reasons and to help domestic automakers. Yet Honda USA, a Japanese-owned company based in the United States, sends Accords to Taiwan and Korea. In another example, when the environmentally conscious Green movement challenged the biotechnology research conducted by BASF, a major German chemical and drug manufacturer, BASF moved its cancer and immune-system research to Cambridge, Massachusetts.

Another advantage for multinationals is their ability to sidestep regulatory problems. U.S. drug maker SmithKline and Britain's Beecham decided to merge in part so they could avoid licensing and regulatory hassles in their largest markets. The merged company can say it's an insider in both Europe and the United States. "When we go to Brussels, we're a member state [of the European Union]," one executive explains. "And when we go to Washington, we're an American company."

Exhibit 3.4 South Korea's Samsung is a leading manufacturer of giant high-definition TVs. Samsung produces the largest curved ultra-high-definition (UHD) screens for the worldwide home-theater market. Samsung's monster 110-inch curved UHD screen is among the world's largest such screens. Unfortunately, for most of the world's consumers, the giant Samsung TVs can be too costly, but the 88-inch version can be purchased for under $20,000. *How does being a multinational corporation enable Samsung to succeed in the high-end electronics market?* (Credit: Chris F/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Multinationals can also shift production from one plant to another as market conditions change. When European demand for a certain solvent declined, Dow Chemical instructed its German plant to switch to manufacturing a chemical that had been imported from Louisiana and Texas. Computer models help Dow make decisions like these so it can run its plants more efficiently and keep costs down.

Multinationals can also tap new technology from around the world. In the United States, Xerox has introduced some 80 different office copiers that were designed and built by Fuji Xerox, its joint venture with a Japanese company. Versions of the super-concentrated detergent that Procter & Gamble first formulated in Japan, in response to a rival's product, are now being sold under the Ariel brand name in Europe and under the Cheer and Tide labels in the United States. Also, consider Otis Elevator's

The World's Top 11 Largest Multinational Corporations			
RANK	RANK COMPANY	Revenues ($M)	Home Country
1	Walmart	$482,130	United States
2	State Grid	$329,601	China
3	China National Petroleum	$299,271	China
4	Sinopec Group	$294,344	China
5	Royal Dutch Shell	$272,156	Netherlands
6	Exxon Mobil	$246,204	United States
7	Volkswagen	$236,600	Germany
8	Toyota Motor	$236,592	Japan
9	Apple	$233,715	United States
10	BP	$225,982	United Kingdom
11	Berkshire Hathaway	$210,821	United States

Table 3.3 Source: Adapted from "The World's Largest Corporations," *Fortune* http://fortune.com/global500/, accessed June 30, 2017.

development of the Elevonic 411, an elevator that is programmed to send more cars to floors where demand is high. It was developed by six research centers in five countries. Otis's group in Farmington, Connecticut, handled the systems integration, a Japanese group designed the special motor drives that make the elevators ride smoothly, a French group perfected the door systems, a German group handled the electronics, and a Spanish group took care of the small-geared components. Otis says the international effort saved more than $10 million in design costs and cut the process from four years to two.

Finally, multinationals can often save a lot in labour costs, even in highly unionized countries. For example, when Xerox started moving copier-rebuilding work to Mexico to take advantage of the lower wages, its union in Rochester, New York, objected because it saw that members' jobs were at risk. Eventually, the union agreed to change work styles and to improve productivity to keep the jobs at home.

3.9 Trends in Global Competition

What are the trends in the global marketplace?

In this section, we will examine several underlying trends that will continue to propel the dramatic growth in world trade. These trends are market expansion, resource acquisition, and the emergence of China and India.

Market Expansion

The need for businesses to expand their markets is perhaps the most fundamental reason for the growth in world trade. The limited size of domestic markets often motivates managers to seek markets beyond their national frontiers. The economies of large-scale manufacturing demand big markets. Domestic markets, particularly in smaller countries like Denmark and the Netherlands, simply can't generate enough demand. Nestlé was one of the first businesses to "go global" because its home country, Switzerland, is so small. Nestlé was shipping milk to 16 different countries as early as 1875. Today, hundreds of thousands of businesses are recognizing the potential rich rewards to be found in international markets.

Resource Acquisition

More and more companies are going to the global marketplace to acquire the resources they need to operate efficiently. These resources may be cheap or skilled labour, scarce raw materials, technology, or capital. Nike, for example, has manufacturing facilities in many Asian countries in order to use cheaper labour. Honda opened a design studio in southern California to put that "California flair" into the design of some of its vehicles. Large multinational banks, such as Bank of New York and Citigroup, have offices in Geneva, Switzerland. Geneva is the private banking center of Europe and attracts capital from around the globe.

The Emergence of China and India

China and India—two of the world's economic powerhouses—are impacting businesses around the globe, in very different ways. The boom in China's worldwide exports has left few sectors unscathed, whether it's garlic growers in California, jeans makers in Mexico, or plastic-mold manufacturers in South Korea. India's impact has altered how hundreds of service companies from Texas to Ireland compete for billions of dollars in contracts.

The causes and consequences of each nation's growth are different. China's exports have boomed largely thanks to foreign investment. Lured by low labour costs, big manufacturers have surged into China to expand their production base and push down prices globally. Now manufacturers of all sizes, making everything from windshield wipers to washing machines to clothing, are scrambling either to reduce costs at home or to outsource more of what they make in cheaper locales such as China and India.[24]

Indians are playing invaluable roles in the global innovation chain. Hewlett-Packard, Cisco Systems, and other tech giants now rely on their Indian teams to devise software platforms and multimedia features for next- generation devices. Google principal scientist Krishna Bharat set up the Google Bangalore lab complete with colorful furniture, exercise balls, and a Yamaha organ—like Google's Mountain View, California, headquarters—to work on core search-engine technology. Indian engineering houses use 3-D computer simulations to tweak designs of everything from car engines and forklifts to aircraft wings for such clients as General Motors Corp. and Boeing Co. Not accounting for unforeseen circumstances, within five years India should vault over Germany as the world's fourth-biggest economy. By mid-century, China should overtake the United States as number one. By then, China and India could account for half of global output.[25]

An accelerating trend is that technical and managerial skills in both China and India are becoming more important than cheap assembly labour. China will stay dominant in mass manufacturing and is one of the few nations building multibillion-dollar electronics and heavy industrial plants. India is a rising power in software, design, services, and precision industry.

Key Terms

absolute advantage	The situation when a country can produce and sell a product at a lower cost than any other country or when it is the only country that can provide the product.
balance of payments	A summary of a country's international financial transactions showing the difference between the country's total payments to and its total receipts from other countries.
balance of trade	The difference between the value of a country's exports and the value of its imports during a specific time.
contract manufacturing	The practice in which a foreign firm manufactures private-label goods under a domestic firm's brand name.
countertrade	A form of international trade in which part or all of the payment for goods or services is in the form of other goods and services.
devaluation	A lowering of the value of a nation's currency relative to other currencies.
direct foreign investment	Active ownership of a foreign company or manufacturing or marketing facilities in a foreign country.
dumping	The practice of charging a lower price for a product in foreign markets than in the firm's home market.
embargo	A total ban on imports or exports of a product.
European integration	The delegation of limited sovereignty by European Union member states to the EU so that common laws and policies can be created at the European level.
European Union	Trade agreement among 28 European nations.
exporting	The practice of selling domestically produced goods to buyers in another country.
exports	Goods and services produced in one country and sold to other countries.
floating exchange rates	A system in which prices of currencies move up and down based upon the demand for and supply of the various currencies.
free trade	The policy of permitting the people and businesses of a country to buy and sell where they please without restrictions.
free-trade zone	An area where the nations allow free, or almost free, trade among each other while imposing tariffs on goods of nations outside the zone.
G20	Informal group that brings together 19 countries and the European Union—the 20 leading economies in the world.
global vision	The ability to recognize and react to international business opportunities, be aware of threats from foreign competition, and effectively use international distribution networks to obtain raw materials and move finished products to customers.

Key Terms

import quota	A limit on the quantity of a certain good that can be imported.
imports	Goods and services that are bought from other countries.
infrastructure	The basic institutions and public facilities upon which an economy's development depends. International Monetary Fund (IMF) An international organization, founded in 1945, that promotes trade, makes short-term loans to member nations, and acts as a lender of last resort for troubled nations.
joint venture	An agreement in which a domestic firm buys part of a foreign firm or joins with a foreign firm to create a new entity.
licensing	The legal process whereby a firm agrees to allow another firm to use a manufacturing process, trademark, patent, trade secret, or other proprietary knowledge in exchange for the payment of a royalty.
Mercosur	Trade agreement between Peru, Brazil, Argentina, Uruguay, and Paraguay.
multinational corporations	Corporations that move resources, goods, services, and skills across national boundaries without regard to the country in which their headquarters are located.
nationalism	A sense of national consciousness that boosts the culture and interests of one country over those of all other countries.
North American Free Trade Agreement (NAFTA)	A 1993 agreement creating a free-trade zone including Canada, Mexico, and the United States.
outsourcing	Sending work functions to another country, resulting in domestic workers losing their jobs.
preferential tariff	A tariff that is lower for some nations than for others.
principle of comparative advantage	The concept that each country should specialize in the products that it can produce most readily and cheaply and trade those products for those that other countries can produce more readily and cheaply.
protectionism	The policy of protecting home industries from outside competition by establishing artificial barriers such as tariffs and quotas.
protective tariffs	Tariffs that are imposed in order to make imports less attractive to buyers than domestic products are.
tariff	A tax imposed on imported goods.
trade deficit	An unfavorable balance of trade that occurs when a country imports more than it exports.
trade surplus	A favorable balance of trade that occurs when a country exports more than it imports.
Uruguay Round	A 1994 agreement originally signed by 117 nations to lower trade barriers worldwide.

Key Terms

World Bank	An international bank that offers low-interest loans, as well as advice and information, to developing nations.
World Trade Organization (WTO)	An organization established by the Uruguay Round in 1994 to oversee international trade, reduce trade barriers, and resolve disputes among member nations.

Summary of Learning Outcomes

1. Why is global trade important to Canada, and how is it measured?

International trade improves relations with friends and allies, eases tensions among nations, helps bolster economies, raises people's standard of living, and improves the quality of life.

Two concepts important to global trade are the balance of trade (the difference in value between a country's exports and its imports over some period) and the balance of payments (the difference between a country's total payments to other countries and its total receipts from other countries).

Another important concept is the exchange rate, which is the price of one country's currency in terms of another country's currency. Currencies float up and down based upon the supply of and demand for each currency. Sometimes a government steps in and devalues its currency relative to the currencies ofother countries.

2. What are the advantages of trading?

Nations trade because they gain by doing so. The principle of comparative advantage states that each country should specialize in the goods it can produce most readily and cheaply and trade them for those that other countries can produce most readily and cheaply. The result is more goods at lower prices than if each country produced by itself everything it needed. Free trade allows trade among nations without government restrictions.

3. What are the barriers to international trade?

The three major barriers to international trade are natural barriers, such as distance and language; tariff barriers, or taxes on imported goods; and nontariff barriers. The nontariff barriers to trade include import quotas and embargoes. The main argument against tariffs is that they discourage free trade and keep the principle of comparative advantage from working efficiently. The main argument for using tariffs is that they help protect domestic companies, industries, and workers.

4. How do governments and institutions foster world trade?

The World Trade Organization, established by the Uruguay Round of trade negotiations, has dramatically lowered trade barriers worldwide. For the first time, a trade agreement covers services, intellectual property rights, and exchange controls. The World Bank makes loans to developing nations to help build infrastructures. The International Monetary Fund makes loans to member nations that cannot meet their budgetary expenses. Despite efforts to expand trade, terrorism can have a negative impact on trade growth.

Summary of Learning Outcomes

5. What are international economic communities?

International economic communities reduce trade barriers among themselves while often establishing common tariffs and other trade barriers toward nonmember countries. The best-known economic communities are the European Union, NAFTA, CAFTA, and Mercosur.

6. How do companies enter the global marketplace?

There are a number of ways to enter the global market. The major ones are exporting, licensing, contract manufacturing, joint ventures, and direct investment.

7. What threats and opportunities exist in the global marketplace?

Domestic firms entering the international arena need to consider the politics, economies, and culture of the countries where they plan to do business. For example, government trade policies can be loose or restrictive, countries can be nationalistic, and governments can change. In the area of culture, many products fail because companies don't understand the culture of the country where they are trying to sell their products. Some developing countries also lack an economic infrastructure, which often makes it very difficult to conduct business.

8. What are the advantages of multinational corporations?

Multinational corporations have several advantages. First, they can sidestep restrictive trade and licensing restrictions because they frequently have headquarters in more than one country. Multinationals can also move their operations from one country to the next depending on which location offers more favorable economic conditions. In addition, multinationals can tap into a vast source of technological expertise by drawing upon the knowledge of a global workforce.

9. What are the trends in the global marketplace?

Global business activity will continue to escalate due to several factors. Firms that desire a larger customer base or need additional resources will continue to seek opportunities outside their country's borders. China and India are emerging as global economic powerhouses.

Chapter 4

Forms of Business Ownership

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What are the advantages and disadvantages of the sole proprietorship form of business organization?
2. What are the advantages of operating as a partnership, and what downside risks should partners consider?
3. How does the corporate structure provide advantages and disadvantages to a company?
4. What other options for business organization does a company have in addition to sole proprietorships, partnerships, and corporations?
5. What makes franchising an appropriate form of organization for some types of business, and why does it continue to grow in importance?
6. Why are mergers and acquisitions important to a company's overall growth?
7. What current trends will affect the business organizations of the future?

This chapter discusses sole proprietorships, as well as several other forms of business ownership, including partnerships and corporations, and compares the advantages and disadvantages of each.

With a good idea and some cash in hand, you decide to start a business. But before you get going, you need to ask yourself some questions that will help you decide what form of business organization will best suit your needs. Would you prefer to go it alone as a *sole proprietorship*, or do you want others to share your burdens and challenges in a *partnership*? Or would the limited liability protection of a *corporation* make more sense?

There are other questions you need to consider too: Will you need financing? How easy will it be to obtain? Will you attract employees? How will the business be taxed, and who will be liable for the company's debts? If you choose to share ownership with others, how much operating control would they want, and what costs would be associated with that?

Most start-up businesses select one of these major ownership forms. In the following pages, we will discover the advantages and disadvantages of each form of business ownership and the factors that may make it necessary to change from one form of organization to another as the needs of the business change. As a company expands from small to midsize or larger, the form of business structure selected in the beginning may no longer be appropriate.

The Canadian Landscape

Innovation, Science and Economic Development Canada (ISED) defines a business based upon the number of paid employees. For this reason, self-employed and "indeterminate" businesses are generally not included in the present publication as they do not have paid employees.

Accordingly, this publication defines an SME (small-to-medium enterprise) as a business establishment with 499–1 paid employees, more specifically:

- A small business has 1 to 99 paid employees.
- A medium-sized business has 100 to 499 paid employees.
- A large business has 500 or more paid employees.
- ISED also categorizes businesses with 4-1 employees as micro-enterprises.

"As of December 2015, there were 1.17 million employer businesses in Canada. Of these, 1.14 million (97.9 percent) businesses were small businesses, 1.8) 21,415 percent) were medium-sized businesses and 0.3) 2,933 percent) were large enterprises." (Industry Canada)

Provincial and federal governments also support small businesses and offer free resources as well as opportunities for funding. Canada Business Network (@canadabusiness #SMEPME) is a collaborative arrangement among federal departments and agencies, provincial and territorial governments and not-for-profit entities.

It offers webinars and other learning events across the country. For example, Ontario's Small Business Access, offers workshops, a help line, funding, and provides up-to-date information on legal requirements.

4.1 Going It Alone: Sole Proprietorships

What are the advantages and disadvantages of the sole proprietorship form of business organization?

Jeremy Shepherd was working full-time for an airline when, at the age of 22, he wandered into an exotic pearl market in China, searching for a gift for his girlfriend. The strand of pearls he handpicked by instinct was later valued by a jeweler back in the States at 20 times what he paid. Jeremy cashed his next paycheck and hurried back to Asia, buying every pearl he could afford. Founded in 1996, his company Pearl Paradise was brought online in 2000. Shepherd chose the sole proprietorship form of business organization—a business that is established, owned, operated, and often financed by one person—because it was the easiest to set up. He did not want partners, and low liability exposure made incorporating unnecessary.

Fluent in Mandarin Chinese, Japanese, and Spanish and immersed in Asian culture, Shepherd believed the internet was the way to market his pearls (http://www.pearlparadise.com). Offering a wide range of pearl jewelry through 14 websites worldwide, his company sells as many as 1,000 items per day. The recent addition of an exclusive Los Angeles showroom allows celebrity customers to shop by appointment. With $20 million in sales annually, PearlParadise.com is the industry leader in terms of sales and volume.[1]

Advantages of Sole Proprietorships

Sole proprietorships have several advantages that make them popular:

- *Easy and inexpensive to form.* As Jeremy Shepherd discovered, sole proprietorships have few legal requirements (local licenses and permits) and are not expensive to form, making them the business organization of choice for many small companies and start-ups.
- *Profits all go to the owner.* The owner of a sole proprietorship obtains the start-up funds and gets all the profits earned by the business. The more efficiently the firm operates, the higher the company's profitability.
- *Direct control of the business.* All business decisions are made by the sole proprietorship owner without having to consult anyone else.
- *Freedom from government regulation.* Sole proprietorships have more freedom than other forms of business with respect to government controls.
- *No special taxation.* Sole proprietorships do not pay special franchise or corporate taxes. Profits are taxed as personal income as reported on the owner's individual tax return.
- *Ease of dissolution.* With no co-owners or partners, the sole proprietor can sell the business or close the doors at any time, making this form of business organization an ideal way to test a new business idea.

Disadvantages of Sole Proprietorships

Along with the freedom to operate the business as they wish, sole proprietors face several disadvantages:

- *Unlimited liability.* From a legal standpoint, the sole proprietor and the company are one and the same, making the business owner personally responsible for all debts the company incurs, even if they exceed the company's value. The owner may need to sell other personal property—their car, home, or other investments—to satisfy claims against the business.
- *Difficulty raising capital.* Business assets are unprotected against claims of personal creditors, so business lenders view sole proprietorships as high risk due to the owner's unlimited liability. Owners must often use personal funds—borrowing on credit cards, second-mortgaging their homes, or selling investments—to finance their business. Expansion plans can also be affected by an inability to raise additional funding.
- *Limited managerial expertise.* The success of a sole proprietorship rests solely with the skills and talents of the owner, who must wear many different hats and make all decisions. Owners are often not equally skilled in all areas of running a business. A graphic designer may be a wonderful artist but not know bookkeeping, how to manage production, or how to market their work.
- *Trouble finding qualified employees.* Sole proprietors often cannot offer the same pay, fringe benefits, and advancement as larger companies, making them less attractive to employees seeking the most favourable employment opportunities.
- *Personal time commitment.* Running a sole proprietorship business requires personal sacrifices and a huge time commitment, often dominating the owner's life with 12-hour workdays and 7-day workweeks.
- *Unstable business life.* The life span of a sole proprietorship can be uncertain. The owner may lose interest, experience ill health, retire, or die. The business will cease to exist unless the owner makes provisions for it to continue operating or puts it up for sale.
- *Losses are the owner's responsibility.* The sole proprietor is responsible for all losses, although tax laws allow these to be deducted from other personal income.

The sole proprietorship may be a suitable choice for a one-person start-up operation with no employees and little risk of liability exposure. For many sole proprietors, however, this is a temporary choice, and as the business grows, the owner may be unable to operate with limited financial and managerial resources. At this point, the owner may decide to take in one or more partners to ensure that the business continues to flourish.

4.2 Partnerships: Sharing the Load

What are the advantages of operating as a partnership, and what downside risks should partners consider?

Can **partnerships**, an association of two or more individuals who agree to operate a business together for profit, be hazardous to a business's health? Let's assume partners Ron and Liz own a stylish and successful beauty salon. After a few years of operating the business, they find they have contrasting visions for their company. Liz is happy with the status quo, while Ron wants to expand the business by bringing in investors and opening salons in other locations.

How do they resolve this impasse? By asking themselves some tough questions. Whose view of the future is more realistic? Does the business actually have the expansion potential Ron believes it does? Where will he find investors to make his dream of multiple locations a reality? Is he willing to dissolve the partnership and start over again on his own? And who would have the right to their clients?

Ron realizes that expanding the business in line with his vision would require a large financial risk and that his partnership with Liz offers many advantages he would miss in a sole proprietorship form of business organization. After much consideration, he decides to leave things as they are.

For those individuals who do not like to "go it alone," a partnership is relatively simple to set up. Offering a shared form of business ownership, it is a popular choice for professional-service firms such as lawyers, accountants, architects, stockbrokers, and real estate companies.

The parties agree, either orally or in writing, to share in the profits and losses of a joint enterprise. A *written partnership agreement*, spelling out the terms and conditions of the partnership, is recommended to prevent later conflicts between the partners. Such agreements typically include the name of the partnership, its purpose, and the contributions of each partner (financial, asset, skill/talent). It also outlines the responsibilities and duties of each partner and their compensation structure (salary, profit sharing, etc.). It should contain provisions for the addition of new partners, the sale of partnership interests, and procedures for resolving conflicts, dissolving the business, and distributing the assets.

Types of Partnerships

There are two basic types of partnerships: *general and limited*. In a **general partnership**, all partners share in the management and profits. They co-own the assets, and each can act on behalf of the firm. Each partner also has unlimited liability for all the business obligations of the firm. A **limited partnership** has two types of partners: one or more **general partners**, who have unlimited liability, and one or more **limited partners**, whose liability is limited to the amount of their investment. In return for limited liability, limited partners agree not to take part in the day-to-day management of the firm. They help to finance the business, but the general partners maintain operational control.

Partnership video:
https://youtu.be/7zRGxjZW8QU

Advantages of Partnerships

Some advantages of partnerships come quickly to mind:

- *Ease of formation.* Like sole proprietorships, partnerships are easy to form. The partners agree to do business together and draw up a partnership agreement. For most partnerships, applicable provincial laws are not complex.
- *Availability of capital.* Because two or more people contribute financial resources, partnerships can raise funds more easily for operating expenses and business expansion. The partners' combined financial strength also increases the firm's ability to raise funds from outside sources.
- *Diversity of skills and expertise.* Partners share the responsibilities of managing and operating the business. Combining partner skills to set goals, manage the overall direction of the firm, and solve problems increases the chances for the partnership's success. To find the right partner, you must examine your own strengths and weaknesses and know what you need from a partner. Ideal partnerships bring together people with complementary backgrounds rather than those with similar experience, skills, and talents. In Table 4.1 you'll find some advice on choosing a partner.
- *Flexibility.* General partners are actively involved in managing their firm and can respond quickly to changes in the business environment.
- *No special taxes.* Each partner's profit or loss is then reported on the partner's personal income tax return, with any profits taxed at personal income tax rates.
- *Relative freedom from government control.* Except for provincial rules for licensing and permits, the government has little control over partnership activities.

Disadvantages of Partnerships

Business owners must consider the following disadvantages of setting up their company as a partnership:

- *Unlimited liability.* All general partners have unlimited liability for the debts of the business. In fact, any one partner can be held personally liable for all partnership debts and legal judgments (such as malpractice)—regardless of who caused them. As with sole proprietorships, business failure can lead to a loss of the general partners' personal assets.
- *Potential for conflicts between partners.* Partners may have different ideas about how to run their business, which employees to hire, how to allocate responsibilities, and when to expand. Differences in personalities and work styles can cause clashes or breakdowns in communication, sometimes requiring outside intervention to save the business.

- *Complexity of profit sharing.* Dividing the profits is relatively easy if all partners contribute equal amounts of time, expertise, and capital. But if one partner puts in more money and others more time, it might be more difficult to arrive at a fair profit-sharing formula.
- *Difficulty exiting or dissolving a partnership.* As a rule, partnerships are easier to form than to leave. When one partner wants to leave, the value of their share must be calculated. To whom will that share be sold, and will that person be acceptable to the other partners? If a partner who owns more than 50 percent of the entity withdraws, dies, or becomes disabled, the partnership must reorganize or end. To avoid these problems, most partnership agreements include specific guidelines for transferring partnership interests and buy–sell agreements that make provision for surviving partners to buy a deceased partner's interest. Partners can also purchase special life insurance policies designed to fund such a purchase.

Business partnerships are often compared to marriages. As with a marriage, choosing the right partner is critical. So if you are considering forming a partnership, allow plenty of time to evaluate your and your potential partner's goals, personality, expertise, and working style before joining forces.

Perfect Partners

Picking a partner is both an art and a science. Someone may have all the right credentials on paper, but does that person share your vision and the ideas you have for your company? Are they a straight shooter? Honesty, integrity, and ethics are important, because you may be liable for what your partner does. Be prepared to talk about everything, and trust your intuition and your gut feelings—they're probably right. Ask yourself and your potential partner the following questions—then see how well your answers match up:

1. Why do you want a partner?
2. What characteristics, talents, and skills does each person bring to the partnership?
3. How will you divide responsibilities—from long-range planning to daily operations? Who will handle such tasks as marketing, sales, accounting, and customer service?
4. What is your long-term vision for the business—its size, life span, financial commitment, etc.?
5. What are your personal reasons for forming this company? Are you looking to create a small company or build a large one? Are you seeking a steady paycheck or financial independence?
6. Will all parties put in the same amount of time, or is there an alternative arrangement that is acceptable to everyone?
7. Do you have similar work ethics and values?
8. What requirements will be in the partnership agreement?

Table 4.1

4.3 Corporations: Limiting Your Liability

How does the corporate structure provide advantages and disadvantages to a company?

When people think of corporations, they typically think of major, well-known companies, such as Apple, Alphabet (parent company of Google), Netflix, IBM, Microsoft, Boeing, and General Electric. But corporations range in size from large multinationals with thousands of employees and billions of dollars in sales to midsize or even smaller firms with few employees and revenues under $25,000.

A **corporation** is a legal entity subject to the laws of the province in which it is formed, where the right to operate as a business is issued by provincial charter. A corporation can own property, enter into contracts, sue and be sued, and engage in business operations under the terms of its charter. Unlike sole proprietorships and partnerships, corporations are taxable entities with a life separate from their owners, who are not personally liable for its debts.

When launching her company, Executive Property Management Services Inc., 32-year-old Linda Ravden realized she needed the liability protection of the corporate form of business organization. Her company specialized in providing customized property management services to mid- and upper-level corporate executives on extended work assignments abroad, often for three to five years or longer. Taking care of substantial properties in the million-dollar range and above was no small responsibility for Ravden's company. Therefore, the protection of a corporate business structure, along with carefully detailed contracts outlining the company's obligations, were crucial in providing Ravden with the liability protection she needed—and the peace of mind to focus on running her business without constant worry.

Sole Proprietorship vs Incorporation video:
https://youtu.be/b6d_WUoT5Qc

The Incorporation Process

Setting up a corporation is more complex than starting a sole proprietorship or partnership. Registration procedures, fees, taxes, and laws that regulate corporations vary from province to province.

A firm does not have to incorporate in the province where it is based and may benefit by comparing the rules of several provinces before choosing a province of incorporation. Incorporating a company involves five main steps:

- Selecting the company's name
- Writing the *articles of incorporation* (see Table 4.2) and filing them with the appropriate provincial office
- Paying required fees and taxes
- Holding an organizational meeting

- Adopting bylaws, electing directors, and passing the first operating resolutions

The province issues a corporate charter based on information in the articles of incorporation. Once the corporation has its charter, it holds an organizational meeting to adopt bylaws, elect directors, and pass initial operating resolutions. Bylaws provide legal and managerial guidelines for operating the firm.

Articles of Incorporation
Articles of incorporation are prepared on a form authorized or supplied by the province of incorporation. Although they may vary slightly from state to state, all articles of incorporation include the following key items:
• Name of corporation • Company's goals • Types of stock and number of shares of each type to issue • Life of the corporation (usually "perpetual," meaning with no time limit) • Minimum investment by owners • Methods for transferring shares of stock • Address of the corporate office • Names and addresses of the first board of directors

Table 4.2

The Corporate Structure

As Exhibit 4.2 shows, corporations have their own organizational structure with three important components: stockholders, directors, and officers.

Stockholders (or shareholders) are the owners of a corporation, holding shares of stock that provide them with certain rights. They may receive a portion of the corporation's profits in the form of dividends, and they can sell or transfer their ownership in the corporation (represented by their shares of stock) at any time.

Stockholders can attend annual meetings, elect the board of directors, and vote on matters that affect the corporation in accordance with its charter and bylaws. Each share of stock generally carries one vote.

The stockholders elect a **board of directors** to govern and handle the overall management of the corporation. The directors set major corporate goals and policies, hire corporate officers, and oversee the firm's operations and finances. Small firms may have as few as 3 directors, whereas large corporations usually have 10 to 15.

Corporate structure video:
https://youtu.be/wtMORWO5h9Y

The boards of large corporations typically include both corporate executives and outside directors (not employed by the organization) chosen for their professional and personal expertise. Outside directors often bring a fresh view to the corporation's activities because they are independent of the firm.

Hired by the board, the *officers* of a corporation are its top management and include the president and chief executive officer (CEO), vice presidents, treasurer, and secretary, who are responsible for achieving corporate goals and policies. Officers may also be board members and stockholders.

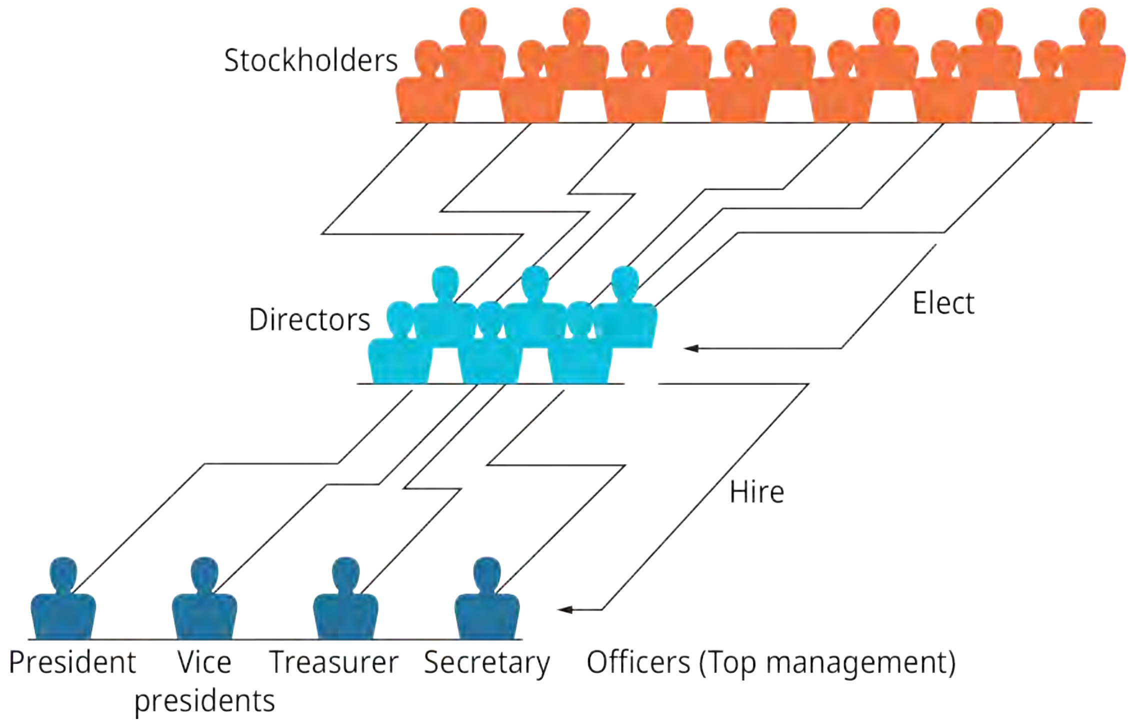


Exhibit 4.2 Organizational Structure of Corporations Attribution: Copyright Rice University, OpenStax, under CC BY-NC-SA 4.0 license

Advantages of Corporations

The corporate structure allows companies to merge financial and human resources into enterprises with great potential for growth and profits:

- *Limited liability.* A key advantage of corporations is that they are separate legal entities that exist apart from their owners. Owners' (stockholders') liability for the obligations of the firm is limited to the amount of the stock they own. If the corporation goes bankrupt, creditors can look only to the assets of the corporation for payment.
- *Ease of transferring ownership.* Stockholders of public corporations can sell their shares at any time without affecting the status of the corporation.

- *Unlimited life.* The life of a corporation is unlimited. Although corporate charters specify a life term, they also include rules for renewal. Because the corporation is an entity separate from its owners, the death or withdrawal of an owner does not affect its existence, unlike a sole proprietorship or partnership.
- *Tax deductions.* Corporations are allowed certain tax deductions, which reduces their taxable income.
- *Ability to attract financing.* Corporations can raise money by selling new shares of stock. Dividing ownership into smaller units makes it affordable to more investors, who can purchase one or several thousand shares. The large size and stability of corporations also helps them get bank financing. All these financial resources allow corporations to invest in facilities and human resources and expand beyond the scope of sole proprietorships or partnerships. It would be impossible for a sole proprietorship or partnership to make automobiles, provide nationwide telecommunications, or build oil or chemical refineries.

Disadvantages of Corporations

Although corporations offer companies many benefits, they have some disadvantages:

- *Double taxation of profits.* Corporations must pay federal and provincial income taxes on their profits. In addition, any profits (dividends) paid to stockholders are taxed as personal income, although at a somewhat reduced rate.
- *Cost and complexity of formation.* As outlined earlier, forming a corporation involves several steps, and costs can run into thousands of dollars, including provincial filing, registration, and license fees, as well as the cost of attorneys and accountants.
- *More government restrictions.* Unlike sole proprietorships and partnerships, corporations are subject to many regulations and reporting requirements.

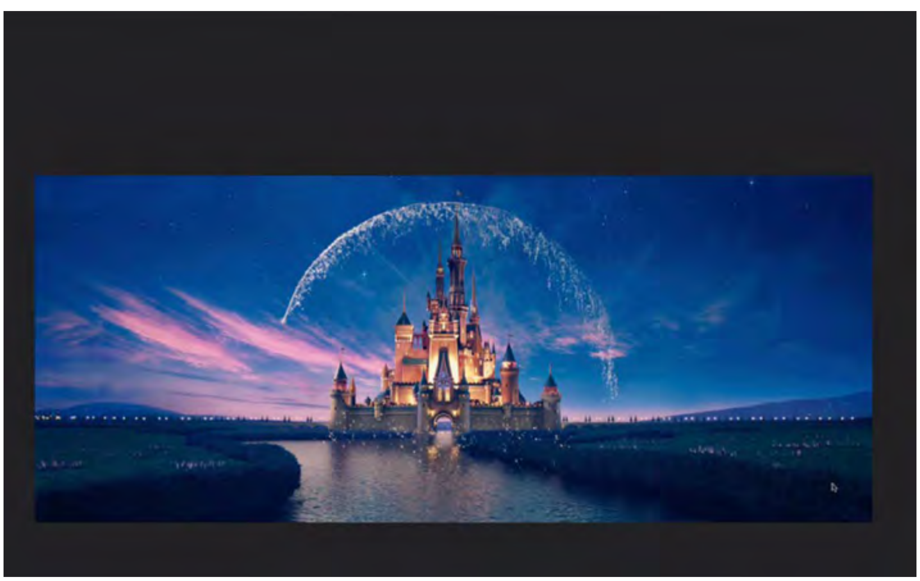


Exhibit 4.1 When Walt Disney cast his now-famous mouse as Steamboat Willie back in the 1920s, he had little idea that his animation project would turn into one of the largest entertainment companies in the world. The house that Walt built, with its magical theme parks, movie studios, and product lines, is overseen today by visionary directors with accomplished backgrounds in media, technology, and government. *What important tasks and responsibilities are entrusted to Disney's board of directors?* (Marc Levin/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

The Canadian Comparison

"Incorporation: Tax savings, but more paperwork", a 2017 article in The Globe and Mail, puts incorporation in to the Canadian perspective:

1. In Ontario, an incorporated business pays a tax rate of 15 per cent on the first $500,000 of income each year, thanks to the small business tax deduction, and 26.5 per cent for anything beyond that. Rates vary by province. A lower tax rate is one of the key advantages to incorporating a business. However, accountants make the distinction that the taxes aren't being saved, but instead deferred. That's because, when the money is taken out of the corporation for personal use, through salary or dividends, the individual winds up paying approximately the same tax rate as if they were a sole proprietor. It's known as the "theory of integration" in the Canadian tax system.
2. Most accountants recommend business owners incorporate if they can afford to leave money in the company longer-term with the goal of watching the value of the assets grow.
3. Another tax advantage comes when it's time to sell the business. The shares of most Canadian private corporations are eligible for a lifetime capital-gains exemption. In 2016, that exemption amounts to the first $824,176 of capital gains from personal income tax, per shareholder. If the business were a sole proprietorship, any gain from the sale of a private corporation would be taxed.
4. Another advantage to incorporating is the opportunity to use income splitting among family members. If one spouse makes more money, you can income-split. Over all, both spouses will be in a lower income-tax bracket.

Table 4.3 summarizes the advantages and disadvantages of each form of business ownership.

Advantages and Disadvantages of Major Types of Business Organization		
Advantages		
Sole Proprietorship	**Partnership**	**Corporation**
Owner receives all profits.	More expertise and managerial skill available.	Limited liability protects owners from losing more than they invest.
Low organizational costs.	Relatively low organizational costs.	Can achieve large size due to marketability of stock (ownership).
Income taxed as personal income of proprietor.	Income taxed as personal income of partners.	Receives certain tax advantages.
Independence.	Fundraising ability is enhanced by more owners.	Greater access to financial resources allows growth.
Secrecy.		Can attract employees with specialized skills.
Ease of dissolution.		Ownership is readily transferable.
		Long life of firm (not affected by death of owners).

Disadvantages		
Sole Proprietorship	**Partnership**	**Corporation**
Owner receives all losses.	Owners have unlimited liability; may have to cover debts of other, less financially sound partners.	Double taxation because both corporate profits and dividends paid to owners are taxed, although the dividends are taxed at a reduced rate.
Owner has unlimited liability; total wealth can be taken to satisfy business debts.	Dissolves or must reorganize when partner dies.	More expensive and complex to form.
Limited fundraising ability can inhibit growth.	Difficult to liquidate or terminate.	Subject to more government regulation.
Proprietor may have limited skills and management expertise.	Potential for conflicts between partners.	Financial reporting requirements make operations public.
Few long-range opportunities and benefits for employees.	Difficult to achieve large- scale operations.	
Lacks continuity when owner dies.		

Table 4.3

4.4 Specialized Forms of Business Organization

What other options for business organization does a company have in addition to sole proprietorships, partnerships, and corporations?

In addition to the three main forms, several specialized types of business organization also play an important role in our economy. We will look at cooperatives in this section and take a detailed look at franchising in the following section.

Cooperatives

A **cooperative** is a legal entity with several *corporate features*, such as limited liability, an unlimited life span, an elected board of directors, and an administrative staff. Member-owners pay annual fees to the cooperative and share in the profits, which are distributed to members in proportion to their contributions. Because they do not retain any profits, cooperatives are not subject to taxes.

Cooperatives video:
https://youtu.be/acxwC4Qfrcs

There are currently 2.6 million cooperatives with one billion members employing more than 12.5 million employees in more than 145 countries worldwide.4 Cooperatives operate in every industry, including agriculture, childcare, energy, financial services, food retailing and distribution, health care, insurance, housing, purchasing and shared services, and telecommunications, among others. They range in size from large enterprises such as Fortune 500 companies to small local storefronts and fall into four distinct categories: consumer, producer, worker, and purchasing/shared services.

Cooperatives are autonomous businesses owned and democratically controlled by their members—the people who buy their goods or use their services—not by investors. Unlike investor-owned businesses, cooperatives are organized solely to meet the needs of the member-owners, not to accumulate capital for investors. As democratically controlled businesses, many cooperatives practice the principle of "one member, one vote," providing members with equal control over the cooperative.

Cooperatives are fairly common in the agricultural community. Co-ops also exist outside agriculture. For example, MEC (Mountain Equipment Co-op), which sells quality outdoor gear, has more than 5 million members across the country, who have each paid $5 for their lifetime memberships. The company shares its financial success with its members and also gives back 1% of its sales to maintain participation in the outdoors.

Exhibit 4.3 Source: MEC in Ottawa retrieved from https://commons.wikimedia.org/

Joint Ventures

In a **joint venture**, two or more companies form an alliance to pursue a specific project, usually for a specified time period. There are many reasons for joint ventures. The project may be too large for one company to handle on its own, and joint ventures also afford companies access to new markets, products, or technologies. Both large and small companies can benefit from joint ventures.

In 2005, South Korea's Hyundai Motor Company announced it signed a $1.24 billion deal to form a joint venture with China's Guangzhou Automobile Group. The arrangement gave the South Korean automaker access to the commercial vehicle market in China, where its passenger cars are already the top selling foreign brand. Each side will hold equal stakes in the new entity, named Guangzhou Hyundai Motor Company. The new plant began production in 2007 with an annual capacity of 200,000 units producing small to large trucks and buses as well as commercial vehicles. According to Reuters, Hyundai made plans to build a fifth factory in China. With five factories in operation, Hyundai's annual Chinese production capacity will be 1.65 million vehicles.[3]

4.5 Franchising: A Popular Trend

What makes franchising an appropriate form of organization for some types of business, and why does it continue to grow in importance?

Franchising is a form of business organization that involves a franchisor, the company supplying the product or service concept, and the franchisee, the individual or company selling the goods or services in a certain geographic area. The franchisee buys a package that includes a proven product or service, proven operating methods, and training in managing the business. Offering a way to own a business without starting it from scratch and to expand operations quickly into new geographic areas with limited capital investment, franchising is one of the fastest growing segments of the economy. If you are interested in franchising, food companies represent the largest number of franchises.

A franchisor (the company that sells the franchise) grants the franchisee (the buyer—you) the right to use a brand name and to sell its goods or services. Franchises market products in a variety of industries, including food, retail, hotels, travel, real estate, business services, cleaning services, and even weight-loss centers and wedding services. Table 4.4 lists the top ten franchises according to Entrepreneur magazine for 2018. Franchises apply to be on the list and are then assessed using Entrepreneur's five pillars.

A **franchise agreement** is a contract that allows the franchisee to use the franchisor's business name, trademark, and logo. The agreement also outlines rules for running the franchise, services provided by the franchisor, and financial terms. The franchisee agrees to follow the franchisor's operating rules by keeping inventory at certain levels, buying a standard equipment package, keeping up sales and service levels, taking part in franchisor promotions, and maintaining a relationship with the franchisor. In return, the franchisor provides the use of a proven company name and symbols, help in finding a site, building plans, guidance and training, management assistance, managerial and accounting systems and procedures, employee training, wholesale prices for supplies, and financial assistance.

Franchising video:
https://youtu.be/EmjA6O2HIus

In Canada, 1 out of every 14 workers is directly or indirectly employed by the franchise industry and there are an estimated 1,300 franchise brands operating in Canada. Individual investments vary widely – from $10,000 to millions. KFC franchises, for example, require a total investment of $1.3 million to $2.5 million each. This fee includes the cost of the property, equipment, training, start-up costs, and the franchise fee—a one-time charge for the right to operate as a KFC outlet. McDonald's is in the same price range ($1 million to $2.3 million). SUBWAY sandwich shops offer a more affordable alternative, with expected total investment ranging from $116,000 to $263,000.

Advantages of Franchises

Like other forms of business organization, franchising offers some distinct advantages:

- *Increased ability for franchisor to expand.* Because franchisees finance their own units, franchisors can grow without making a major investment.
- *Recognized name, product, and operating concept.* Consumers know they can depend on products from franchises such as Pizza Hut, Hertz, and Holiday Inn. As a result, the franchisee's risk is reduced and the opportunity for success increased. The franchisee gets a widely known and accepted business with a proven track record, as well as operating procedures, standard goods and services, and national advertising.
- *Management training and assistance.* The franchisor provides a structured training program that gives the new franchisee a crash course in how to start and operate their business. Ongoing training programs for managers and employees are another plus. In addition, franchisees have a peer group for support and sharing ideas.
- *Financial assistance.* Being linked to a nationally known company can help a franchisee obtain funds from a lender. Also, the franchisor typically gives the franchisee advice on financial management, referrals to lenders, and help in preparing loan applications. Many franchisors also offer short-term credit for buying supplies, payment plans, and loans to purchase real estate and equipment. Although franchisors give up a share of profits to their franchisees, they receive ongoing revenues in the form of royalty payments.

Exhibit 4.4 Countless franchise opportunities exist for entrepreneurs with access to start-up capital. Despite the broad range of franchise opportunities available, lists of the fastest-growing franchises are heavily weighted with restaurant chains and cleaning services. Start-up costs for a Quiznos franchise can be pricey; expenses associated with opening a Club Pilates franchise or a Visiting Angels adult care service are significantly lower. *How do entrepreneurs evaluate which franchising opportunity is right for them?* (Credit: Mr. Blue Mau Mau/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Disadvantages of Franchises

Franchising also has some disadvantages:

- *Loss of control.* The franchisor has to give up some control over operations and has less control over its franchisees than over company employees.
- *Cost of franchising.* Franchising can be a costly form of business. Costs will vary depending on the type of business and may include expensive facilities and equipment. The franchisee also pays fees and/or royalties, which are usually tied to a percentage of sales. Fees for national and local advertising and management advice may add to a franchisee's ongoing costs.
- *Restricted operating freedom.* The franchisee agrees to conform to the franchisor's operating rules and facilities design, as well as inventory and supply standards. Some franchises require franchisees to purchase from only the franchisor or approved suppliers. The franchisor may also restrict the franchisee's territory or site, which could limit growth. Failure to conform to franchisor policies could mean the loss of the franchise.

Franchise Growth

Many of today's major franchise brands, such as McDonald's and KFC, started in the 1950s. Through the 1960s and 1970s, many more types of businesses—clothing, convenience stores, business services, and many others—used franchising to distribute their goods and services. Growth comes from expansion of established franchises—for example, Subway, Pizza Hut, and Orangetheory Fitness—as well as new entrants such as those identified by Entrepreneur and Franchise Gator among other sources. According to Entrepreneur magazine, the top three new franchises in 2017 are (1) Mosquito Joe, (2) Blaze Fast-Fire'd Pizza, and (3) uBreakiFix, whereas according to Franchise Gator, the top three new franchises in 2017 are (1) Mosquito Joe, (2) Digital Doc, and (3) Nurse Next Door Home Healthcare Services. On both rankings, Mosquito Joe ranks at the top.

Mosquito Joe provides mosquito control treatment services for both residential and commercial clients.[4]

Changing demographics drive franchise industry growth, in terms of who, how, and what experiences the most rapid growth. The continuing growth and popularity of technology and personal computing is responsible for the rapidly multiplying of eBay drop-off stores, and tech consultants such as Geeks on Call are in greater demand than ever. Other growth franchise industries are the specialty coffee market, children's enrichment and tutoring programs, senior care, weight control, and fitness franchises.

The Next Big Thing in Franchising

All around you, people are talking about the next big thing—Subway is the new miracle weight-loss solution, the workout at Orangetheory Fitness is the answer to America's fitness needs—and you are ready to take the plunge and buy a trendy franchise. But consumers' desires can change with the tide, so how do you plan an entrance—and exit—strategy when purchasing a franchise that's a big hit today but could be old news by tomorrow? Table 4.5 outlines some tips on purchasing a franchise.

International Franchising

Like other forms of business, franchising is part of our global marketplace economy. As international demand for all types of goods and services grows, most franchise systems are already operating internationally or planning to expand overseas. Restaurants, hotels, business services, educational products, car rentals, and nonfood retail stores are popular international franchises.

Franchisors in foreign countries face many of the same problems as other firms doing business abroad. In addition to tracking markets and currency changes, franchisors must understand local culture, language differences, and the political environment. Franchisors in foreign countries also face the challenge of aligning their business operations with the goals of their franchisees, who may be located half a globe away.

Tips for Purchasing a Franchise
1. Take a personality test to determine the traits that will help and hurt you and assess your strengths and weaknesses. 2. Do your research about the franchise company, its services, and your potential location, and study the field. 3. Seek assistance from tax advisors and contract specialists. 4. Focus on financials: count your money, limit liability with appropriate business structure, and look beyond. 5. Beware of franchise consultants. 6. Use the franchise disclosure document to ensure everything is clear. 7. Utilize your instincts and follow your gut.

Table 4.5 Sources: "12 Things To Do Before You Buy a Franchise," *Forbes,* https://www.forbes.com, June 22, 2016; U.S. Small Business Administration, "6 Franchise Purchasing Tips," https://www.sba.gov, August 19, 2014; "5 Tips for Buying a Franchise," *Small BusinessTrends,* https://smalltrends.com, January 29, 2013.

Is Franchising in Your Future?

Are you ready to be a franchisee? Before taking the plunge, ask yourself some searching questions: Are you excited about a specific franchise concept? Are you willing to work hard and put in long hours? Do you have the necessary financial resources? Do you have prior business experience? Do your expectations and personal goals match the franchisor's?

Qualities that rank high on franchisors' lists are passion about the franchise concept, desire to be your own boss, willingness to make a substantial time commitment, assertiveness, optimism, patience, and integrity. Prior business experience is also a definite plus, and some franchisors prefer or require experience in their field.

So what can you do to prepare when considering the purchase of a franchise? When evaluating franchise opportunities, professional guidance can prevent expensive mistakes, so interview advisers to find those that are right for you. Selecting an attorney with franchise experience will hasten the review of your franchise agreement. Getting to know your banker will speed up the loan process if you plan to finance your purchase with a bank loan, so stop by and introduce yourself. The proper real estate is a critical component for a successful retail franchise, so establish a relationship with a commercial real estate broker to begin scouting locations. Doing your homework can spell the difference between success and failure, and some early preparation can help lay the groundwork for the successful launch of your franchised business.

If the franchise route to business ownership seems right for you, begin educating yourself on the franchise process by investigating various franchise opportunities. You should research a franchise company thoroughly before making any financial commitment.

Would-be franchisees should also check recent issues of small-business magazines such as Entrepreneur, Inc., Startups, and Success for industry trends, ideas on promising franchise opportunities, and advice on how to choose and run a franchise. The International Franchise Association website at http://www.franchise.org has links to Franchising World and other useful sites.

4.6 Mergers and Acquisitions

Why are mergers and acquisitions important to a company's overall growth?

A **merger** occurs when two or more firms combine to form one new company. For example, in 2016, Johnson Controls, a leading provider of building efficiency solutions, agreed to merge with Ireland's Tyco International, a leading provider of fire and security solutions, resulting in a company that will be a leader in products, technologies, and integrated solutions for the building and energy sectors. The merger is valued at $30 billion, with new Johnson Controls PLC to be based in Ireland. Currently, AT&T and Time Warner have an $85.4 billion merger pending. "Once we complete our acquisition of Time Warner Inc., we believe there is an opportunity to build an automated advertising platform that can do for premium video and TV advertising what the web search and social media companies have done for digital advertising," AT&T's CEO Randall Stephenson said in a prepared statement. Mergers such as this one, in a well-established industry, can produce winning results in terms of improved efficiency and cost savings.[5]

Difference between merger and acquisition video:
https://youtu.be/g-v8SKvXPpc

An **acquisition**, on the other hand, occurs when a company purchases the assets of another business (such as stock, property, plants, equipment) and usually permits the acquired company to continue operating as it did prior to the acquisition. *Acquisition* usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger and/or longer-established company and retain the name of the latter for the post-acquisition combined entity.

In an **acquisition**, a corporation or investor group finds a target company and negotiates with its board of directors to purchase it. In Verizon's recent $4.5 billion acquisition of Yahoo, Verizon was the acquirer, and Yahoo the target company.[6]

Types of Mergers

The three main types of mergers are horizontal, vertical, and conglomerate. A **horizontal merger** occurs between companies in the same industry. This type of merger is essentially a consolidation of two or more businesses that operate in the same market space, often as competitors offering the same good or service. Horizontal mergers are common in industries with fewer firms, since competition tends to be higher, and the synergies and potential market-share gains are much greater in those industries. In a horizontal merger, companies at the same stage in the same industry merge to reduce costs, expand product offerings, or reduce competition. Many of the largest mergers are horizontal mergers to achieve economies of scale. Its $1.25 billion acquisition of trucking company Overnite allowed UPS, the world's largest shipping carrier, to expand its heavy freight delivery business, thus expanding its product offerings.[8]

Facebook + Instagram = Horizontal Merger

When Facebook acquired Instagram in 2012 for a reported $1 billion, Facebook was looking to strengthen its position in the social-media and social-sharing space. Both Facebook and Instagram operated in the same industry and were in similar positions with regard to their photo-sharing services. Facebook clearly saw Instagram as an opportunity to grow its market share, increase its product line, reduce competition, and access new markets.

In a **vertical merger**, is characterized by the merger of two organizations that have a buyer-seller relationship or, more generally, two or more firms that are operating at different levels within an industry's supply chain. Most often the logic behind the merger is to increase synergies by merging firms that would be more efficient operating as one. Buying a supplier of raw materials, a distribution company, or a customer service company gives the acquiring firm more control. A good example of this is Google's acquisition of Urchin Software Corp., a San Diego based company that sells web analytics software and services that help companies track the effectiveness of their websites and online advertising. The move enables Google to bolster the software tools it provides to its advertisers.[9]

Apple: The King of Vertical Integration

Apple Inc. is famous for perfecting the art of vertical integration. The company manufactures its custom A-series chips for its iPhones and iPads. It also manufactures its custom touch ID fingerprint sensor. Apple opened up a laboratory in Taiwan for the development of LCD and OLED screen technologies in 2015. It also paid 18.2$ million for a -70,000square-foot manufacturing facility in North San Jose in 2015. These investments (i.e., mergers) enable Apple to move along the supply chain in a backward integration, giving it flexibility and freedom in its manufacturing capabilities.[1]

Types of mergers video:
https://youtu.be/wlLdX0fs6hE

A **conglomerate merger** brings together companies in unrelated businesses to reduce risk. Combining companies whose products have different seasonal patterns or respond differently to business cycles can result in more stable sales. The Philip Morris Company, now called Altria Group, started out in the tobacco industry but diversified as early as the 1960s with the acquisition of Miller Brewing Company. It diversified into the food industry with its subsequent purchase of General Foods, Kraft Foods, and Nabisco, among others. Later spinning off many businesses, current product categories include cigarettes, smokeless tobacco such as Copenhagen and Skoal, cigars, e-vapor products such as MarkTen, and wines.

The Canadian Landscape

In June 2013, Shoppers Drug Mart, Canada's biggest pharmacy chain merged with Loblaw, Canada's largest grocery retailer, in a 12.4 billion dollar deal. Rather than cutting into each other's market share, the deal allows the two companies to play on each other's strengths. Shoppers has about $1 billion in food sales annually, versus Loblaw's $30 billion. But Loblaw's share of the pharmacy market is only five per cent, so adding Shoppers health products and services to Loblaw grocery stores allows the food retailer to expand its services in what it sees as a growing sector: health, wellness, and nutrition (www.cbc.ca). Contrast this merger with an acquisition in that same year. Sobey's acquired 200 Safeway stores in Western Canada under a 5.8 billion dollar deal. According to news reports, along with 213 Safeway grocery stores — more than 60 percent of which are in Calgary, Vancouver, Edmonton and Winnipeg — Sobeys will also acquire:

- 199 in-store pharmacies;
- 62 gas stations;
- 10 liquor stores;
- primary distribution centres and a related wholesale business; and
- 12 manufacturing facilities.

Sobeys will also get $1.8 billion worth of real estate in the deal.

Motives Behind Mergers and Acquisitions

Although headlines tend to focus on mega-mergers, "merger mania" affects small companies too, and motives for mergers and acquisitions tend to be similar regardless of the company's size. The goal is often strategic: to improve overall performance of the merged firms through cost savings, elimination of overlapping operations, improved purchasing power, increased market share, or reduced competition.

Company growth, broadening product lines, acquiring technology or management skills, and the ability to quickly acquire new markets are other motives for acquiring a company. Yahoo Inc.'s $1 billion cash purchase of a 40 percent stake in China's biggest e-commerce firm, Alibaba.com, instantly strengthened its ties to the world's second largest internet market.[12]

Purchasing a company can also offer a faster, less risky, less costly option than developing products or markets in-house or expanding internationally. Amazon's 2017 purchase of Whole Foods Market, an upscale grocery chain, for $13.7 billion was a move to enter the retail grocery sector. In addition to the new product market, this move offers Amazon opportunity to sell Amazon tech products in the grocery stores as well as access to an entirely new set of data on consumers.[13]

Companies are motivated to merge or acquire other companies for a number of reasons, including the following:

- Gain Complementary Products
- Shoppers Drug Mart began to sell President's Choice products in its merger with Loblaw.
- Loblaw is able to add Shoppers health care products to its shelves.
- Sobey's gains Safeway's gas stations and liquors stores in its acquisition.
- Attain New Markets or Distribution Channels
- Sobey's acquired access to 12 manufacturing facilities, 4 distribution centres, and a related wholesale business.
- Loblaw increases access to urban centres where Shoppers are already located, bringing a wider variety of products to customers in densely populated areas.
- Realize Synergies
- Integration of the companies' loyalty programs will provide the two with a vast knowledge base of consumers' buying habits and provide economies of scale — which, the companies estimate, will translate into savings of about $300 million annually.
- Loblaw's share of the pharmacy market is only five per cent. Adding Shoppers health products and services to its grocery stores will allow the food retailer to expand its services in what it sees as a growing sector: health, wellness, and nutrition.

4.7 Trends in Business Ownership

What current trends will affect the business organizations of the future?

As we learned earlier, an awareness of trends in the business environment is critical to business success. Many social, demographic, and economic factors affect how businesses organize. When reviewing options for starting or organizing a business or choosing a career path, consider the following trends.

"Baby Boomers" and "Millennials" Drive Franchise Trends

We all hear and read a great deal about the "graying of Canada," which refers to the "baby boomer" generation heading toward retirement age. This unprecedented demographic phenomenon—in 2006 the first of the members of the baby boomer generation turned 60—is driving the ongoing battle to stay young, slim, and healthy. Every day, there are thousands of boomers turning 65, and the trend is likely to continue until 2030.

Boomers have transformed every life stage they've touched so far, and their demographic weight means that business opportunities are created wherever they go.

With their interest in staying fit, Boomers are contributing to the growth of fitness and weight-loss franchises. In just the past year, this category in Entrepreneur's Franchise 500 has grown to over 50 franchisors.

Another area of boomer-driven franchise growth is eldercare. Founded in 1994, Home Instead Senior Care is recognized as one of the world's fastest growing franchise companies in the eldercare market, with a network of over 1,000 independently owned and operated franchises in 12 countries. And as the world's population continues to age, the need for its unique services will continue to increase.

Home Instead Senior Care provides a meaningful solution for the elderly who prefer to remain at home. Compared with the annual cost for a nursing home placement ($72,000–$92,000), home care, at around $45,000–$60,000 a year, is somewhat more affordable. Elder quality of life is enhanced by Home Instead Senior Care's part-time, full-time, and around-the-clock services, designed for people who are capable of managing their physical needs but require some assistance and supervision. Home Instead Senior Care provides meal preparation, companionship, light housekeeping, medication reminders, incidental transportation, and errands. These services make it possible for the elderly to remain in the familiar comfort of their own homes for a longer period of time.[17]

But the best deal yet may be adult day services, one of the fastest-growing franchises and "still one of the best-kept secrets around" according to Entrepreneur magazine. Based on the concept of day care services for children, Sarah Adult Day Services Inc. offers a franchising opportunity that meets the two criteria for a successful and socially responsible business: a booming demographic market with great potential for growth, and excellent elder care. Programs such as SarahCare are highly affordable for its clients, costing around $17,900 a year. The SarahCare franchise allows entrepreneurs to become part of an expanding industry while restoring a sense of dignity and vibrancy to the lives of older adults.[18]

Millennials—individuals born between 1980 and 2000—are the largest living generation in the United States, according to Pew Research. Millennials spend more money in restaurants per capita than any previous generation. They have been recognized as changing the restaurant scene by looking for brands that offer customized food choices, quality ingredients, freshness, authenticity, transparency, and environmental and social responsibility. According to Forbes magazine, 72 percent of millennials would like to be their own boss, 74 percent want flexible work schedules, and 88 percent want "work–life integration." When it comes to owning a franchise, growth potential and meeting a flexible, fulfilling lifestyle are both something that attracts Millennials. A survey by the CT Corporation found that 60 percent of college graduates wanted to start a business after graduation, 67 percent lacked the know-how, 45 percent didn't think they could come up with a name, and 30 percent were not knowledgeable about how to market the business. Franchising is the perfect solution to these issues. For example, Chicago area native and millennial Sal Rehman grew up working in his family's diner. Sal had a dream of operating his own restaurant, and he decided to take the franchising path. In 2015, at the age of 27, Sal opened his first Wing Zone store in suburban Glendale Heights, Illinois. He currently owns five Wing Zones.[19]

Boomers Rewrite the Rules of Retirement

At age 64, Bob Drucker could be the poster child for retirement except that the concept makes him recoil. Drucker is living his dream. He and his wife have a large house on Long Island where Drucker kicks back by floating in his pool when he's not spoiling his granddaughters with trips to Disneyland.

"The only way you can get me out of here is to carry me out," Drucker says, referring to RxUSA, the online pharmacy he founded and runs in Port Washington, New York. "I love my work, and I cannot imagine sitting home and doing nothing."

Drucker is not alone. Today's boomers are working longer at their jobs and embracing postretirement second careers, which often means starting their own small business.[20] As retirees opt to go into business for themselves, they are choosing different forms of business organizations depending on their needs and goals. Some may start small consulting businesses using the simple sole proprietorship form of business organization, while couples or friends might choose to become partners in a retail or franchise venture.

The more healthy and energetic the baby boomer generation remains, the more interested it is in staying active and engaged—and that may mean postponing retirement or not retiring at all. The annual retirement survey by Transamerica Center for Retirement Studies found that as this record number of Americans approaches retirement age, many are not slowing down. In fact, 51 percent of boomers plan to work in some capacity during their retirement years, and 82 percent indicated that they will not retire at or before age 65.[21]

Mergers and Foreign Investment Boom Too

There is a new merger wave. In 2016, North American companies announced deals totaling almost $2 trillion. Many of these deals were large ones, with the largest deal, announced in 2016, AT&T's merger with Time Warner for over $85 billion. In addition, foreign merger activity has reached a new high. Worldwide deal volume in 2015 was 44,000 transactions totaling $4.5 trillion. In 2016, the number of transactions increased to over 48,000, one of the most active periods of merger activity to date. The increase is the result of improving economic growth and better stock prices.[22] Whether these new mergers will be good for the global economy remains to be seen. Transactions that lead to cost savings, streamlined operations, and more funding for research and capital investment in new facilities will have positive effects on profitability. Many deals, however, may fail to live up to the acquirers' expectations.

Key Terms

acquisition	The purchase of a target company by another corporation or by an investor group typically negotiated with the target company board of directors.
board of directors	A group of people elected by the stockholders to handle the overall management of a corporation, such as setting major corporate goals and policies, hiring corporate officers, and overseeing the firm's operations and finances.
conglomerate merger	A merger of companies in unrelated businesses; done to reduce risk.
cooperative	A legal entity typically formed by people with similar interests, such as suppliers or customers, to reduce costs and gain economic power. A cooperative has limited liability, an unlimited life span, an elected board of directors, and an administrative staff; all profits are distributed to the member-owners in proportion to their contributions.
corporation	A legal entity with an existence and life separate from its owners, who are not personally liable for the entity's debts. A corporation is chartered by the state in which it is formed and can own property, enter into contracts, sue and be sued, and engage in business operations under the terms of its charter.
franchise agreement	A contract setting out the terms of a franchising arrangement, including the rules for running the franchise, the services provided by the franchisor, and the financial terms. Under the contract, the franchisee is allowed to use the franchisor's business name, trademark, and logo.
franchisee	The individual or company that sells the goods or services of the franchisor in a certain geographic area within a franchising arrangement.
franchising	A form of business organization based on a business arrangement between a franchisor, which supplies the product or service concept, and the franchisee, who sells the goods or services of the franchisor in a certain geographic area.
franchisor	The company that supplies the product or service concept to the franchisee within a franchising arrangement.
general partners	Partners who have unlimited liability for all of the firm's business obligations and control its operations.
general partnership	A partnership in which all partners share in the management and profits. Each partner can act on behalf of the firm and has unlimited liability for all its business obligations.
horizontal merger	A merger of companies at the same stage in the same industry; done to reduce costs, expand product offerings, or reduce competition.
joint venture	Two or more companies that form an alliance to pursue a specific project, usually for a specified time period.
leveraged buyout (LBO)	A corporate takeover financed by large amounts of borrowed money; can be started by outside investors or the corporation's management.
limited partners	Partners whose liability for the firm's business obligations is limited to the amount of their investment. They help to finance the business but do not participate in the firm's operations.

Key Terms

limited partnership	A partnership with one or more general partners, who have unlimited liability, and one or more limited partners, whose liability is limited to the amount of their investment in the company.
merger	The combination of two or more firms to form one new company.
partnership	An association of two or more individuals who agree to operate a business together for profit.
sole proprietorship	A business that is established, owned, operated, and often financed by one person.
stockholders (or shareholders)	The owners of a corporation who hold shares of stock that carry certain rights.
vertical merger	A merger of companies at different stages in the same industry; done to gain control over supplies of resources or to gain access to different markets.

Summary of Learning Outcomes

1. What are the advantages and disadvantages of the sole proprietorship form of business organization?

The advantages of sole proprietorships include ease and low cost of formation, the owner's rights to all profits, the owner's control of the business, relative freedom from government regulation, absence of special taxes, and ease of dissolution. Disadvantages include owner's unlimited liability for debts and personal absorption of all losses, difficulty in raising capital, limited managerial expertise, difficulty in finding qualified employees, large personal time commitment, and unstable business life.

2. What are the advantages of operating as a partnership, and what downside risks should partners consider?

The advantages of partnerships include ease of formation, availability of capital, diversity of managerial skills and expertise, flexibility to respond to changing business conditions, no special taxes, and relative freedom from government control. Disadvantages include unlimited liability for general partners, potential for conflict between partners, sharing of profits, and difficulty exiting or dissolving the partnership. Partnerships can be formed as either general or limited partnerships. In a general partnership, the operations of the business are controlled by one or more general partners with unlimited liability. The partners co-own the assets and share the profits. Each partner is individually liable for all debts and contracts of the partnership. In a limited partnership, the limited partners are financial partners whose liability is limited to their investment; they do not participate in the firm's operations.

3. How does the corporate structure provide advantages and disadvantages to a company?

A corporation is a legal entity chartered by a state. Its organizational structure includes stockholders who own the corporation, a board of directors elected by the stockholders to govern the firm, and officers who carry out the goals and policies set by the board. Stockholders can sell or transfer their shares at any time and are entitled to receive profits in the form of dividends. Advantages of corporations include limited liability, ease of transferring ownership, unlimited life tax deductions, and the ability to attract financing. Disadvantages include double taxation of profits, the cost and complexity of formation, and government restrictions.

Summary of Learning Outcomes

4. What other options for business organization does a company have in addition to sole proprietorships, partnerships, and corporations?

Cooperatives are collectively owned by individuals or businesses with similar interests that combine to achieve more economic power. Cooperatives distribute all profits to their members. A joint venture is an alliance of two or more companies formed to undertake a special project. Joint ventures can be set up in various ways, through partnerships or special-purpose corporations. By sharing management expertise, technology, products, and financial and operational resources, companies can reduce the risk of new enterprises.

5. What makes franchising an appropriate form of organization for some types of business, and why does it continue to grow in importance?

Franchising is one of the fastest-growing forms of business ownership. It involves an agreement between a franchisor, the supplier of goods or services, and a franchisee, an individual or company that buys the right to sell the franchisor's products in a specific area. With a franchise, the business owner does not have to start from scratch but buys a business concept with a proven product or service and operating methods. The franchisor provides use of a recognized brand-name product and operating concept, as well as management training and financial assistance. Franchises can be costly to start, and operating freedom is restricted because the franchisee must conform to the franchisor's standard procedures. The growth in franchising is attributed to its ability to expand business operations quickly into new geographic areas with limited capital investment.

6. Why are mergers and acquisitions important to a company's overall growth?

In a merger, two companies combine to form one company. In an acquisition, one company or investor group buys another. Companies merge for strategic reasons to improve overall performance of the merged firm through cost savings, eliminating overlapping operations, improving purchasing power, increasing market share, or reducing competition. Desired company growth, broadened product lines, and the rapid acquisition of new markets, technology, or management skills are other motives. Another motive for merging is financial restructuring—cutting costs, selling off units, laying off employees, and refinancing the company to increase its value to stockholders.

There are three types of mergers. In a horizontal merger, companies at the same stage in the same industry combine for more economic power, to diversify, or to win greater market share. A vertical merger involves the acquisition of a firm that serves an earlier or later stage of the production or sales process, such as a supplier or sales outlet. In a conglomerate merger, unrelated businesses come together to reduce risk through diversification.

7. What current trends will affect the business organizations of the future?

Canadians are getting older but continue to open new businesses, from sole proprietorships to partnerships, corporations to franchise operations. The service sector is booming in efforts to meet the demand for fitness, health, and eldercare.

Other key trends include an escalation of worldwide foreign investment through the number of mergers taking place. All forms of business organization can benefit from outsourcing, tapping into the intellectual capital of developing countries.

Chapter 5

Entrepreneurship: Starting and Managing Your Own Business

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. Why do people become entrepreneurs, and what are the different types of entrepreneurs?
2. What characteristics do successful entrepreneurs share?
3. How do small businesses contribute to the Canadian economy?
4. What are the first steps to take if you are starting your own business?
5. Why does managing a small business present special challenges for the owner?
6. What are the advantages and disadvantages of being an owner of a small business?

5.1 Entrepreneurship Today

Why do people become entrepreneurs, and what are the different types of entrepreneurs?

Brothers Fernando and Santiago Aguerre exhibited entrepreneurial tendencies at an early age. At 8 and 9 years old respectively, they sold strawberries and radishes from a vacant lot near their parents' home in Plata del Mar on the Atlantic coast of Argentina. At 11 and 12, they provided a surfboard repair service from their garage. As teenagers, Fer and Santi, as they call each other, opened Argentina's first surf shop, which led to their most ambitious entrepreneurial venture of all.

The flat-footed brothers found that traipsing across hot sand in flip-flops was uncomfortable, so in 1984 they sank their $4,000 savings into manufacturing their own line of beach sandals. Now offering sandals and footwear for women, men, and children; clothing for men; Reef sandals have become the world's hottest beach footwear, with a presence in nearly every surf shop in North America.[1]

The Aguerres, who currently live two blocks from each other in La Jolla, California, sold Reef to VF Corporation for more than $100 million in 2005. In selling Reef, "We've finally found our freedom," Fernando says. "We traded money for time," adds Santiago. Fernando remains active with surfing organizations, serving as president of the International Surfing Association, where he became known as "Ambassador of the Wave" for his efforts in getting all 90 worldwide members of the International Olympic Committee to unanimously vote in favour of including surfing in the 2020 Olympic Games.[2] He has also been named "Waterman of the Year" by the Surf Industry Manufacturers Association two times in 24 years.[3] Santi raises funds for his favorite not-for-profit, SurfAid. Both brothers are enjoying serving an industry that has served them so well.

The world is blessed with a wealth of entrepreneurs such as the Aguerres who want to start a **small business**. According to research by the Small Business Administration, two-thirds of college students intend to be entrepreneurs at some point in their careers, aspiring to become the next Bill Gates or Jeff Bezos, founder of Amazon.com. But before you put out any money or expend energy and time, you'd be wise to check out Table 5.1 for some preliminary advice.

Why has entrepreneurship remained such a strong part of the foundation of the business system for so many years? Because today's global economy rewards innovative, flexible companies that can respond quickly to changes in the business environment. Such companies are started by **entrepreneurs**, people with vision, drive, and creativity, who are willing to take the risk of starting and managing a business to make a profit.

Are You Ready to Be an Entrepreneur?

Here are some questions would-be entrepreneurs should ask themselves:

1. What is new and novel about your idea? Are you solving a problem or unmet need?
2. Are there similar products/services out there? If so, what makes yours better?
3. Who is your target market? How many people would use your product or service?
4. Have you talked with potential customers to get their feedback? Would they buy your product/service?
5. What about production costs? How much do you think the market will pay?
6. How defensible is the concept? Is there good intellectual property?
7. Is this innovation strategic to my business?
8. Is the innovation easy to communicate?
9. How might this product evolve over time? Would it be possible to expand it into a product line? Can it be updated/enhanced in future versions?
10. Where would someone buy this product/service?
11. How will the product/service be marketed? What are the costs to sell and market it?
12. What are the challenges involved in developing this product/service?

Table 5.1 Sources: Jess Ekstrom, “5 Questions to Ask Yourself Before You Start a Business,” Entrepreneur, https://www.entrepreneur.com, accessed February 1, 2018; “Resources,” http://www.marketsmarter.com, accessed February 1, 2018; Monique Reece, Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution (Upper Saddle River, NJ: FT Press/Pearson, 2010); Mike Collins, “Before You Start–Innovator’s Inventory,” The Wall Street Journal, May 9, 2005, p. R4.

Entrepreneur or Small-Business Owner?

The term *entrepreneur* is often used in a broad sense to include most small-business owners. The two groups share some of the same characteristics, and we’ll see that some of the reasons for becoming an entrepreneur or a small-business owner are very similar. But there is a difference between entrepreneurship and small- business management. Entrepreneurship involves taking a risk, either to create a new business or to greatly change the scope and direction of an existing one. Entrepreneurs typically are innovators who start companies to pursue their ideas for a new product or service. They are visionaries who spot trends.

Although entrepreneurs may be small-business owners, not all small-business owners are entrepreneurs. Small-business owners are managers or people with technical expertise who started a business or bought an existing business and made a conscious decision to stay small. For example, the proprietor of your local independent bookstore is a small-business owner. Jeff Bezos, founder of Amazon.com, also sells books. But Bezos is an entrepreneur: he developed a new model—web-based book retailing—that revolutionized the bookselling world and then moved on to change retailing in general. Entrepreneurs are less likely to accept the status quo, and they generally take a longer-term view than the small-business owner.

Types of Entrepreneurs

Entrepreneurs fall into several categories: classic entrepreneurs, multipreneurs, and intrapreneurs.

Classic Entrepreneurs

Classic entrepreneurs are risk-takers who start their own companies based on innovative ideas. Some classic entrepreneurs are *micropreneurs* who start small and plan to stay small. They often start businesses just for personal satisfaction and the lifestyle. Miho Inagi is a good example of a micropreneur. On a visit to New York with college friends in 1998, Inagi fell in love with the city's bagels. "I just didn't think anything like a bagel could taste so good," she said. Her passion for bagels led the young office assistant to quit her job and pursue her dream of one day opening her own bagel shop in Tokyo. Although her parents tried to talk her out of it, and bagels were virtually unknown in Japan, nothing deterred her. Other trips to New York followed, including an unpaid six-month apprenticeship at Ess-a-Bagel, where Inagi took orders, cleared trays, and swept floors. On weekends, owner Florence Wilpon let her make dough.

In August 2004, using $20,000 of her own savings and a $30,000 loan from her parents, Inagi finally opened tiny Maruichi Bagel. The timing was fortuitous, as Japan was about to experience a bagel boom. After a slow start, a favourable review on a local bagel website brought customers flocking for what are considered the best bagels in Tokyo. Inagi earns only about $2,300 a month after expenses, the same amount she was making as a company employee. "Before I opened this store I had no goals," she says, "but now I feel so satisfied."[4]

In contrast, *growth-oriented entrepreneurs* want their business to grow into a major corporation. Most high- tech companies are formed by growth-oriented entrepreneurs. Jeff Bezos recognized that with Internet technology he could compete with large chains of traditional book retailers. Bezos's goal was to build his company into a high-growth enterprise—and he chose a name that reflected his strategy: Amazon.com. Once his company succeeded in the book sector, Bezos applied his online retailing model to other product lines, from toys, house and garden items to tools, apparel, music, and services. In partnership with other retailers, Bezos is well on his way to making Amazon's vision "to be Earth's most customer-centric company; to build a place where people can come to find and discover anything they might want to buy online."—a reality.[5]

Multipreneurs

Then there are *multipreneurs*, entrepreneurs who start a series of companies. They thrive on the challenge of building a business and watching it grow. In fact, over half of the chief executives at Inc. 500 companies say they would start another company if they sold their current one. Brothers Jeff and Rich Sloan are a good example of multipreneurs, having turned numerous improbable ideas into successful companies. Over the past 20-plus years, they have renovated houses, owned a horse breeding and marketing business, invented a device to prevent car batteries from dying, and so on. Their latest venture, a multimedia company called StartupNation, helps individuals realize their entrepreneurial dreams. And the brothers know what company they want to start next: yours.[6]

Exhibit 5.1 If there is one person responsible for the mainstream success of solar energy and electric vehicles in the past 10 years, it's Elon Musk, founder and CEO of Tesla. Since the 2000s when he founded Tesla, launching innovation in solar technology, and commercial space exploration with SpaceX, Musk has pioneered countless innovations and has challenged traditional automobile, trucking, and energy companies to challenge and rethink their businesses. What entrepreneurial type best describes Elon Musk? (Credit: Steve Jurvetson/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Intrapreneurs

Some entrepreneurs don't own their own companies but apply their creativity, vision, and risk-taking within a large corporation. Called **intrapreneurs**, these employees enjoy the freedom to nurture their ideas and develop new products, while their employers provide regular salaries and financial backing. Intrapreneurs have a high degree of autonomy to run their own minicompanies within the larger enterprise. They share many of the same personality traits as classic entrepreneurs, but they take less personal risk. According to Gifford Pinchot, who coined the term *intrapreneur* in his book of the same name, large companies provide seed funds that finance in-house entrepreneurial efforts. These include Intel, IBM, Texas Instruments (a pioneering intrapreneurial company), Salesforce.com, and Xerox.

Why Become an Entrepreneur?

As the examples in this chapter show, entrepreneurs are found in all industries and have different motives for starting companies. The most common reason, cited by CEOs of the Inc. 500, the magazine's annual list of fastest-growing private companies, is the challenge of building a business, followed by the desire to control their own destiny. Other reasons include financial independence and the frustration of working for someone else. Two important motives mentioned in other surveys are a feeling of personal satisfaction with their work and creating the lifestyle that they want. Do entrepreneurs feel that going into business for themselves was worth it? The answer is a resounding yes. Most say they would do it again.

5.2 Characteristics of Successful Entrepreneurs

What characteristics do successful entrepreneurs share?

Do you have what it takes to become an entrepreneur? Having a great concept is not enough. An entrepreneur must be able to develop and manage the company that implements his or her idea. Being an entrepreneur requires special drive, perseverance, passion, and a spirit of adventure, in addition to managerial and technical ability. Entrepreneurs *are* the company; they tend to work longer hours, take fewer vacations, and cannot leave problems at the office at the end of the day. They also share other common characteristics as described in the next section.

The Entrepreneurial Personality

Studies of the entrepreneurial personality find that entrepreneurs share certain key traits. Most entrepreneurs are:

- *Ambitious*: They are competitive and have a high need for achievement.
- *Independent*: They are individualists and self-starters who prefer to lead rather than follow.
- *Self-confident*: They understand the challenges of starting and operating a business and are decisive and confident in their ability to solve problems.
- *Risk-takers*: Although they are not averse to risk, most successful entrepreneurs favour business opportunities that carry a moderate degree of risk where they can better control the outcome over highly risky ventures where luck plays a large role.
- *Visionary*: Their ability to spot trends and act on them sets entrepreneurs apart from small-business owners and managers.
- *Creative*: To compete with larger firms, entrepreneurs need to have creative product designs, bold marketing strategies, and innovative solutions to managerial problems.
- *Energetic*: Starting and operating a business takes long hours. Even so, some entrepreneurs start their companies while still employed full-time elsewhere.
- *Passionate*: Entrepreneurs love their work, as Miho Inagi demonstrated by opening a bagel shop in Tokyo despite the odds against it being a success.
- *Committed*: Because they are so committed to their companies, entrepreneurs are willing to make personal sacrifices to achieve their goals.

Most entrepreneurs combine many of the above characteristics. Sarah Levy, 23, loved her job as a restaurant pastry chef but not the low pay, high stress, and long hours of a commercial kitchen. So she found a new one—in her parents' home—and launched Sarah's Pastries and Candies. Part-time staffers help her fill pastry and candy orders to the soothing sounds of music videos playing in the background. Conor McDonough started his own web design firm, OffThePathMedia.com, after becoming disillusioned with the rigid structure of his job. "There wasn't enough room for my own expression," he says. "Freelancing keeps me on my toes," says busy graphic artist Ana Sanchez. "It forces me to do my best work because I know my next job depends on my performance."[7]

Exhibit 5.2 Celebrity Ashton Kutcher is more than just a pretty face. The actor-mogul is an active investor in technology-based start-ups such as Airbnb, Skype, and Foursquare with an empire estimated at $200 million dollars. What personality traits are common to successful young entrepreneurs such as Kutcher? (Credit: TechCrunch/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Managerial Ability and Technical Knowledge

A person with all the characteristics of an entrepreneur might still lack the necessary business skills to run a successful company. Entrepreneurs need the technical knowledge to carry out their ideas and the managerial ability to organize a company, develop operating strategies, obtain financing, and supervise day-to-day activities. Jim Crane, who built Eagle Global Logistics from a start-up into a $250 million company, addressed a group at a meeting saying, "I have never run a $250 million company before so you guys are going to have to start running this business."[8]

Good interpersonal and communication skills are important in dealing with employees, customers, and other business associates such as bankers, accountants, and attorneys. As we will discuss later in the chapter, entrepreneurs believe they can learn these much-needed skills. When Jim Steiner started his toner cartridge remanufacturing business, Quality Imaging Products, his initial investment was $400. He spent $200 on a consultant to teach him the business and $200 on materials to rebuild his first printer cartridges. He made sales calls from 8.00 a.m. to noon and made deliveries to customers from noon until 5:00 p.m. After a quick dinner, he moved to the garage, where he filled copier cartridges until midnight, when he collapsed into bed, sometimes covered with carbon soot. And this was not something he did for a couple of months until he got the business off the ground—this was his life for 18 months.[9] But entrepreneurs usually soon learn that they can't do it all themselves. Often they choose to focus on what they do best and hire others to do the rest.

5.3 Small Business: Driving Canada's Growth

How do small businesses contribute to the Canadian economy?

What Is a "Small Business"?

Small businesses are defined in many ways. Let's start by looking at the criteria used by Industry Canada. In 2012 Industry Canada defined it as firms that have fewer than 100 employees. A small business is one that is independently owned and operated, exerting little influence in its industry.

Statistics for small businesses vary based on criteria such as new/start-up businesses, the number of employees, total revenue, length of time in business, nonemployees, businesses with employees, geographic location, and so on.

Although large corporations dominated the business scene for many decades, in recent years small businesses have once again come to the forefront. Downsizings that accompany economic downturns have caused many people to look toward smaller companies for employment, and they have plenty to choose from. Small businesses play an important role in the Canadian economy, representing about half of Canadian economic output, employing about half the private sector workforce, and giving individuals from all walks of life a chance to succeed.

Why Are Small Businesses Important?

Small businesses are a force in Canada and other economies around the world. The millions of individuals who have started businesses have helped shape the business world as we know it today. Some small business founders like Henry Ford and Thomas Edison have even gained places in history. Others, including Bill Gates (Microsoft), Mike Lazaridis (Research in Motion), Steve Jobs (Apple Computer), and Larry Page and Sergey Brin (Google), have changed the way global business is done today.

Aside from contributions to our general economic well-being, founders of small businesses also contribute to growth and vitality in specific areas of economic and socio-economic development. In particular, small businesses do the following: create jobs. spark innovation, provide opportunities for many people, including women and minorities, to achieve financial success and independence. In addition, they complement the economic activity of large organizations by providing them with components, services, and distribution of their products. Let's take a closer look at some of these contributions.

Job Creation

The majority of Canadian workers first entered the business world working for small businesses. Although the split between those working in small companies and those working in big companies is about even, small firms hire more frequently and fire more frequently than do big companies.[15] Why is this true? At any given point in time, lots of small companies are started and some expand. These small companies need workers and so hiring takes place. But the survival and expansion rates for small firms is poor, and so, again at any given point in time, many small businesses close or contract and workers lose their jobs. Fortunately, over time more jobs are added by small firms than are taken away, which results in a net increase in the number of workers.

The size of the net increase in the number of workers for any given year depends on a number of factors, with the economy being at the top of the list. A strong economy encourages individuals to start small businesses and expand existing small companies, which adds to the workforce. A weak economy does just the opposite: discourages start-ups and expansions, which decreases the workforce through layoffs.

Opportunities for Women

Small business is the portal through which many people enter the economic mainstream. Business ownership allows individuals to achieve financial success, as well as pride in their accomplishments. While the majority of small businesses are still owned by white males, the past two decades have seen a substantial increase in the number of businesses owned by women.

Canada's 2018 budget had continued investment in women entrepreneurs. On February 28, 2018, the Financial Post reported:

> "By far, the largest net new impact on Canada's entrepreneurial class is the $1.65 billion in new financing being made available to women business owners, to be delivered over three years through the Business Development Bank of Canada and Export Development Canada."

5.4 Ready, Set, Start Your Own Business

What are the first steps to take if you are starting your own business?

You have decided that you'd like to go into business for yourself. What is the best way to go about it? Start from scratch? Buy an existing business? Or buy a franchise? About 75 percent of business start-ups involve brand-new organizations, with the remaining 25 percent representing purchased companies or franchises. Franchising may have been discussed elsewhere in your course, so we'll cover the other two options in this section.

Getting Started

The first step in starting your own business is a self-assessment to determine whether you have the personal traits you need to succeed and, if so, what type of business would be best for you. Table 5.2 provides a checklist to consider before starting your business.

Finding the Idea

Entrepreneurs get ideas for their businesses from many sources. It is not surprising that about 80 percent of *Inc.* 500 executives got the idea for their company while working in the same or a related industry. Starting a firm in a field where you have experience improves your chances of success. Other sources of inspiration are personal experiences as a consumer; hobbies and personal interests; suggestions from customers, family, and friends; industry conferences; and college courses or other education.

Checklist for Starting a Business
Before you start your own small business, consider the following checklist:
• Identify your reasons • Self-analysis • Personal skills and experience • Finding a niche • Conduct market research • Plan your start-up: write a business plan • Finances: how to fund your business

Table 5.2 Source: “10 Steps to Start Your Business,” https://www.sba.gov, accessed February 2, 2018.

An excellent way to keep up with small-business trends is by reading entrepreneurship and small-business magazines and visiting their websites. With articles on everything from idea generation to selling a business, they provide an invaluable resource and profile some of the young entrepreneurs and their successful business ventures (Table 5.3).[10]

Successful Entrepreneurs	
RANK	**RANK COMPANY**
Philip Kimmey, 27	Kimmey’s dog-sitting and dog-walking network, Rover.com, raised almost $100 million in venture capital and was valued at $300 million in 2017.
Max Mankin, 27	Mankin cofounded Modern Electron and raised $10 million in venture capital to create “advanced thermionic energy converters” that will generate “cheap, scalable, and reliable electricity.” Modern Electron will turn every home into a power station.
Alexandra Cristin White, 28	In her early 20s, White founded Glam Seamless, which sells tape- in hair extensions. In 2016, her self-funded company grossed $2.5 million.
Steph Korey, 29; Jen Rubio, 29	Korey and Rubio founded Away, selling “first-class luggage at a coach price” in 2015. They raised $31 million in funding and grossed $12 million in sales in 2016.
Allen Gannet, 26	Gannet founded TrackMaven, a web-marketing analytics company, in 2012; by 2016, his company was grossing $6.7 million a year.

Jake Kassan, 25; Kramer LaPlante, 25	Kassan and Kramer launched their company, MVMT, through Indiegogo, raising $300,000, and in 2016 grossed $60 million, selling primarily watches and sunglasses.
Brian Streem, 29	Streem's company, Aerobo, provides drone services to the film industry, selling "professional aerial filming and drone cinematography." Aerobo grossed $1 million in 2016, its first full year of business.
Natalya Bailey, 30; Louis Perna, 29	Accion Systems began in 2014, raised $10 million in venture funding, and grossed $4.5 million in 2016, making tiny propulsion systems for satellites.
Jessy Dover, 29	Dover is the cofounder of Dagne Dover, a company making storage-efficient handbags for professional women. She and her cofounders grossed $4.5 million in 2016 and debuted on Nordstrom.com in 2017.

Table 5.3

These dynamic individuals, who are already so successful in their 20s and 30s, came up with unique ideas and concepts and found the right niche for their businesses.

Interesting ideas are all around you. Many successful businesses get started because someone identifies a need and then finds a way to fill it. Do you have a problem that you need to solve? Or a product that doesn't work as well as you'd like? Raising questions about the way things are done and seeing opportunity in adversity are great ways to generate ideas.

Choosing a Form of Business Organization

A key decision for a person starting a new business is whether it will be a sole proprietorship, partnership or corporation. As discussed earlier, each type of business organization has advantages and disadvantages. The choice depends on the type of business, number of employees, capital requirements, tax considerations, and the level of risk involved.

Developing the Business Plan

Once you have the basic concept for a product or service, you must develop a plan to create the business. This planning process, culminating in a sound **business plan**, is one of the most important steps in starting a business. It can help to attract appropriate loan financing, minimize the risks involved, and be a critical determinant in whether a firm succeeds or fails. Many people do not venture out on their own because they are overwhelmed with doubts and concerns. A comprehensive business plan lets you run various "what if" analyses and evaluate your business without any financial outlay or risk. You can also develop strategies to overcome problems well before starting the business.

Taking the time to develop a good business plan pays off. A venture that seems sound at the idea stage may not look so good on paper. A well-prepared, comprehensive, written business plan forces entrepreneurs to take an objective and critical look at their business venture and analyze their concept carefully; make decisions about marketing, sales, operations, production, staffing, budgeting and financing; and set goals that will help them manage and monitor its growth and performance.

Exhibit 5.3 Each year, a variety of organizations hold business plan competitions to engage the growing number of college students starting their own businesses. The University of Essex and the iLearn entrepreneurship curriculum developed by the University of Texas in Austin, which partnered with Trisakti University in Jakarta, Indonesia, and the U.S. embassy to help run an entrepreneurship course and competition are examples of such competitions. Seven students from “iLearn: Entrepreneurship” were selected as finalists to pitch their business plans to a panel of Indonesian business leaders and embassy representatives. The winning business plan, which was an ecotourism concept, earned $1,000 in seed money. What research goes into a winning business plan? (Credit: University of Essex /flickr/ Attribution 2.0 Generic (CC BY 2.0))

The business plan also serves as the initial operating plan for the business. Writing a good business plan takes time. But many businesspeople neglect this critical planning tool in their eagerness to begin doing business, getting caught up in the day-to-day operations instead.

The key features of a business plan are a general description of the company, the qualifications of the owner(s), a description of the products or services, an analysis of the market (demand, customers, competition), sales and distribution channels, and a financial plan. The sections should work together to demonstrate why the business will be successful, while focusing on the uniqueness of the business and why it will attract customers. Table 5.4 describes the essential elements of a business plan.

A common use of a business plan is to persuade lenders and investors to finance the venture. The detailed information in the plan helps them assess whether to invest. Even though a business plan may take months to write, it must capture potential investors’ interest within minutes. For that reason, the basic business plan should be written with a particular reader in mind. Then you can fine-tune and tailor it to fit the investment goals of the investor(s) you plan to approach.

Key Elements of a Business Plan
Executive summary provides an overview of the total business plan. Written after the other sections are completed, it highlights significant points and, ideally, creates enough excitement to motivate the reader to continue reading.
Vision and mission statement concisely describe the intended strategy and business philosophy for making the vision happen. Company values can also be included in this section.
Company overview explains the type of company, such as manufacturing, retail, or service; provides background information on the company if it already exists; and describes the proposed form of organization—sole proprietorship, partnership, or corporation. This section should include company name and location, company objectives, nature and primary product or service of the business, current status (start-up, buyout, or expansion) and history (if applicable), and legal form of organization.
Product and/or service plan describes the product and/or service and points out any unique features, as well as explains why people will buy the product or service. This section should offer the following descriptions: product and/or service; features and benefits of the product or service that provide a competitive advantage; available legal protection—patents, copyrights, and trademarks.
Marketing plan shows who the firm's customers will be and what type of competition it will face; outlines the marketing strategy and specifies the firm's competitive edge; and describes the strengths, weaknesses, opportunities, and threats of the business. This section should offer the following descriptions: analysis of target market and profile of target customer; methods of identifying, attracting, and retaining customers; a concise description of the value proposition; selling approach, type of sales force, and distribution channels; types of marketing and sales promotions, advertising, and projected marketing budget; product and/or service pricing strategy; and credit and pricing policies.
Management plan identifies the key players—active investors, management team, board members, and advisors— citing the experience and competence they possess. This section should offer the following descriptions: management team, outside investors and/or directors and their qualifications, outside resource people and their qualifications, and plans for recruiting and training employees.

Table 5.4 Sources: "7 Elements of a Business Plan," https://quickbooks.intuit.com, accessed February 2, 2018; David Ciccarelli, "Write a Winning Business Plan with These 8 Key Elements," Entrepreneur, https://www.entrepreneur.com, accessed February 2, 2018; Patrick Hull, "10 Essential Business Plan Components," Forbes, https://www.forbes.com, accessed February 2, 2018; Justin G. Longenecker, J. William Petty, Leslie E. Palich, and Frank Hoy, Small Business Management: Launching & Growing Entrepreneurial Ventures, 18th edition (Mason, OH: Cengage, 2017); Monique Reece, Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution (Upper Saddle River, NJ: FT Press/Pearson, 2010).

Key Elements of a Business Plan
Operating plan explains the type of manufacturing or operating system to be used and describes the facilities, labor, raw materials, and product-processing requirements. This section should offer the following descriptions: operating or manufacturing methods, operating facilities (location, space, and equipment), quality-control methods, procedures to control inventory and operations, sources of supply, and purchasing procedures.
Financial plan specifies financial needs and contemplated sources of financing, as well as presents projections of revenues, costs, and profits. This section should offer the following descriptions: historical financial statements for the last 3–5 years or as available; pro forma financial statements for 3–5 years, including income statements, balance sheets, cash flow statements, and cash budgets (monthly for first year and quarterly for second year); financial assumptions; breakeven analysis of profits and cash flows; and planned sources of financing.
Appendix of supporting documents provides materials supplementary to the plan. This section should offer the following descriptions: management team biographies; the company's values; information about the company culture (if it's unique and contributes to employee retention); and any other important data that support the information in the business plan, such as detailed competitive analysis, customer testimonials, and research summaries.

Table 5.5 Sources: "7 Elements of a Business Plan," https://quickbooks.intuit.com, accessed February 2, 2018; David Ciccarelli, "Write a Winning Business Plan with These 8 Key Elements," Entrepreneur, https://www.entrepreneur.com, accessed February 2, 2018; Patrick Hull, "10 Essential Business Plan Components," Forbes, https://www.forbes.com, accessed February 2, 2018; Justin G. Longenecker, J. William Petty, Leslie E. Palich, and Frank Hoy, Small Business Management: Launching & Growing Entrepreneurial Ventures, 18th edition (Mason, OH: Cengage, 2017); Monique Reece, Real-Time Marketing for Business Growth: How to Use Social Media, Measure Marketing, and Create a Culture of Execution (Upper Saddle River, NJ: FT Press/Pearson, 2010).

But don't think you can set aside your business plan once you obtain financing and begin operating your company. Entrepreneurs who think their business plan is only for raising money make a big mistake. Business plans should be dynamic documents, reviewed and updated on a regular basis—monthly, quarterly, or annually, depending on how the business progresses and the particular industry changes.

Owners should adjust their sales and profit projections up or down as they analyze their markets and operating results. Reviewing your plan on a constant basis will help you identify strengths and weaknesses in your marketing and management strategies and help you evaluate possible opportunities for expansion considering both your original mission and goals, current market trends, and business results.

Financing the Business

Once the business plan is complete, the next step is to obtain financing to set up your company. The funding required depends on the type of business and the entrepreneur's own investment. Businesses started by lifestyle entrepreneurs require less financing than growth-oriented businesses, and manufacturing and high- tech companies generally require a large initial investment.

Who provides start-up funding for small companies? Like Miho Inagi and her Tokyo bagel shop, 94 percent of business owners raise start-up funds from personal accounts, family, and friends. Personal assets and money from family and friends are important for new firms, whereas funding from financial institutions may become more important as companies grow. Three-quarters of Inc. 500 companies have been funded on $100,000 or less.[11]

The two forms of business financing are **debt**, borrowed funds that must be repaid with interest over a stated time period, and **equity**, funds raised through the sale of stock (i.e., ownership) in the business. Those who provide equity funds get a share of the business's profits. Because lenders usually limit debt financing to no more than a quarter to a third of the firm's total needs, equity financing often amounts to about 65 to 75 percent of total start-up financing.

Exhibit 5.4 FUBU started when a young entrepreneur from Hollis, Queens, began making tie-top skullcaps at home with some friends. With funding from a $100,000 mortgage and a later investment from the Samsung Corporation, CEO Daymond John, turned his home into a successful sportswear company. The FUBU brand tops the list for today's fashionistas who don everything from FUBU's classic Fat Albert line to swanky FUBU suits and tuxedos. How do start-ups obtain funding? (Credit: U.S. Embasy Nairobi/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

One way to finance a start-up company is bootstrapping, which is basically funding the operation with your own resources. If the resources needed are not available to an individual, there are other options. Two sources of equity financing for young companies are angel investors and venture-capital firms. **Angel investors** are individual investors or groups of experienced investors who provide financing for start-up businesses by investing their own money, often referred to as "seed capital." This gives the investors more flexibility on what they can and will invest in, but because it is their own money, angels are careful. Angel investors often invest early in a company's development, and they want to see an idea they understand and can have confidence in. Table 5.5 offers some guidelines on how to attract angel financing.

Making a Heavenly Deal
You need financing for your start-up business. How do you get angels interested in investing in your business venture?
• Show them something they understand, ideally a business from an industry they've been associated with. • Know your business details: Information important to potential investors includes annual sales, gross profit, profit margin, and expenses. • Be able to describe your business—what it does and who it sells to—in less than a minute. Limit PowerPoint presentations to 10 slides. • Angels can always leave their money in the bank, so an investment must interest them. It should be something they're passionate about. And timing is important—knowing when to reach out to an angel can make a huge difference. • They need to see management they trust, respect, and like. Present a competent management team with a strong, experienced leader who can explain the business and answer questions from potential investors with specifics. • Angels prefer something they can bring added value to. Those who invest could be involved with your company for a long time or perhaps take a seat on your board of directors. • They are more partial to deals that don't require huge sums of money or additional infusions of angel cash. • Emphasize the likely exits for investors and know who the competition is, why your solution is better, and how you are going to gain market share with an infusion of cash.

Table 5.6 Sources: Guy Kawasaki, "The Art of Raising Angel Capital," https://guykawasaki.com, accessed February 2, 2018; Murray Newlands, "How to Raise an Angel Funding Round," Forbes, https://www.forbes.com, March 16, 2017; Melinda Emerson, "5 Tips for Attracting Angel Investors," Small Business Trends, https://smallbiztrends.com, July 26, 2016; Nicole Fallon, "5 Tips for Attracting Angel Investors," Business News Daily, https://www.businessnewsdaily.com, January 2, 2014; Stacy Zhao, "9 Tips for Winning over Angels," Inc., https://www.inc.com, June 15, 2005; Rhonda Abrams, "What Does It Take to Impress an Angel Investor?" Inc., https://www.inc.com, March 29, 2001.

Venture capital is financing obtained from *venture capitalists*, investment firms that specialize in financing small, high-growth companies. Venture capitalists receive an ownership interest and a voice in management in return for their money. They typically invest at a later stage than angel investors. We'll discuss venture capital in greater detail when discussing how to finance the enterprise.

Buying a Small Business

Another route to small-business ownership is buying an existing business. Although this approach is less risky, many of the same steps for starting a business from scratch apply to buying an existing company. It still requires careful and thorough analysis. The potential buyer must answer several important questions: Why is the owner selling? Does he or she want to retire or move on to a new challenge, or are there problems with the business? Is the business operating at a profit? If not, can this be corrected? On what basis has the owner valued the company, and is it a fair price? What are the owner's plans after selling the company? Will he or she be available to provide assistance through the change of ownership of the business? And depending on the type of business it is, will customers be more loyal to the owner than to the product or service being offered? Customers could leave the firm if the current owner decides to open a similar business. To protect against this, many purchasers include a noncompete clause in the contract of sale, which generally means that the owner of the company being sold may not be allowed to compete in the same industry of the acquired business for a specific amount of time.

You should prepare a business plan that thoroughly analyzes all aspects of the business. Get answers to all your questions, and determine, via the business plan, whether the business is a sound one. Then you must negotiate the price and other terms of purchase and obtain appropriate financing. This can be a complicated process and may require the use of a consultant or business broker.

Risky Business

Running your own business may not be as easy as it sounds. Despite the many advantages of being your own boss, the risks are great as well. Over a period of five years, nearly 50% percent of small businesses fail according to the Kauffman Foundation.[12]

Businesses close for many reasons—and not all are failures. Some businesses that close are financially successful and close for nonfinancial reasons. But the causes of business failure can be interrelated. For example, low sales and high expenses are often directly related to poor management. Some common causes of business closure are:

- Economic factors—business downturns and high interest rates
- Financial causes—inadequate capital, low cash balances, and high expenses
- Lack of experience—inadequate business knowledge, management experience, and technical expertise
- Personal reasons—the owners may decide to sell the business or move on to other opportunities

Inadequate early planning is often at the core of later business problems. As described earlier, a thorough feasibility analysis, from market assessment to financing, is critical to business success. Yet even with the best plans, business conditions change, and unexpected challenges arise. An entrepreneur may start a company based on a terrific new product only to find that a larger firm with more marketing, financing, and distribution clout introduces a similar item.

The stress of managing a business can also take its toll. The business can consume your whole life. Owners may find themselves in over their heads and unable to cope with the pressures of business operations, from the long hours to being the main decision maker. Even successful businesses must deal with ongoing challenges. Growing too quickly can cause as many problems as sluggish sales. Growth can strain a company's finances when additional capital is required to fund expanding operations, from hiring additional staff to purchasing more raw material or equipment. Successful business owners must respond quickly and develop plans to manage its growth.

So, how do you know when it is time to quit? "Never give up" may be a good motivational catchphrase, but it is not always good advice for a small-business owner. Yet, some small-business owners keep going no matter what the cost. For example, Ian White's company was trying to market a new kind of city map. White maxed out 11 credit cards and ran up more than $100,000 in debt after starting his company. He ultimately declared personal bankruptcy and was forced to find a job so that he could pay his bills. Maria Martz didn't realize her small business would become a casualty until she saw her tax return showing her company's losses in black and white—for the second year in a row. It convinced her that enough was enough and she gave up her gift- basket business to become a full-time homemaker. But once the decision is made, it may be tough to stick to. "I got calls from people asking how come I wasn't in business anymore. It was tempting to say I'd make their basket, but I had to tell myself it is finished now."[13]

5.5 Managing a Small Business

Why does managing a small business present special challenges for the owner?

Managing a small business is quite a challenge. Whether you start a business from scratch or buy an existing one, you must be able to keep it going. The small-business owner must be ready to solve problems as they arise and move quickly if market conditions change.CH

A sound business plan is key to keeping the small-business owner in touch with all areas of his or her business. Hiring, training, and managing employees is another important responsibility because the owner's role may change over time. As the company grows, others will make many of the day-to-day decisions while the owner focuses on managing employees and planning for the firm's long-term success. The owner must constantly evaluate company performance and policies, consider changing market and economic conditions, and develop new policies as required. He or she must also nurture a continual flow of ideas to keep the business growing. The types of employees needed may change too as the firm grows. For instance, a larger firm may need more managerial talent and technical expertise.

Using Outside Consultants

One way to ease the burden of managing a business is to hire outside consultants. Nearly all small businesses need a good certified public accountant (CPA) who can help with financial record keeping, decision-making, and tax planning. An accountant who works closely with the owner to help the business grow is a valuable asset. An attorney who knows about small-business law can provide legal advice and draw up essential contracts and documents. Consultants in areas such as marketing, employee benefits, and insurance can be used on an as-needed basis. Outside directors with business experience are another way for small companies to get advice. Resources such as these free the small-business owner to concentrate on medium- and long- range planning and day-to-day operations.

Some aspects of business can be outsourced or contracted out to specialists. Among the more common departments that use outsourcing are information technology, marketing, customer service, order fulfillment, payroll, and human resources. Hiring an outside company—in many cases another small business—can save money because the purchasing firm buys just the services it needs and makes no investment in expensive technology. Management should review outsourced functions as the business grows because at some point it may be more cost-effective to bring them in-house.

Hiring and Retaining Employees

It is important to identify all the costs involved in hiring an employee to make sure your business can afford it. Recruiting, help-wanted ads, extra space, and taxes will easily add about 10–15 percent to their salary, and employee benefits will add even more. Hiring an employee may also mean more work for you in terms of training and management. It's a catch-22: to grow you need to hire more people but making the shift from solo worker to boss can be stressful.

Attracting good employees is more difficult for a small firm, which may not be able to match the higher salaries, better benefits, and advancement potential offered by larger firms. Small companies need to be creative to attract the right employees and convince applicants to join their firm. Once they hire an employee, small-business owners must make employee satisfaction a top priority in order to retain good people. A company culture that nurtures a comfortable environment for workers, flexible hours, employee benefit programs, opportunities to help make decisions, and a share in profits and ownership are some ways to do this.

Duane Ruh figured out how to build a $1.2 million business in a town with just 650 residents. It's all about treating employees right. The log birdhouse and bird feeder manufacturer, Little Log Co., located in Sargent, Nebraska, boasts employee-friendly policies you read about but rarely see put into practice. Ruh offers his employees a flexible schedule that gives them plenty of time for their personal lives. During a slow period, last summer, Ruh cut back on hours rather than lay anyone off. There just aren't that many jobs in that part of Nebraska that his employees could go to, so when he received a buyout offer that would have closed his facility but kept him in place with an enviable salary, he turned it down. Ruh also encourages his employees to pursue side or summer jobs if they need to make extra money, assuring them that their Little Log jobs are safe.[14]

Going Global with Exporting

More and more small businesses are discovering the benefits of looking beyond Canada for market opportunities. The global marketplace represents a huge opportunity for Canadian businesses, both large and small. Small businesses' decision to export is driven by many factors, one of which is the desire for increased sales and higher profits. Canadian goods are less expensive for overseas buyers when the value of the Canadian dollar declines against foreign currencies, and this creates opportunities for Canadian companies to sell globally. In addition, economic conditions such as a domestic recession, foreign competition within Canada, or new markets opening up in foreign countries may also encourage Canadian companies to export.

Like any major business decision, exporting requires careful planning. Small businesses may hire international-trade consultants or distributors to get started selling overseas. These specialists have the time, knowledge, and resources that most small businesses lack. Export trading companies (ETCs) buy goods at a discount from small businesses and resell them abroad. Export management companies (EMCs) act on a company's behalf. For fees of 5–15 percent of gross sales and multiyear contracts, they handle all aspects of exporting, including finding customers, billing, shipping, and helping the company comply with foreign regulations.

5.6 Small Business, Large Impact

What are the advantages and disadvantages of being an owner of a small business?

Advantages of Small Business Ownership:

- *Independence and a better lifestyle*: Large corporations no longer represent job security or offer the fast- track career opportunities they once did. Mid-career employees leave the corporate world—either voluntarily or because of downsizing—in search of the new opportunities that self-employment provides. Many new college and business school graduates shun the corporate world altogether to start their own companies or look for work in smaller firms.
- *Personal satisfaction from work*: Many small-business owners cite this as one of the primary reasons for starting their companies. They love what they do.
- *Best route to success*: Business ownership provides greater advancement opportunities for women and minorities. It also offers small-business owners the potential for profit.
- *Rapidly changing technology:* Technology advances and decreased costs provide individuals and small companies with the power to compete in industries that were formerly closed to them.
- *Major corporate restructuring and downsizing*: This forces many employees to look for other jobs or careers. It may also provide the opportunity to buy a business unit that a company no longer wants.
- *Outsourcing*: As a result of downsizing, corporations may contract with outside firms for services they used to provide in-house. Outsourcing creates opportunities for smaller companies that offer these specialized goods and services.
- *Small businesses are resilient*: They can respond fairly quickly to changing economic conditions by refocusing their operations.

Disadvantages of Small Business Ownership:

- *Financial risk*: The financial resources needed to start and grow a business can be extensive. You may need to commit most of your savings or even go into debt to get started. If things don't go well, you may face substantial financial loss. In addition, there's no guaranteed income. There might be times, especially in the first few years, when the business isn't generating enough cash for you to live on.
- *Stress*: As a business owner, you are the business. There're many things to worry about—competition, employees, bills, equipment breakdowns, etc. As the owner, you're also responsible for the well-being of your employees.
- *Time commitment*: People often start businesses so that they'll have more time to spend with their families. Unfortunately, running a business is extremely time-consuming. In theory, you have the freedom to take time off, but in reality, you may not be able to get away. In fact, you'll probably have less free time than you'd have working for someone else. For many entrepreneurs and small business owners, a forty-hour workweek is a myth. Vacations will be difficult to take and will often be interrupted. In recent years, the difficulty of getting away from the job has been compounded by cell phones, iPhones, Internet-connected laptops and iPads, and many small business owners have come to regret that they're always reachable.

- *Undesirable duties*: When you start up, you'll undoubtedly be responsible for either doing or overseeing just about everything that needs to be done. You can get bogged down in detail work that you don't enjoy. As a business owner, you'll probably have to perform some unpleasant tasks, like firing people.
- *Limitations*: On the other hand, being small is not always an asset. The founders may have limited managerial skills or encounter difficulties obtaining adequate financing, potential obstacles to growing a company. Complying with federal regulations is also more expensive for small firms. Those with fewer than 20 employees spend about twice as much per employee on compliance than do larger firms. In addition, starting and managing a small business requires a major commitment by the owner. Long hours, the need for owners to do much of the work themselves, and the stress of being personally responsible for the success of the business can take a toll.

Key Terms

angel investors	Individual investors or groups of experienced investors who provide financing for start-up businesses by investing their own funds.
business plan	A formal written statement that describes in detail the idea for a new business and how it will be carried out; includes a general description of the company, the qualifications of the owner(s), a description of the product or service, an analysis of the market, and a financial plan.
debt	A form of business financing consisting of borrowed funds that must be repaid with interest over a stated time period.
entrepreneurs	People with vision, drive, and creativity who are willing to take the risk of starting and managing a business to make a profit, or greatly changing the scope and direction of an existing firm.
equity	A form of business financing consisting of funds raised through the sale of stock (i.e., ownership) in a business.
intrapreneurs	Entrepreneurs who apply their creativity, vision, and risk-taking within a large corporation, rather than starting a company of their own.
small business	A business with under 500 employees that is independently managed, is owned by an individual or a small group of investors, is based locally, and is not a dominant company in its industry.
venture capital	Financing obtained from venture capitalists, investment firms that specialize in financing small, high-growth companies and receive an ownership interest and a voice in management in return for their money.

Summary of Learning Outcomes

1. Why do people become entrepreneurs, and what are the different types of entrepreneurs?

Entrepreneurs are innovators who take the risk of starting and managing a business to make a profit. Most want to develop a company that will grow into a major corporation. People become entrepreneurs for four main reasons: the opportunity for profit, independence, personal satisfaction, and lifestyle. Classic entrepreneurs may be micropreneurs, who plan to keep their businesses small, or growth-oriented entrepreneurs. Multipreneurs start multiple companies, while intrapreneurs work within large corporations.

2. What characteristics do successful entrepreneurs share?

Successful entrepreneurs are ambitious, independent, self-confident, creative, energetic, passionate, and committed. They have a high need for achievement and a willingness to take moderate risks. Good managerial, interpersonal, and communication skills, as well as technical knowledge are important for entrepreneurial success.

3. How do small businesses contribute to the Canadian economy?

Small businesses play an important role in the economy. Founders of small businesses contribute to growth and vitality in specific areas including: job creation; innovation; and opportunities for women and minorities to achieve financial success and independence. Over time more jobs are added by small firms than are taken away, which results in a net increase in the number of workers. While the majority of small businesses are still owned by white males, the past two decades have seen a substantial increase in the number of businesses owned by women.

4. What are the first steps to take if you are starting your own business?

After finding an idea that satisfies a market need, the small-business owner should choose a form of business organization. Preparing a formal business plan helps the business owner analyze the feasibility of his or her idea. The written plan describes in detail the idea for the business and how it will be implemented and operated. The plan also helps the owner obtain both debt and equity financing for the new business.

5. Why does managing a small business present special challenges for the owner?

At first, small-business owners are involved in all aspects of the firm's operations. Hiring and retaining key employees and the wise use of outside consultants can free up an owner's time to focus on planning, strategizing, and monitoring market conditions, in addition to overseeing day-to-day operations. Expanding into global markets can be a profitable growth strategy for a small business.

6. What are the advantages and disadvantages of being an owner of a small business?

Because of their streamlined staffing and structure, small businesses can be efficiently operated. They have the flexibility to respond to changing market conditions. Small firms can serve specialized markets more profitably than large firms, and they provide a higher level of personal service. Disadvantages include limited managerial skill, difficulty in raising capital needed for start-up or expansion, the burden of complying with increasing levels of government regulation, and the major personal commitment that is required by the owner.

Chapter 6

Management

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What is the role of management?
2. What are the four types of planning?
3. What are the primary functions of managers in organizing activities?
4. How do leadership styles influence a corporate culture?
5. How do organizations control activities?
6. What roles do managers take on in different organizational settings?
7. What set of managerial skills is necessary for managerial success?
8. What trends will affect management in the future?

6.1 The Role of Management

What is the role of management?

Management is the process of guiding the development, maintenance, and allocation of resources to attain organizational goals. Managers are the people in the organization responsible for developing and carrying out this management process. Management is dynamic by nature and evolves to meet needs and constraints in the organization's internal and external environments. In a global marketplace where the rate of change is rapidly increasing, flexibility and adaptability are crucial to the managerial process. This process is based in four key functional areas of the organization: planning, organizing, leading, and controlling. Although these activities are discussed separately in the chapter, they actually form a tightly integrated cycle of thoughts and actions.

Exhibit 6.1 Cycle of the key functional areas of the organization

From this perspective, the managerial process can be described as (1) anticipating potential problems or opportunities and designing plans to deal with them, (2) coordinating and allocating the resources needed to implement plans, (3) guiding personnel through the implementation process, and (4) reviewing results and making any necessary changes. This last stage provides information to be used in ongoing planning efforts, and thus the cycle starts over again. The four functions are highly interdependent, with managers often performing more than one of them at a time and each of them many times over the course of a normal workday.

Exhibit 6.2 To encourage greater collaboration between employees, Apple is investing $5 billion in the construction of its new Cupertino, CA, headquarters, which is replacing several buildings the company had outgrown. Most headquarters-based employees of Apple now share not only the same office space, but also the same technology tools and corporate culture. *How do Apple's planning and organizing decisions increase organizational efficiency and effectiveness?* (Credit: Tom Pavel / flickr/ Attribution 2.0 Generic (CC BY 2.0))

The four management functions can help managers increase organizational efficiency and effectiveness. **Efficiency** is using the least possible amount of resources to get work done, whereas **effectiveness** is the ability to produce a desired result. Managers need to be both efficient and effective in order to achieve organizational goals. For example in 2016, Delta, one of the most efficient network U.S. airlines, operated at revenue of 12.15 cents per seat-mile, which is the revenue the company makes on one seat (occupied or not) the distance of one mile. No other airline came close to operating this efficiently except Southwest, which flew seats that produced 12.51 cents a mile, the best performance of all U.S. airlines.[1] There are many ways that airlines can manage to produce higher revenue per seat-mile. For instance, they can raise ticket prices, fill more of their seats, operate more efficient aircrafts that utilize less fuel, or negotiate favorable salaries with their employees. While efficiency and effectiveness are sometimes lauded by investors, airlines also need to account for customer satisfaction, which can mean extra costs.[2]

To meet the demands of rapid growth, Skechers hired a new chief financial officer, John Vandemore, which allowed their existing CFO (David Weinberg) to concentrate on international expansion. Skechers CEO Robert Greenberg commented: "As international now represents more than 50 percent of our total business, we must continue to ramp up operations and infrastructure to meet the demand. David (Weinberg) understands how to do it the right way at the right speed to maintain our forward momentum. With John (Vandemore) handling CFO responsibilities, David will now have the bandwidth to travel and find opportunities to maximize our efficiencies around the globe."[3]

As these examples and Table 6.1 show, good management uses the four management functions to increase a company's efficiency and effectiveness, which leads to the accomplishment of organizational goals and objectives. Let's look more closely at what each of the management functions entails.

What Managers Do and Why					
Good management consists of these four activities:			Which results in		And leads to
Planning • Set objectives and state mission • Examine alternatives • Determine needed resources • Create strategies to reach objectives	**Leading** • Lead and motivate employees to accomplish organizational goals • Communicate with employees • Resolve conflicts • Manage change				
Organizing • Design jobs and specify tasks • Create organizational structure • Staff positions • Coordinate work activities • Set policies and procedures • Allocate resources	**Controlling** • Measure performance • Compare performance to standards • Take necessary action to improve performance	Leads to	Organizational efficiency and effectiveness	Leads to	Achievement of organizational mission and objectives

Table 6.1

Management 4 functions video:
https://youtu.be/3OhlrAL0gQA

6.2 Planning

What are the four types of planning?

Planning begins by anticipating potential problems or opportunities the organization may encounter. Managers then design strategies to solve current problems, prevent future problems, or take advantage of opportunities. These strategies serve as the foundation for goals, objectives, policies, and procedures. Put simply, planning is deciding what needs to be done to achieve organizational objectives, identifying when and how it will be done, and determining who should do it. Effective planning requires extensive information about the external business environment in which the firm competes, as well as its internal environment.

There are four basic types of planning: strategic, tactical, operational, and contingency. Most of us use these different types of planning in our own lives. Some plans are very broad and long term (more strategic in nature), such as planning to attend graduate school after earning a bachelor's degree. Some plans are much more specific and short term (more operational in nature), such as planning to spend a few hours in the library this weekend. Your short-term plans support your long-term plans. If you study now, you have a better chance of achieving some future goal, such as getting a job interview or attending graduate school. Like you, organizations tailor their plans to meet the requirements of future situations or events. A summary of the four types of planning appears in Table 6.2.

Strategic planning involves creating long-range (one to five years), broad goals for the organization and determining what resources will be needed to accomplish those goals. An evaluation of external environmental factors such as economic, technological, and social issues is critical to successful strategic planning. Strategic plans, such as the organization's long-term mission, are formulated by top-level managers and put into action at lower levels in the organization.

Goals, strategies, objectives video:
https://youtu.be/voZI75TyeHI

For example, when Mickey Drexler took over as CEO of J.Crew, the company was floundering and had been recently purchased by a private equity group. One of Drexler's first moves was to change the strategic direction of the company by moving it out of the crowded trend-following retail segment, where it was competing with stores such as Gap, American Eagle, and Abercrombie and back into the preppie, luxury segment where it began. Rather than trying to sell abundant inventory to a mass market, J.Crew cultivated scarcity, making sure items sold out early rather than hit the sale rack later in the season. The company also limited the number of new stores it opened during a two-year span but planned to double the number of stores in the next five to six years. Drexler led the company through public offerings and back to private ownership before bringing on a new CEO in 2017. He remained chairman with ownership in the company.[4]

Types of Planning						
Type of Planning	Time Frame	Level of Management	Extent of coverage	Purpose and Goal	Breadth of Content	Accuracy and Predictability
Strategic	1–5 years	Top management (CEO, vice presidents, directors, division heads)	External environment and entire organization	Establish mission and long-term goals	Broad and general	High degree of uncertainty
Tactical	Less than 1 year	Middle management	Strategic business units	Establish mid-range goals for implement-ation	More specific	Moderate degree of certainty
Operational	Current	Supervisory management	Geographic and functional divisions	Implement and activate specific objectives	Specific and concrete	Reasonable degree of certainty
Contingency	When an event occurs or a situation demands	Top and middle management	External environment and entire organization	Meet unforeseen challenges and opportunities	Both broad and detailed	Reasonable degree of certainty once event or situation occurs

Table 6.2

An organization's **mission** is formalized in its **mission statement**, a document that states the purpose of the organization and its reason for existing. For example, Twitter's mission statement formalizes both concepts while staying within its self-imposed character limit; see Table 6.3.

Mission statement video:
https://youtu.be/b2MyaR0gMo0

Twitter's Mission, Values, and Strategy
Mission: Give everyone the power to create and share ideas and information instantly, without barriers.
Values: We believe in free expression and think every voice has the power to impact the world.
Strategy: Reach the largest daily audience in the world by connecting everyone to their world via our information sharing and distribution platform products and be one of the top revenue generating Internet companies in the world.
Twitter combines its mission and values to bring together a diverse workforce worldwide to fulfill its strategy.
The 3 Parts of a Company Mission Statement: • Purpose • Value • Action

Table 6.3 Sources: "About" and "Our Values," https://about.twitter.com, accessed October 30, 2017; Justin Fox, "Why Twitter's Mission Statement Matters," Harvard Business Review, https://hbr.org, accessed October 30, 2017; Jeff Bercovici, "Mission Critical: Twitter's New 'Strategy Statement' Reflects Shifting Priorities," Inc., https://www.inc.com, accessed October 30, 2017.

In all organizations, plans and goals at the tactical and operational levels should clearly support the organization's mission statement.

Tactical planning begins the implementation of strategic plans. Tactical plans have a shorter (less than one year) time frame than strategic plans and more specific objectives designed to support the broader strategic goals. Tactical plans begin to address issues of coordinating and allocating resources to different parts of the organization.

Under Mickey Drexler, many new tactical plans were implemented to support J.Crew's new strategic direction. For example, he severely limited the number of stores opened each year, with only nine new openings in the first two years of his tenure (he closed seven). Instead, he invested the company's resources in developing a product line that communicated J.Crew's new strategic direction. Drexler dumped trend-driven apparel because it did not meet the company's new image. He even cut some million-dollar volume items. In their place, he created limited editions of a handful of garments that he thought would be popular, many of which fell into his new luxury strategy. For example, J.Crew now buys shoes directly from the same shoe manufacturers that produce footwear for designers such as Prada and Gucci. In general, J.Crew drastically tightened inventories, a move designed to keep reams of clothes from ending up on sale racks and to break its shoppers' habit of waiting for discounts.

This part of the plan generated great results. Prior to Drexler's change in strategy, half of J.Crew's clothing sold at a discount. After implementing tactical plans aimed to change that situation, only a small percentage does. The shift to limited editions and tighter inventory controls has not reduced the amount of new merchandise, however. On the contrary, Drexler created a J.Crew bridal collection, a jewelry line, and Crew Cuts, a line of kids' clothing. The results of Drexler's tactical plans were impressive. J.Crew saw same-store sales rise 17 percent in one year.[5]

Operational planning creates specific standards, methods, policies, and procedures that are used in specific functional areas of the organization. Operational objectives are current, narrow, and resource focused. They are designed to help guide and control the implementation of tactical plans. In an industry where new versions of software have widely varying development cycles, Autodesk, maker of software tools for designers and engineers, implemented new operational plans that dramatically increased profits. Former CEO Carol Bartz shifted the company away from the erratic release schedule it had been keeping to regular, annual software releases. By releasing upgrades on a defined and predictable schedule, the company is able to use annual subscription pricing, which is more affordable for small and midsize companies. The new schedule keeps Autodesk customers on the most recent versions of popular software and has resulted in an overall increase in profitability.[6]

The key to effective planning is anticipating future situations and events. Yet even the best-prepared organization must sometimes cope with unforeseen circumstances, such as a natural disaster, an act of terrorism, or a radical new technology. Therefore, many companies have developed **contingency plans** that identify alternative courses of action for very unusual or crisis situations. The contingency plan typically stipulates the chain of command, standard operating procedures, and communication channels the organization will use during an emergency.

An effective contingency plan can make or break a company. Consider the example of Marriott Hotels in Puerto Rico. Anticipating Hurricane Maria in 2017, workers at the San Juan Marriott had to shift from their regular duties to handling the needs of not only customers, but everyone who needed assistance in the wake of the hurricane that devastated the island. A contingency plan and training for events such as this were a key part of managing this crisis.[7] The company achieved its goal of being able to cater to guests and general needs due to planning and training while having a contingency plan in place. One guest commented on TripAdvisor, "Could not believe how friendly, helpful & responsive staff were even during height of hurricane. Special thanks to Eydie, Juan, Jock, Ashley and security Luis. They kept us safe & were exemplary. Will always stay at Marriott from now on."[8] Within one month after Hurricane Maria hit, operations were back to normal at the San Juan Marriott.[9]

6.3 Organizing

What are the primary functions of managers in organizing activities?

A second key function of managers is **organizing**, which is the process of coordinating and allocating a firm's resources to carry out its plans. Organizing includes developing a structure for the people, positions, departments, and activities within the firm. Managers can arrange the structural elements of the firm to maximize the flow of information and the efficiency of work processes. They accomplish this by doing the following:

- Dividing up tasks (*division of labour*)
- Grouping jobs and employees (*departmentalization*)

- Assigning authority and responsibilities (*delegation*)

These and other elements of organizational structure are discussed in detail elsewhere. In this chapter, however, you should understand the three levels of a managerial hierarchy. This hierarchy is often depicted as a pyramid, as in Exhibit 6.3. The fewest managers are found at the highest level of the pyramid. Called **top management**, they are the small group of people at the head of the organization (such as the CEO, president, and vice president). Top-level managers develop strategic plans and address long-range issues such as which industries to compete in, how to capture market share, and what to do with profits. These managers design and approve the firm's basic policies and represent the firm to other organizations. They also define the company's values and ethics and thus set the tone for employee standards of behaviour. For example, Jack Welch, the former CEO of General Electric, was a role model for his managers and executives. Admirers say that he had an extraordinary capacity to inspire hundreds of thousands of people in many countries and he could change the direction of a huge organization like General Electric as if it were a small firm. Following his leadership, General Electric's executives turned in impressive results. During his tenure, General Electric's average annual shareholder return was 25 percent.[10]

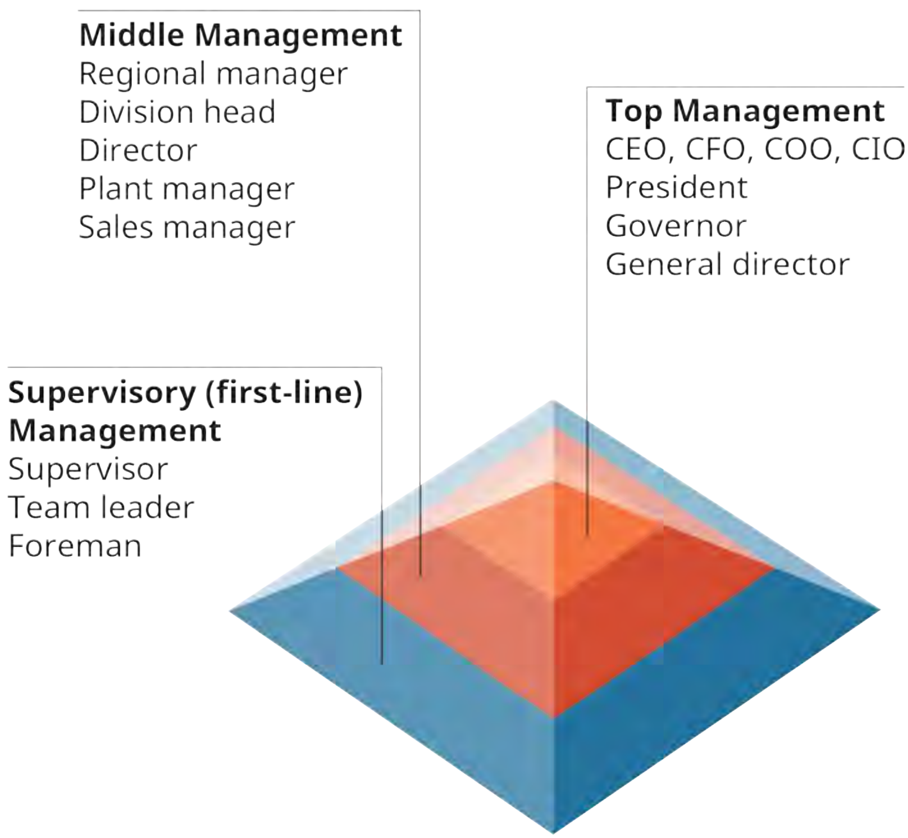


Exhibit 6.3 The Managerial Pyramid (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

The second and third tiers of the hierarchy are called **middle management** and **supervisory (first-line) management**, respectively. Middle managers (such as division heads, departmental managers, and regional sales managers) are responsible for beginning the implementation of strategic plans. They design and carry out tactical plans in specific areas of the company. They begin the process of allocating resources to meet organizational goals, and they oversee supervisory managers throughout the firm. Supervisors, the most numerous of the managers, are at the bottom of the managerial pyramid. These managers design and carry out operational plans for the ongoing daily activities of the firm. They spend a great deal of their time guiding and motivating the employees who actually produce the goods and services.

6.4 Leading, Guiding, and Motivating Others

How do leadership styles influence a corporate culture?

Leadership, the third key management function, is the process of guiding and motivating others toward the achievement of organizational goals. A leader can be anyone in an organization, regardless of position, able to influence others to act or follow, often by their own choice. Managers are designated leaders according to the organizational structure but may need to use negative consequences or coercion to achieve change. In the organization structure, top managers use leadership skills to set, share, and gain support for the company's direction and strategy—mission, vision, and values, such as Jeff Bezos does at Amazon. Middle and supervisory management use leadership skills in the process of directing employees on a daily basis as the employees carry out the plans and work within the structure created by management. Top-level leadership demonstrated by Bezos was also exhibited by Jack Welch while leading General Electric and led to many studies of his approach to leadership. Organizations, however, need strong effective leadership at all levels in order to meet goals and remain competitive.
To be effective leaders, managers must be able to influence others' behaviours. This ability to influence others to behave in a particular way is called **power**. Researchers have identified five primary sources, or bases, of power:

- **Legitimate power**, which is derived from an individual's position in an organization
- **Reward power**, which is derived from an individual's control over rewards
- **Coercive power**, which is derived from an individual's ability to threaten negative outcomes
- **Expert power**, which is derived from an individual's extensive knowledge in one or more areas
- **Referent power**, which is derived from an individual's personal charisma and the respect and/or admiration the individual inspires

Many leaders use a combination of all of these sources of power to influence individuals toward goal achievement. While CEO of Procter & Gamble, A.G. Lafley got his legitimate power from his position, his reward power came from reviving the company and making the stock more valuable. Also, raises and bonuses for managers who met their goals were another form of reward power. Lafley also was not hesitant to use his coercive power. He eliminated thousands of jobs, sold underperforming brands, and killed weak product lines. With nearly 40 years of service to the company, Lafley had a unique authority when it came to P&G's products, markets, innovations, and customers. The company's sales doubled during his nine years as CEO, and its portfolio of brands increased from 10 to 23. He captained the purchase of Clairol, Wella AG, and IAMS, as well as the multibillion-dollar merger with Gillette. As a result, Lafley had a substantial amount of referent power. Lafley is also widely respected, not only by people at P&G, but by the general business community as well. Ann Gillin Lefever, a managing director at Lehman Brothers, said, "Lafley is a leader who is liked. His directives are very simple. He sets a strategy that everybody understands, and that is more difficult than he gets credit for."[11]

Leadership Styles

Individuals in leadership positions tend to be relatively consistent in the way they attempt to influence the behaviour of others, meaning that each individual has a tendency to react to people and situations in a particular way. This pattern of behaviour is referred to as **leadership style**. As Table 6.4 shows, leadership styles can be placed on a continuum that encompasses three distinct styles: autocratic, participative, and free rein.

Autocratic leaders are directive leaders, allowing for very little input from subordinates. These leaders prefer to make decisions and solve problems on their own and expect subordinates to implement solutions according to very specific and detailed instructions. In this leadership style, information typically flows in one direction, from manager to subordinate. The military, by necessity, is generally autocratic. When autocratic leaders treat employees with fairness and respect, they may be considered knowledgeable and decisive. But often autocrats are perceived as narrow-minded and heavy-handed in their unwillingness to share power, information, and decision-making in the organization. The trend in organizations today is away from the directive, controlling style of the autocratic leader.

Exhibit 6.4 Recently ranked near the top of the Forbes list of the world's most powerful women was Sheryl Sandberg, the COO at Facebook. As Facebook's chief operating officer since 2008, Sandberg has helped dramatically boost revenues at the social network. Sandberg also founded Lean In, a nonprofit named after her bestselling book, to support women's empowerment. What are Sheryl Sandberg's primary sources of power? (Credit: JD Lasica/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Instead, businesses are looking more and more for **participative leaders**, meaning leaders who share decision-making with group members and encourage discussion of issues and alternatives. Participative leaders use a democratic, consensual, consultative style. One CEO known for her participative leadership style is Meg Whitman, former CEO at Hewlett Packard.

When Whitman worked at eBay, a team in the German-based operation began a promotional "treasure hunt," launching registration pages, clues, and an hourly countdown clock. Trouble was, the launch violated eBay's well-established corporate project-development processes.

When the treasure hunt began, 10 million contestants logged on, crashing the local servers. Rather than shut the project down, the VP in charge of the German operation allowed the promotion to be fixed and fly under the radar of corporate headquarters. Successful innovations emerged, such as an Easy Lister feature and separate registration processes for private and business sellers. When the VP shared this experience with Meg Whitman, she fostered the idea of rapid prototyping throughout the organization, which "breaks rules to get something done," and modeled such behaviour for the entire organization.[12]

Leadership Styles of Managers		
Amount of authority held by the leader		
Autocratic Style	**Participative Style (Democratic, Consensual, Consultative)**	**Free-Rein (Laissez-Faire) Style**
Manager makes most decisions and act in authoritative manner. Manager is usually unconcerned about subordinates' attitudes toward decisions. Emphasis is on getting task accomplished. Approach is used mostly by military officers and some production line supervisors.	Manager shares decision-making with group members and encourages teamwork. Manager encourages discussion of issues and alternatives. Manager is concerned about subordinates' ideas and attitudes. Manager coaches subordinates and helps coordinate efforts. Approach is found in many successful organizations.	Manager turns over virtually all authority and control to group. Members of group are presented with task and given freedom to accomplish it. Approach works well with highly motivated, experienced, educated personnel. Approach is found in high-tech firms, labs, and colleges.
Amount of authority held by group members		

Table 6.4

Participative leadership has three types: democratic, consensual, and consultative. **Democratic leaders** solicit input from all members of the group and then allow the group members to make the final decision through a voting process. This approach works well with highly trained professionals. The president of a physicians' clinic might use the democratic approach. **Consensual leaders** encourage discussion about issues and then require that all parties involved agree to the final decision. This is the general style used by labour mediators.

Consultative leaders confer with subordinates before making a decision but retain the final decision-making authority. This technique has been used to dramatically increase the productivity of assembly-line workers.

The third leadership style, at the opposite end of the continuum from the autocratic style, is **free-rein** or **laissez-faire** (French for "leave it alone") **leadership**. Managers who use this style turn over all authority and control to subordinates. Employees are assigned a task and then given free rein to figure out the best way to accomplish it. The manager doesn't get involved unless asked. Under this approach, subordinates have unlimited freedom as long as they do not violate existing company policies. This approach is also sometimes used with highly trained professionals as in a research laboratory.

Although one might at first assume that subordinates would prefer the free-rein style, this approach can have several drawbacks. If free-rein leadership is accompanied by unclear expectations and lack of feedback from the manager, the experience can be frustrating for an employee. Employees may perceive the manager as being uninvolved and indifferent to what is happening or as unwilling or unable to provide the necessary structure, information, and expertise.

No leadership style is effective all the time. Effective leaders recognize employee growth and use **situational leadership**, selecting a leadership style that matches the maturity and competency levels of those completing the tasks. Newly hired employees may respond well to authoritative leadership until they understand the job requirements and show the ability to handle routine decisions. Once established, however, those same employees may start to feel undervalued and perform better under a participative or free-rein leadership style. Using situational leadership empowers employees as discussed next.

Employee Empowerment

Participative and free-rein leaders use a technique called empowerment to share decision-making authority with subordinates. **Empowerment** means giving employees increased autonomy and discretion to make their own decisions, as well as control over the resources needed to implement those decisions. When decision- making power is shared at all levels of the organization, employees feel a greater sense of ownership in, and responsibility for, organizational outcomes.

Management use of employee empowerment is on the rise. This increased level of involvement comes from the realization that people at all levels in the organization possess unique knowledge, skills, and abilities that can be of great value to the company. For example, when Hurricane Katrina hit the Gulf Coast, five miles of railroad tracks were ripped off a bridge connecting New Orleans to Slidell, Louisiana. Without the tracks, which fell into Lake Pontchartrain, Norfolk Southern Railroad couldn't transport products between the East and West Coasts. Before the storm hit, however, Jeff McCracken, a chief engineer at the company, travelled to Birmingham with equipment he thought he might need and then to Slidell with 100 employees. After conferring with dozens of company engineers and three bridge companies, McCracken decided to try to rescue the miles of track from the lake. (Building new tracks would have taken several weeks at the least.) To do so, he gathered 365 engineers, machine operators, and other workers, who lined up eight huge cranes and, over the course of several hours, lifted the five miles of sunken tracks in one piece out of the lake and bolted it back on the bridge.[13] By giving employees the autonomy to make decisions and access to required resources, Norfolk Southern was able to avoid serious interruptions in its nationwide service.

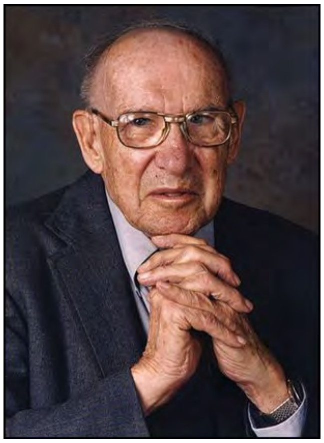


Exhibit 6.5 Management thought leader Peter Drucker (1909–2005) was the author of more than three dozen books, translated into almost as many languages. Most management scholars have remarked that although he was firmly associated with the human relations school of management—along with Douglas McGregor and Warren Bennis, for example—the thought leader Drucker most admired was Frederick Winslow Taylor, the father of "scientific" management. *Should anyone "school" of management predominate thinking, or should all approaches be considered?* (Credit: IsaacMao/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Corporate Culture

The leadership style of managers in an organization is usually indicative of the underlying philosophy, or values, of the organization. The set of *attitudes*, *values*, and *standards of behaviour* that distinguishes one organization from another is called **corporate culture**. A corporate culture evolves over time and is based on the accumulated history of the organization, including the vision of the founders. It is also influenced by the dominant leadership style within the organization. Evidence of a company's culture is seen in its heroes (e.g., the late Andy Grove of Intel[14], myths (stories about the company passed from employee to employee), symbols (e.g., the Nike swoosh), and ceremonies. The culture at Google, working in teams and fostering innovation, sometimes is overlooked while its employee perks are drooled over. But both are important to the company's corporate culture. Since 2007 Google has been at or near the top of *Fortune's* list of the "100 Best Companies to Work For," an annual list based on employee survey results tabulated by an independent company: Great Place to Work®. [15] "We have never forgotten since our startup days that great things happen more frequently within the right culture and environment," a company spokesperson said in response to the company first taking over the top spot.[16]

Culture may be intangible, but it has a tremendous impact on employee morale and a company's success. Google approaches morale analytically. When it found that mothers were leaving the company in higher rates than other employee groups, the company improved its parental-leave policies. The result was a 50 percent reduction in attrition for working moms. An analytical approach along with culture-building activities such as town halls led by black employees and allies, support for transgender employees, and unconscious-bias workshops are why employees say Google is a safe and inclusive place to work.[17] Clearly Google leaders recognize culture is critical to the company's overall success.

6.5 Controlling

How do organizations control activities?

The fourth key function that managers perform is controlling. Controlling is the process of assessing the organization's progress toward accomplishing its goals. It includes monitoring the implementation of a plan and correcting deviations from that plan. As Exhibit 6.6 shows, controlling can be visualized as a cyclical process made up of five stages:

Exhibit 6.6 The Control Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Performance standards are the levels of performance the company wants to attain. These goals are based on its strategic, tactical, and operational plans. The most effective performance standards state a measurable behavioural objective that can be achieved in a specified time frame. For example, the performance objective for the sales division of a company could be stated as "$200,000 in gross sales for the month of January." Each individual employee in that division would also have a specified performance goal. Actual firm, division, or individual performance can be measured against desired performance standards to see if a gap exists between the desired level of performance and the actual level of performance. If a performance gap does exist, the reason for it must be determined and corrective action taken.

Feedback is essential to the process of control. Most companies have a reporting system that identifies areas where performance standards are not being met. A feedback system helps managers detect problems before they get out of hand. If a problem exists, the managers take corrective action. Toyota uses a simple but effective control system on its automobile assembly lines. Each worker serves as the customer for the process and is empowered to act as a quality control inspector. If a part is defective or not installed properly, the next worker won't accept it. Any worker can alert the supervisor to a problem by tugging on a rope that turns on a warning light (i.e., feedback). If the problem isn't corrected, the worker can stop the entire assembly line.

Why is controlling such an important part of a manager's job? First, it helps managers to determine the success of the other three functions: planning, organizing, and leading. Second, control systems direct employee behaviour toward achieving organizational goals. Third, control systems provide a means of coordinating employee activities and integrating resources throughout the organization.

6.6 Managerial Roles

What roles do managers take on in different organizational settings?

In carrying out the responsibilities of planning, organizing, leading, and controlling, managers take on many different roles. A role is a set of behavioural expectations, or a set of activities that a person is expected to perform. Managers' roles fall into three basic categories: informational roles, interpersonal roles, and decisional roles. These roles are summarized in Table 6.5. In an **informational role**, the manager may act as an information gatherer, an information distributor, or a spokesperson for the company. A manager's **interpersonal roles** are based on various interactions with other people. Depending on the situation, a manager may need to act as a figurehead, a company leader, or a liaison. When acting in a **decisional role**, a manager may have to think like an entrepreneur, make decisions about resource allocation, help resolve conflicts, or negotiate compromises.

Managerial Decision Making

In every function performed, role taken on, and set of skills applied, a manager is a decision maker. Decision- making means choosing among alternatives. Decision-making occurs in response to the identification of a problem or an opportunity. The decisions managers make fall into two basic categories: programmed and nonprogrammed. **Programmed decisions** are made in response to routine situations that occur frequently in a variety of settings throughout an organization. For example, the need to hire new personnel is a common situation for most organizations. Therefore, standard procedures for recruitment and selection are developed and followed in most companies.

The Many Roles Managers Play in an Organization		
Role	**Description**	**Example**
Information Roles		
Monitor	Seeks out and gathers information relevant to the organization	Finding out about legal restrictions on new product technology
Disseminator	Provides information where it is needed in the organization	Providing current production figures to workers on the assembly line
Spokesperson	Transmits information to people outside the organization	Representing the company at a shareholders' meeting
Interpersonal Roles		
Figurehead	Represents the company in a symbolic way	Cutting the ribbon at ceremony for the opening of a new building
Leader	Guides and motivates employees to achieve organizational goals	Helping subordinates to set monthly performance goals
Liaison	Acts as a go-between among individuals inside and outside the organization	Representing the retail sales division of the company at a regional sales meeting
Decisional Roles		
Entrepreneur	Searches out new opportunities and initiates change	Implementing a new production process using new technology
Disturbance handler	Handles unexpected events and crises	Handling a crisis situation such as a fire
Resource allocator	Designates the use of financial, human, and other organizational resources	Approving the funds necessary to purchase computer equipment and hire personnel
Negotiator	Represents the company at negotiating processes	Participating in salary negotiations with union representatives

Table 6.5

Infrequent, unforeseen, or very unusual problems and opportunities require **nonprogrammed decisions** by managers. Because these situations are unique and complex, the manager rarely has a precedent to follow. The earlier example of the Norfolk Southern employee, who had to decide the best way to salvage a five-mile- long piece of railroad track from the bottom of Lake Pontchartrain, is an example of a nonprogrammed decision. Likewise, when Hurricane Katrina was forecast to make landfall, Thomas Oreck, then CEO of the vacuum manufacturer that bears his name, had to make a series of nonprogrammed decisions. Oreck's corporate headquarters were in New Orleans, and its primary manufacturing facility was in Long Beach, Mississippi. Before the storm hit, Oreck transferred its computer systems and call-center operations to backup locations in Colorado and planned to move headquarters to Long Beach. The storm, however, brutally hit both locations. Oreck executives began searching for lost employees, tracking down generators, assembling temporary housing for workers, and making deals with UPS to begin distributing its product (UPS brought food and water to Oreck from Atlanta and took vacuums back to the company's distribution center there). All these decisions were made in the middle of a very challenging crisis environment.

Whether a decision is programmed or nonprogrammed, managers typically follow five steps in the decision- making process, as illustrated in Exhibit 6.7:

1. Recognize or define the problem or opportunity. Although it is more common to focus on problems because of their obvious negative effects, managers who do not take advantage of new opportunities may lose competitive advantage to other firms.
2. Gather information to identify alternative solutions or actions.
3. Select one or more alternatives after evaluating the strengths and weaknesses of each possibility.
4. Put the chosen alternative into action.
5. Gather information to obtain feedback on the effectiveness of the chosen plan.

It can be easy (and dangerous) for managers to get stuck at any stage of the decision-making process. For example, entrepreneurs can become paralyzed evaluating the options. For the Gabby Slome, the cofounder of natural pet food maker Ollie, the idea for starting the company came after her rescue dog began having trouble digesting store-bought pet food after living on scraps. Slome decided that the pet food industry, a $30 billion a year business, was ripe for a natural food alternative. She laments, however, that she let perfect be the enemy of the very good by indulging in "analysis paralysis."[18]

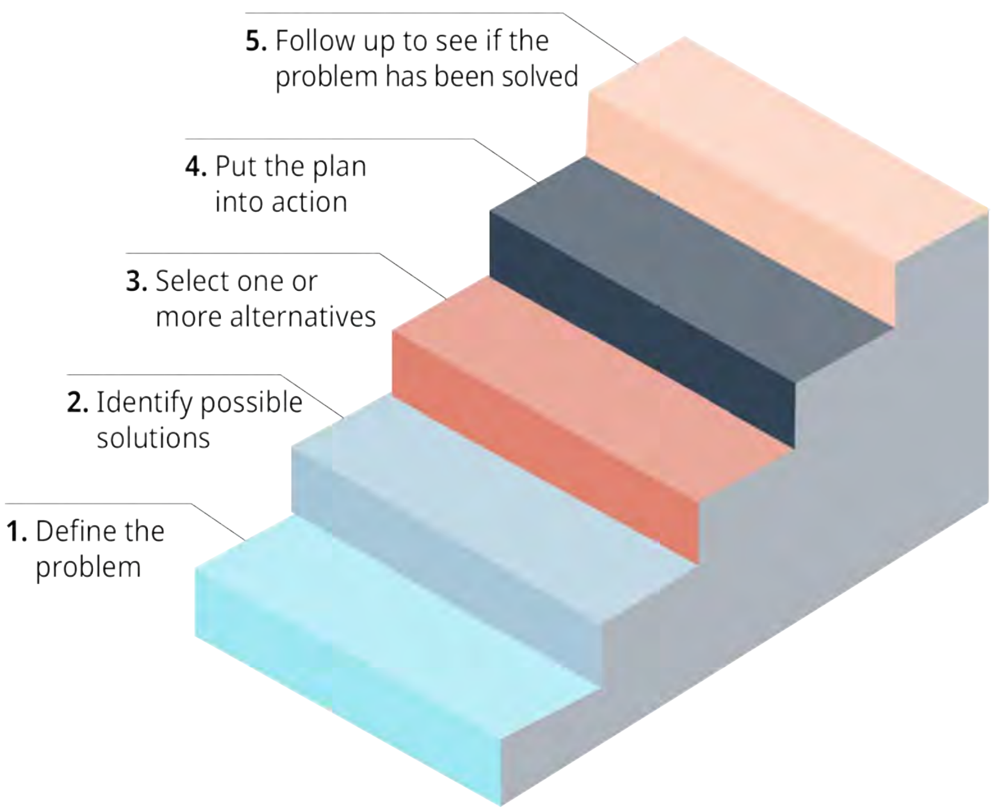


Exhibit 6.7 The Decision-Making Process (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

6.7 Managerial Skills

What set of managerial skills is necessary for managerial success?

To be successful in planning, organizing, leading, and controlling, managers must use a wide variety of skills. A *skill* is the ability to do something proficiently. Managerial skills fall into three basic categories: technical, human relations, and conceptual skills. The degree to which each type of skill is used depends upon the level of the manager's position as seen in Exhibit 6.8. Additionally, in an increasingly global marketplace, it pays for managers to develop a special set of skills to deal with global management issues.

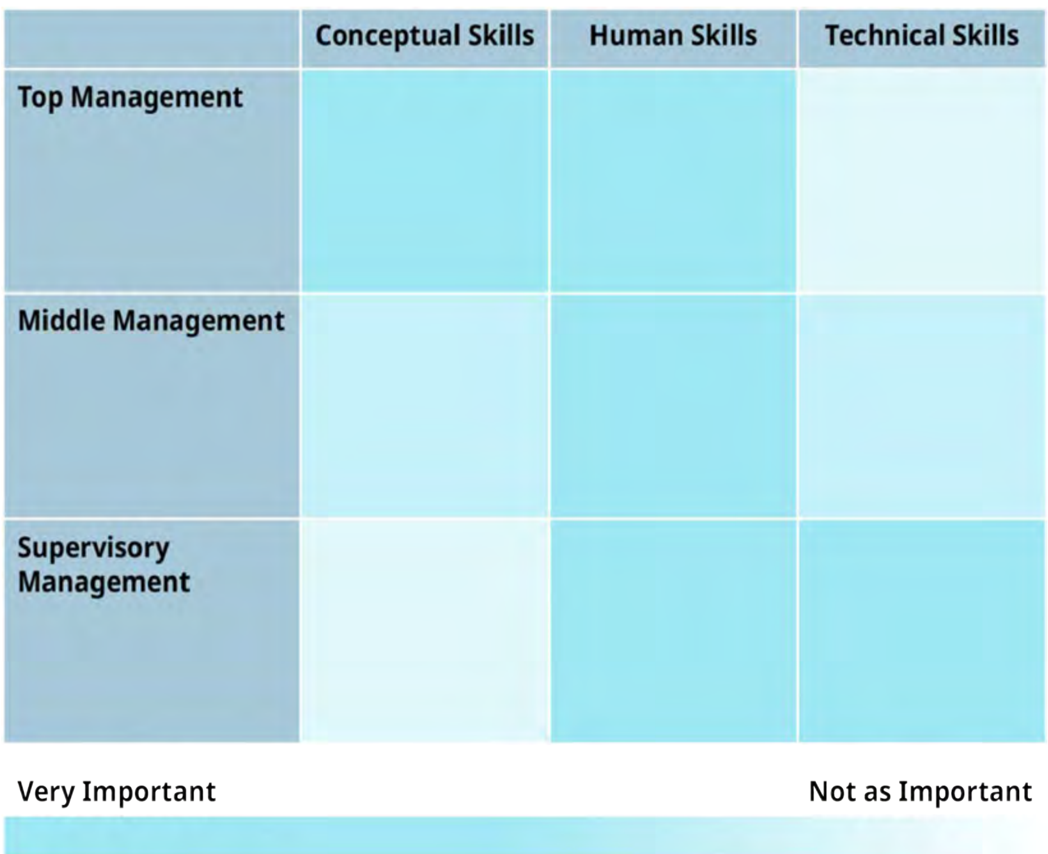


Exhibit 6.8 The Importance of Managerial Skills at Different Management Levels (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Technical Skills

Specialized areas of knowledge and expertise and the ability to apply that knowledge make up a manager's **technical skills**. Preparing a financial statement, programming a computer, designing an office building, and analyzing market research are all examples of technical skills. These types of skills are especially important for supervisory managers because they work closely with employees who are producing the goods and/or services of the firm.

Human Relations Skills

Human relations skills are the interpersonal skills managers use to accomplish goals using human resources. This set of skills includes the ability to understand human behaviour, to communicate effectively with others, and to motivate individuals to accomplish their objectives. Giving positive feedback to employees, being sensitive to their individual needs, and showing a willingness to empower subordinates are all examples of good human relations skills. Identifying and promoting managers with human relations skills are important for companies. A manager with little or no people skills can end up using an authoritarian leadership style and alienating employees.

Conceptual Skills

Conceptual skills include the ability to view the organization as a whole, understand how the various parts are interdependent, and assess how the organization relates to its external environment. These skills allow managers to evaluate situations and develop alternative courses of action. Good conceptual skills are especially necessary for managers at the top of the management pyramid, where strategic planning takes place.

6.8 Trends in Management and Leadership

What trends will affect management in the future?

Four important trends in management today are crisis management, outside directors, the growing use of information technology, and the increasing need for global management skills.

Crisis Management

Crises, both internal and external, can hit even the best-managed organization. Sometimes organizations can anticipate crises, in which case managers develop contingency plans, and sometimes they can't. Take, for example, the sudden death of McDonald's CEO Jim Cantalupo. The company had a solid succession plan in place and immediately named Charlie Bell as new CEO. Only a few months later, Bell announced that he had terminal cancer. Even though the company had prepared for the event of its leader's untimely death, surely it couldn't have anticipated that his successor would also be stricken by a terminal illness at almost the same time. Likewise, consider the devastation caused by Hurricanes Harvey, Irma, Maria, and Nate in 2017. Part of Marriott Hotels' crisis management plan included relaxing its "no pets" policy and allowing patrons fleeing the storm to check in with their pets because it was the right thing to do.[19]

Crises cannot be fully anticipated, but managers can develop contingency plans to help navigate through the aftermath of a disaster. For example, consider the challenges that faced Rajiv Joseph, the author of several plays including *Bengal Tiger at the Baghdad Zoo*, who was in Houston preparing to open his new play, *Describe the Night*, at the Alley Theater when Hurricane Harvey hit and flooded the theater a few weeks prior to opening night. The six New York–based actors, the director, the stage manager, and Joseph decided to help in the relief efforts and made their way to the George Brown Convention Center, which had become the central location for relief efforts. When they arrived, and the staffers discovered they were theater artists, they were deployed to handle the writing and deployment of public address announcements and manage the incoming crowds.

What made the relief efforts successful was planning—matching the skill sets of volunteers with tasks they are best able to perform.[20] Even though those in charge of the relief efforts had contingency plans, they still needed to make dozens of nonprogrammed decisions to effectively manage the ever-changing situation.[21]

No manager or executive can be completely prepared for these types of unexpected crises. However, how a manager handles the situation could mean the difference between disaster, survival, and even financial gain. No matter the crisis, there are some basic guidelines managers should follow to minimize negative outcomes. Managers should not become immobilized by the problem or ignore it. Managers should face the problem head on. Managers should always tell the truth about the situation and then put the best people on the job to correct the problem. Managers should ask for help if they need it, and finally, managers must learn from the experience to avoid the same problem in the future.[22] Table 6.6 describes what CEOs and other leaders learned about crisis management.

Managers and Information Technology

The second trend having a major impact on managers is the proliferation of data and analytics in information technology. An increasing number of organizations are selling technology, and an increasing number are looking for cutting-edge technology to make and market the products and services they sell. One particularly useful type of technology is dashboard software. Much like the dashboard in a car, dashboard software gives managers a quick look into the relevant information they need to manage their companies. Most large companies are organized in divisions, and often each division relies on a particular type of application or database software. Dashboard software allows employees to access information from software they don't routinely use, for example, from an application used by a different division from their own. More important, however, is the ability of a dashboard to show up-to-the-minute information and to allow employees to see all the information they need—such as financial and performance data—on a single screen.

Lessons Leaders Learned about Managing Crises	
Howard Schultz Chairman, Starbucks	Learn from one crisis at a time. After the Seattle earthquake of 2001, the company invested in a notification system that could handle text messaging. The night before Hurricane Katrina hit, Starbucks sent out 2,300 phone calls to associates in the region, telling them about available resources.
Lary Loveman CEO, Harrah's	Make life easier for your employees. Before the storm hit, management announced that in the event of total entertainment disaster, employees would be paid for at least 90 days. The decision was meant to provide employees with some certainty during a very uncertain time.
J.W. Marriott CEO, Marriott	Communicate for safety. Marriott moved its email system out of New Orleans before Katrina hit. As a result, employees were able to communicate with each other and vendors to get food and water to affected areas. A massive publicity campaign (Dial 1-800-Marriott) helped the company find 2,500 of its 2,800 people in the region.

Table 6.6 Sources: Danny Gavin, "Customer Service Lessons Learned in the Wake of Hurricane Harvey," Forbes, September 26, 2017; Jay Steinfeld, "5 Lessons Learned from Hurricane Harvey," Inc., September 21, 2017; Susan Burns and David Hackett, "Business Lessons from Hurricane Irma," 941CEO, November-December 2017; "New Lessons to Learn," Fortune, October 3, 2005, pp. 87–88; AZQuotes, Accessed February 25, 2018, http://www.azquotes.com/quote/863856.

Lessons Leaders Learned about Managing Crises	
Geno Auriemma University of Connecticut Basketball Coach	It's about doing it in a way that it can't be done any better. That is the goal every day.
Danny Gavin, VP, Brian Gavin Diamonds	"Create an unforgettable customer experience" may sound like a cliché, but this is our golden rule. Despite waist-high water and treacherous conditions, we had several international orders that needed to be shipped the Wednesday after Hurricane Harvey hit. FedEx and UPS had ceased operations around the Houston area during the storm, but our CEO Brian Gavin was determined to deliver an outstanding customer service experience. That's why he drove with the packages in hand to the nearest FedEx store that was open: College Station. The standard three-hour round trip ended up taking five hours.
Bob Bardelli CEO, Home Depot	Prepare for the next big one. After each catastrophic event, Home Depot does a postmortem on its response efforts so that employees and managers can become more experienced and better prepared. Before Katrina hit, the company prestaged extra supplies and generators, sent 1,000 relief associates to work in the stores in the Gulf Region, and made sure that area stores were overstocked with first-response items such as insecticides, water, and home generators.
Scott Ford CEO, Alltel	Take care of everybody. When Katrina hit, Alltel was missing 35 employees. When the company had found all but one, managers used the company's network infrastructure to track her phone activity, contact the last person she had called, and worked with the army to find her.
Paul Pressler CEO, Gap	Empower the workforce. Gap had 1,300 employees affected by Katrina, and one of the biggest problems the company faced was getting people their paychecks. The company, which had extended payroll by 30 days to affected employees, now encourages all employees to use direct deposit as a means to ensure access to their pay.
Jim Skinner CEO, Mcdonalds	Be flexible with company assets. McDonald's had 280 restaurants close in the immediate aftermath of the storm, but shortly afterward, 201 were already open. During the crisis, McDonald's converted its human resource service center into a crisis command center. The quickly formed help center fielded 3,800 calls.
Robert Baugh COO, Chiles Restaurants	With Hurricane Irma approaching, Baugh communicated with staff for several days before the storm to prepare and to find out which employees would be evacuating, which would be staying, and which had special needs. The Chiles Group used Hot Schedules, a platform all employees log into, to create a timeline to secure all three restaurants (since these restaurants have lots of outdoor seating and outdoor bars, it was a huge chore) and to broadcast when the restaurants would reopen. Team leaders were responsible for communicating with their members. Vendors and chefs were told earlier in the week to reduce food orders to minimize loss. Freezers and refrigerators were packed with hundreds of bags of ice.

Table 6.6 Sources: Danny Gavin, "Customer Service Lessons Learned in the Wake of Hurricane Harvey," Forbes, September 26, 2017; Jay Steinfeld, "5 Lessons Learned from Hurricane Harvey," Inc., September 21, 2017; Susan Burns and David Hackett, "Business Lessons from Hurricane Irma," 941CEO, November-December 2017; "New Lessons to Learn," Fortune, October 3, 2005, pp. 87–88; AZQuotes, Accessed February 25, 2018, http://www.azquotes.com/quote/863856.

Such integrated functionality made dashboards extremely popular. A Gartner commentary suggests that companies put data and analytics at the heart of every company business decision.[23] Despite the increasing popularity of dashboard technology, the control tool has some drawbacks, such as focusing too intently on short-term results and ignoring the overall progress toward long-term goals. And some employees might bristle at being monitored as closely as dashboard tools allow.

Nonetheless, companies are seeing real results from implementing dashboard software. Robert Romanoff, a partner at the law firm of Levenfeld Romanoff in Chicago, uses dashboards that aggregate data from clients, strategic partners, and internal staff from the mailroom to the boardroom to improve what he calls the 3 Ps. The 3 Ps are process efficiency, project management, and strategic pricing.[24]

Exhibit 6.9 Marketing and sales professionals are increasingly turning to advanced software programs called “dashboards” to monitor business and evaluate performance. These computer tools use analytics and big data to help managers identify valuable customers, track sales, and align plans with company objectives—all in real time. A typical dashboard might include sales and bookings forecasts, monthly close data, customer satisfaction data, and employee training schedules. This example tracks customers attending the Consumer Electronics Show so that the buzz created by influencers can be measured. *How does information technology affect managerial decision-making?* (Credit: Intel Free Press/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Managing Multinational Cultures

The increasing globalization of the world market has created a need for managers who have **global management skills**, that is, the ability to operate in diverse cultural environments. With more and more companies choosing to do business in multiple locations around the world, employees are often required to learn the geography, language, and social customs of other cultures. It is expensive to train employees for foreign assignments and pay their relocation costs; therefore, choosing the right person for the job is especially important. Individuals who are open minded, flexible, willing to try new things, and comfortable in a multicultural setting are good candidates for international management positions.

As companies expand around the globe, managers will continue to face the challenges of directing the behaviour of employees around the world. They must recognize that because of cultural differences, people respond to similar situations in very different ways. The burden, therefore, falls on the manager to produce results while adapting to the differences among the employees he or she manages.

How a manager gets results, wins respect, and leads employees varies greatly among countries, cultures, and individuals. For example, different cultures have different approaches to time. American, German, and Swiss cultures, among others, take a linear view of time, whereas southern European counties such as Italy take a multi-active time approach, and many Eastern cultures, such as China, take a cyclic approach. An American manager with a linear view of time will approach schedule planning with a different method than colleagues with a multi-active or cyclic approach.[25] Despite differences such as these (examples of which can be cited for every country in the world), managing within a different culture is only an extension of what managers do every day: working with differences in employees, processes, and projects.

Key Terms

autocratic leaders	Directive leaders who prefer to make decisions and solve problems on their own with little input from subordinates.
coercive power	Power that is derived from an individual's ability to threaten negative outcomes.
conceptual skills	A manager's ability to view the organization as a whole, understand how the various parts are interdependent, and assess how the organization relates to its external environment.
consensual leaders	Leaders who encourage discussion about issues and then require that all parties involved agree to the final decision.
consultative leaders	Leaders who confer with subordinates before making a decision but retain the final decision-making authority.
contingency plans	Plans that identify alternative courses of action for very unusual or crisis situations; typically stipulate the chain of command, standard operating procedures, and communication channels the organization will use during an emergency.
controlling	The process of assessing the organization's progress toward accomplishing its goals; includes monitoring the implementation of a plan and correcting deviations from the plan.
corporate culture	The set of attitudes, values, and standards that distinguishes one organization from another.
decisional roles	A manager's activities as an entrepreneur, resource allocator, conflict resolver, or negotiator.
democratic leaders	Leaders who solicit input from all members of the group and then allow the members to make the final decision through a vote.
effectiveness	The ability to produce the desired result or good.
efficiency	Using the least amount of resources to accomplish the organization's goals.
empowerment	The process of giving employees increased autonomy and discretion to make decisions, as well as control over the resources needed to implement those decisions.
expert power	Power that is derived from an individual's extensive knowledge in one or more areas.
free-rein (laissez-faire) leadership	A leadership style in which the leader turns over all authority and control to subordinates.
global management skills	A manager's ability to operate in diverse cultural environments.
human relations skills	A manager's interpersonal skills that are used to accomplish goals through the use of human resources.
informational roles	A manager's activities as an information gatherer, an information disseminator, or a spokesperson for the company.
interpersonal roles	A manager's activities as a figurehead, company leader, or liaison.
leadership	The process of guiding and motivating others toward the achievement of organizational goals.
leadership style	The relatively consistent way that individuals in leadership positions attempt to influence the behaviour of others.

Key Terms

legitimate power	Power that is derived from an individual's position in an organization.
management	The process of guiding the development, maintenance, and allocation of resources to attain organizational goals.
middle management	Managers who design and carry out tactical plans in specific areas of the company.
mission	An organization's purpose and reason for existing; its long-term goals.
mission statement	A formal document that states an organization's purpose and reason for existing and describes its basic philosophy.
nonprogrammed decisions	Responses to infrequent, unforeseen, or very unusual problems and opportunities where the manager does not have a precedent to follow in decision-making.
operational planning	The process of creating specific standards, methods, policies, and procedures that are used in specific functional areas of the organization; helps guide and control the implementation of tactical plans.
organizing	The process of coordinating and allocating a firm's resources in order to carry out its plans.
participative leaders	Leaders who share decision-making with group members and encourage discussion of issues and alternatives; includes democratic, consensual, and consultative styles.
planning	The process of deciding what needs to be done to achieve organizational objectives; identifying when and how it will be done; and determining who should do it.
power	The ability to influence others to behave in a particular way.
programmed decisions	Decisions made in response to frequently occurring routine situations.
referent power	Power that is derived from an individual's personal charisma and the respect and/or admiration the individual inspires.
reward power	Power that is derived from an individual's control over rewards.
situational leadership	Selecting a leadership style based on the maturity and competency level of those who will complete the task.
strategic planning	The process of creating long-range (one to five years), broad goals for the organization and determining what resources will be needed to accomplish those goals.
supervisory (first-line) management	Managers who design and carry out operation plans for the ongoing daily activities of the firm.
tactical planning	The process of beginning to implement a strategic plan by addressing issues of coordination and allocating resources to different parts of the organization; has a shorter time frame (less than one year) and more specific objectives than strategic planning.
technical skills	A manager's specialized areas of knowledge and expertise, as well as the ability to apply that knowledge.
top management	The highest level of managers; includes CEOs, presidents, and vice presidents, who develop strategic plans.

Summary of Learning Outcomes

1. What is the role of management?

Management is the process of guiding the development, maintenance, and allocation of resources to attain organizational goals. Managers are the people in the organization responsible for developing and carrying out this management process. The four primary functions of managers are planning, organizing, leading, and controlling. By using the four functions, managers work to increase the efficiency and effectiveness of their employees, processes, projects, and organizations as a whole.

2. What are the four types of planning?

Planning is deciding what needs to be done, identifying when and how it will be done, and determining who should do it. Managers use four different types of planning: strategic, tactical, operational, and contingency planning. Strategic planning involves creating long-range (one to five years), broad goals and determining the necessary resources to accomplish those goals. Tactical planning has a shorter time frame (less than one year) and more specific objectives that support the broader strategic goals. Operational planning creates specific standards, methods, policies, and procedures that are used in specific functional areas of the organization. Contingency plans identify alternative courses of action for very unusual or crisis situations.

3. What are the primary functions of managers in organizing activities?

Organizing involves coordinating and allocating a firm's resources in order to carry out its plans. It includes developing a structure for the people, positions, departments, and activities within the firm. This is accomplished by dividing up tasks (division of labor), grouping jobs and employees (departmentalization), and assigning authority and responsibilities (delegation).

4. How do leadership styles influence a corporate culture?

Leading is the process of guiding and motivating others toward the achievement of organizational goals. Managers have unique leadership styles that range from autocratic to free-rein. The set of attitudes, values, and standards of behavior that distinguishes one organization from another is called corporate culture. A corporate culture evolves over time and is based on the accumulated history of the organization, including the vision of the founders.

5. How do organizations control activities?

Controlling is the process of assessing the organization's progress toward accomplishing its goals. The control process is as follows: (1) set performance standards (goals), (2) measure performance, (3) compare actual performance to established performance standards, (4) take corrective action (if necessary), and (5) use information gained from the process to set future performance standards.

6. What roles do managers take on in different organizational settings?

In an informational role, the manager may act as an information gatherer, an information distributor, or a spokesperson for the company. A manager's interpersonal roles are based on various interactions with other people. Depending on the situation, a manager may need to act as a figurehead, a company leader, or a liaison.

Summary of Learning Outcomes

7. What set of managerial skills is necessary for managerial success?

Managerial skills fall into three basic categories: technical, human relations, and conceptual skills. Specialized areas of knowledge and expertise and the ability to apply that knowledge make up a manager's technical skills. Human relations skills include the ability to understand human behaviour, to communicate effectively with others, and to motivate individuals to accomplish their objectives. Conceptual skills include the ability to view the organization as a whole, understand how the various parts are interdependent, and assess how the organization relates to its external environment.

8. What trends will affect management in the future?

Three important trends in management today are preparing for crises management, the increasing use of information technology, and the need to manage multinational cultures. Crisis management requires quick action, telling the truth about the situation, and putting the best people on the task to correct the situation. Finally, management must learn from the crisis in order to prevent it from happening again. Using the latest information technology, such as dashboard software, managers can make quicker, better-informed decisions. As more companies "go global," the need for multinational cultural management skills is growing. Managers must set a good example, create personal involvement for all employees, and develop a culture of trust.

Chapter 7

Money and Banking

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. What is money, what are its characteristics and functions, and what are the three parts of the Canadian money supply?
2. How does the Bank of Canada manage the money supply?
3. What are the key financial institutions, and what role do they play in the process of financial intermediation?
4. How does the Canada Deposit Insurance Corporation (CDIC) protect depositors' funds?
5. What roles do Canadian banks play in the international marketplace?
6. What trends are reshaping financial institutions?

7.1 Show Me the Money

What is money, what are its characteristics and functions, and what are the three parts of the Canadian money supply?

Money is anything that is acceptable as payment for goods and services. It affects our lives in many ways. We earn it, spend it, save it, invest it—and often wish we had more of it. Businesses and governments use money in similar ways. Both require money to finance their operations. By controlling the amount of money in circulation, the federal government can promote economic growth and stability. For this reason, money has been called the lubricant of the machinery that drives our economic system. Our banking system was developed to ease the handling of money.

Characteristics of Money

For money to be a suitable means of exchange, it should have these key characteristics:

- *Scarcity*: Money should be scarce enough to have some value but not so scarce as to be unavailable. Pebbles, which meet some of the other criteria, would not work well as money because they are widely available. Too much money in circulation increases prices and inflation. Governments control the scarcity of money by limiting the quantity of money in circulation.
- *Durability*: Any item used as money must be durable. A perishable item such as a banana becomes useless as money when it spoils. Even early societies used durable forms of money, such as metal coins and paper money, which lasted for a long time.
- *Portability*: Money must be easily moved around. Large or bulky items, such as boulders or heavy gold bars, cannot be transported easily from place to place.
- *Divisibility*: Money must be capable of being divided into smaller parts. Divisible forms of money help make transactions of all sizes and amounts possible.

Functions of Money

Using a variety of items as money would be confusing. Thus, societies develop a uniform money system to measure the value of goods and services. For money to be acceptable, it must function as a medium of exchange, as a standard of value, and as a store of value.

As a *medium of exchange*, money makes transactions easier. Having a common form of payment is much less complicated than having a barter system, wherein goods and services are exchanged for other goods and services. Money allows the exchange of products to be a simple process.

Money also serves as a *standard of value*. With a form of money whose value is accepted by all, goods and services can be priced in standard units. This makes it easy to measure the value of products and allows transactions to be recorded in consistent terms.

As a *store of value*, money is used to hold wealth. It retains its value over time, although it may lose some of its purchasing power due to inflation. Individuals may choose to keep their money for future use rather than exchange it today for other types of products or assets.

The Canadian Money Supply

The Canadian money supply is composed of currency, demand deposits, and time deposits. **Currency** is cash held in the form of coins and paper money. Other forms of currency include travelers' checks, cashier's checks, and money orders. The amount of currency in circulation depends on public demand. Domestic demand is influenced primarily by prices for goods and services, income levels, and the availability of alternative payment methods such as credit cards.

Demand deposits consist of money kept in checking accounts that can be withdrawn by depositors on demand. Demand deposits include regular checking accounts as well as interest-bearing and other special types of checking accounts. **Time deposits** are deposits at a bank or other financial institution that pay interest but cannot be withdrawn on demand. Examples are certain savings accounts, money market deposit accounts, and certificates of deposit. Credit cards, sometimes referred to as "plastic money," are routinely used as a substitute for cash and checks. Credit cards are not money; they are a form of borrowing. When a bank issues a credit card to a consumer, it gives a short-term loan to the consumer by directly paying the seller for the consumer's purchases. The consumer pays the credit card company after receiving the monthly statement. Credit cards do not replace money; they simply defer payment.

7.2 The Bank of Canada

How does the Bank of Canada manage the money supply?

The Bank of Canada is Canada's central bank. It was created in 1935 during the depression. The Bank plays a crucial role in managing the Canadian economy and is very important to Canada's financial system as it regulates certain areas of chartered bank operations. The Bank is a government owned crown corporation but is run independently of the federal government; The Prime Minister (or anyone else in the government) does not make decisions for the Bank nor can it instruct the Bank of Canada on how to operate. The Bank is managed by a board of governors which consists of a governor, a deputy governor, and 12 directors appointed from different regions of the country. The Bank has 4 main responsibilities: regulating the financial system, designing and issuing bank notes, managing monetary policy and funds for the federal government.

The Bank of Canada's primary mission is to oversee the nation's monetary and credit system and to support the ongoing operation of Canada's private-banking system. The Bank's actions affect the interest rates banks charge businesses and consumers, help keep inflation under control, and ultimately stabilize the Canadian financial system.

Bank of Canada video:
https://youtu.be/ULqvuY2penk

Carrying Out Monetary Policy

The most important function of the Bank of Canada is carrying out monetary policy. It uses its power to change the money supply in order to control inflation and interest rates, increase employment, and influence economic activity. Two tools used by the Bank of Canada in managing the money supply are open market operations and the discount rate. Table 7.1 summarizes the short-term effects of these tools on the economy.

Open market operations—the tool most frequently used by the Bank of Canada to control the money supply growth rate—involves the buying and selling of government securities (Canadian government bonds). If the Bank wants to increase the money supply in the Canadian economy, it can buy government securities. When the Bank of Canada buys government securities, it puts money into the economy. Banks have more money to lend, so they reduce interest rates, which generally stimulates economic activity. The opposite occurs when the Bank of Canada sells government securities.

The Bank of Canada's Monetary Tools and Their Effects				
Tool	**Action**	**Effect on Money Supply**	**Effect on Interest Rates**	**Effect on Economic Activity**
Open market operations	Buy government bonds	Increases	Lowers	Stimulates
	Sell government bonds	Decreases	Raises	Slows Down

Table 7.1

The Federal Reserve System's Monetary Tools and Their Effects				
Tool	**Action**	**Effect on Money Supply**	**Effect on Interest Rates**	**Effect on Economic Activity**
Discount rate	Raise discount rate	Decreases	Raises	Slows Down
	Lower discount rate	Increases	Lowers	Stimulates

Table 7.2

The Bank of Canada is called “the banker’s bank” because it lends money to banks that need it. The interest rate that the bank of Canada charges its member banks is called the **discount rate**. It is also referred to as the bank rate. Commercial banks borrow from the Bank of Canada and then lend the funds at a higher rate to customers. The banks profit from the *spread*, or difference, between the rate they charge their customers and the rate paid to the Bank of Canada. Changes in the discount rate usually produce changes in the interest rate that banks charge their customers. The Bank of Canada raises the discount rate to slow the growth rate in the money supply, this makes it more expensive for the commercial banks to borrow. Commercial banks then raise the interest rates they charge to businesses and consumers at their branches. This slows down economic activity. When the Bank of Canada lowers the discount rate it has the opposite effect and stimulates growth.

7.3 Canadian Financial Institutions

What are the key financial institutions, and what role do they play in the process of financial intermediation?

The well-developed financial system in Canada supports our high standard of living. The system allows those who wish to borrow money to do so with relative ease. It also gives savers a variety of ways to earn interest on their savings. For example, a computer company that wants to build a new headquarters in Toronto might be financed partly with the savings of families in Calgary. The Calgarians deposit their money in a local financial institution. That institution looks for a profitable and safe way to use the money and decides to make a real estate loan to the computer company. The transfer of funds from savers to investors enables businesses to expand and the economy and grow.

Households are important participants in the Canadian financial system. Although many households borrow money to finance purchases, they supply funds to the financial system through their purchases and savings. Overall, businesses and governments are users of funds. They borrow more money than they save.

Sometimes those who have funds deal directly with those who want them. A wealthy realtor, for example, may lend money to a client to buy a house. Most often, financial institutions act as intermediaries—or go-betweens—between the suppliers and demanders of funds. The institutions accept savers’ deposits and invest them in financial products (such as loans) that are expected to produce a return. This process, called **financial intermediation**, is shown in Exhibit 7.1. Households are shown as suppliers of funds, and businesses and governments are shown as demanders. However, a single household, business, or government can be either a supplier or a demander, depending on the circumstances.

Financial institutions are the heart of the financial system. They are convenient vehicles for financial intermediation. They can be divided into two broad groups: depository institutions (those that accept deposits) and nondepository institutions (those that do not accept deposits).

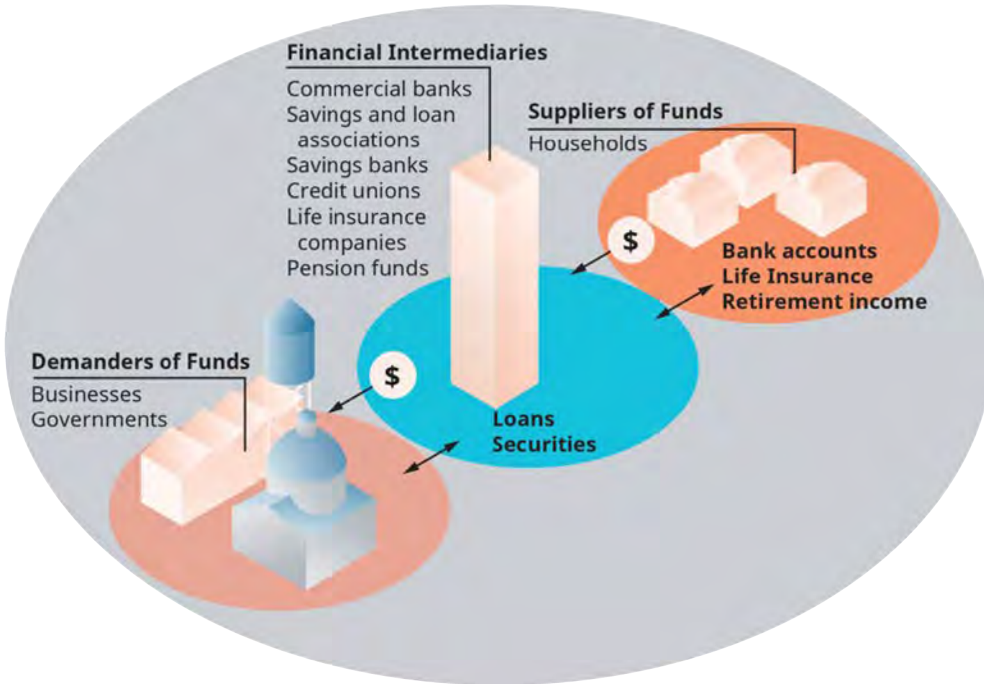


Exhibit 7.1 The Financial Intermediation Process* Only the dominant suppliers and demanders are shown here. Clearly, a single household, business, or government can be either a supplier or demander, depending on circumstances. (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

Depository Financial Institutions

Not all depository financial institutions are alike. Most people call the place where they save their money a "bank." Some of those places are indeed banks, but other depository institutions include thrift institutions and credit unions.

Commercial Banks

A **commercial bank** is a profit-oriented financial institution that accepts deposits, makes business and consumer loans, invests in government and corporate securities, and provides other financial services. Commercial banks are corporations owned and operated by individuals or other corporations. A large share of the nation's banking business is held by a relatively small number of big banks.

Customers' deposits are a commercial bank's major source of funds, the main use for which is loans. The difference between the interest the bank earns on loans and the interest it pays on deposits, plus fees it earns from other financial services, pays the bank's costs and provides a profit.

Credit Unions

A **credit union** is a not-for-profit, member-owned financial cooperative. Credit union members typically have something in common: they may, for example, work for the same employer, belong to the same union or professional group, or attend the same church or school. The credit union pools their assets, or savings, in order to make loans and offer other services to members. The not-for-profit status of credit unions makes them tax-exempt, so they can pay good interest rates on deposits and offer loans at favorable interest rates.

Credit unions video:
https://youtu.be/0LIpQ5Er02E

Nondepository Financial Institutions

Some financial institutions provide certain banking services but do not accept deposits. These nondepository financial institutions include insurance companies, pension funds, brokerage firms, and finance companies. They serve both individuals and businesses.

Insurance Companies

Insurance companies are major suppliers of funds. Policyholders make payments (called *premiums*) to buy financial protection from the insurance company. Insurance companies invest the premiums in stocks, bonds, real estate, business loans, and real estate loans for large projects.

Exhibit 7.2 Insurance companies, hurt by billions of dollars in unforeseen payouts during natural disasters such as Hurricane Irma in 2017, are rethinking their reliance on catastrophe-risk modelers, whose risk estimates failed to anticipate cataclysmic storms such as Hurricanes Katrina, Irma, and Harvey. Cat-risk businesses forecast potential weather-related expenses for insurers through sophisticated computer modeling that analyzes historical meteorological data. *How do frequent natural disasters affect insurance companies and their policyholders?* (Credit: Cayobo/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))

Services Offered by Depository Financial Institutions	
Service	**Description**
Savings accounts	Pay interest on deposits
Checking accounts	Allow depositors to withdraw any amount of funds at any time up to the amount on deposit
Money market deposit accounts	Savings accounts on which the interest rate is set at market rates
Certificates of deposit (CD)	Pay a higher interest rate than regular savings accounts, provided that the deposit remains for a specified period
Consumer loans	Loans to individuals to finance the purchase of a home, car, or other expensive items
Business loans	Loans to businesses and other organizations to finance their operations
Electronic funds transfer	Use of computers and mobile devices to conduct financial transactions
Automated teller machine (ATM)	Allows bank customers to make deposits, withdrawals, and transfers from their accounts 24 hours a day
Debit cards	Allow customers to transfer money from their bank account directly to a merchant's account to pay for purchases
Online banking	Allows customers to conduct financial transactions via the internet or through a dial-in line that operates with a bank's software
Mobile apps	Technology that allows consumers to download programs to mobile devices that enable them to take care of banking, financial, and other transactions
Direct deposit of paychecks	Enabled through employers and payroll service vendors; allows financial institutions to accept direct deposits of payroll checks to consumers' checking and/or savings accounts on a regular basis

Table 7.3

Pension Funds

Corporations, unions, and governments set aside large pools of money for later use in paying retirement benefits to their employees or members. These **pension funds** are managed by the employers or unions themselves or by outside managers, such as life insurance firms, commercial banks, and private investment firms. Pension plan members receive a specified monthly payment when they reach a given age. After setting aside enough money to pay near-term benefits, pension funds invest the rest in business loans, stocks, bonds, or real estate. They often invest large sums in the stock of the employer.

Brokerage Firms

A *brokerage firm* buys and sells securities (stocks and bonds) for its clients and gives them related advice.

Many brokerage firms offer some banking services. They may offer clients a combined checking and savings account with a high interest rate and also make loans, backed by securities, to them.

Finance Companies

A *finance company* makes short-term loans for which the borrower puts up tangible assets (such as an automobile, inventory, machinery, or property) as security. Finance companies often make loans to individuals or businesses that cannot get credit elsewhere. Promising new businesses with no track record and firms that can't get more credit from a bank often obtain loans from *commercial finance companies*. *Consumer finance companies* make loans to individuals, often to cover the lease or purchase of large consumer goods such as automobiles or major household appliances. To compensate for the extra risk, finance companies usually charge higher interest rates than banks.

7.4 Insuring Bank Deposits

How does the Canada Deposit Insurance Corporation (CDIC) protect depositors' funds?

The Canada Deposit Insurance Corporation (CDIC) is a federal agency that insures most bank deposits in Canada. It was created in 1967 to instill public confidence in the Canadian banking system. Before the CDIC was established, if a bank was in trouble or even if there was a rumour that a bank was in financial jeopardy, depositors would rush to the bank to withdraw their money, this was known as a run on the bank. Only the people that got their first would get their money as the banks would run out of money and then go bankrupt leaving many depositors without receiving any of their money. Now, if a CDIC-insured bank goes bankrupt depositors are reimbursed up to $100 000.

7.5 International Banking

What roles do Canadian banks play in the international marketplace?

The financial marketplace spans the globe, with money routinely flowing across international borders. Canadian banks play an important role in global business by providing loans to foreign governments and businesses. Multinational corporations need many special banking services, such as foreign-currency exchange and funding for overseas investments. Canadian banks also offer trade-related services, such as global cash management, that help firms manage their cash flows, improve their payment efficiency, and reduce their exposure to operational risks. Sometimes consumers in other nations have a need for banking services that banks in their own countries don't provide. Therefore, large banks often look beyond their national borders for profitable banking opportunities.

Many Canadian banks have expanded into the United States. The arena that the Boston Bruins and Celtics play out of is now called the TD Garden. They have also expanded into overseas markets by opening offices in Europe, Latin America, the Caribbean, and Asia. They often provide better customer service than local banks and have access to more sources of funding.

For Canadian banks, expanding internationally can be difficult. Banks in other nations are often subject to fewer regulations than Canadian banks, making it easier for them to undercut Canadian banks on the pricing of loans and services. Some governments also protect their banks against foreign competition. For example, the Chinese government imposes high fees and limits the amount of deposits that foreign banks can accept from customers. It also controls foreign-bank deposit and loan interest rates, limiting the ability of foreign banks to compete with government-owned Chinese banks.

The World's Biggest Banks, 2017
Industrial and Commercial Bank of China
China Construction Bank
JPMorgan Chase & Co. (USA)
Wells Fargo & Co. (USA)
Agricultural Bank of China
Bank of America Corp. (USA)
Bank of China Ltd.
Citigroup (USA)
BNP Paribas (France)
Mitsubishi UFJ Financial Group (Japan)

Political and economic uncertainty in other countries can make international banking a high-risk venture. European and Asian banks were not immune to the financial crisis of 2007–2009. In fact, several countries, including Greece, Portugal, Spain, and Ireland, continue to rebound slowly from the near-collapse of their economic and financial systems they experienced a decade ago. Financial bailouts spearheaded by the European Union and the International Monetary Fund have helped stabilize the European and global economy. It is unclear at this time, however, whether the impending "Brexit" move by the United Kingdom (leaving the European Union) will impact international banking, as many of the world's top financial institutions seek to move their global operations out of London and shift them to other financial capitals within the eurozone.[1]

Table 7.4 Source: "The World's Biggest Banks in 2017: The American Bull Market Strengthens," *Forbes,* http://www.forbes.com, May 24, 2017.

7.6 Trends in Financial Institutions

What trends are reshaping financial institutions?

What factors will influence financial institutions in the coming years? The latest reports suggest there will be a continued focus on regulatory and compliance issues (especially after the recent financial crisis), as well as on operational efficiency and technological advances.

Banks will continue to tackle customer engagement and technology initiatives over the next few years. According to a report by Aite Group, a Boston-based firm that forecasts banking trends, technology continues to empower consumers to control their banking and commerce experiences. Financial institutions have become better at using data and data analytics to improve their understanding of customers' needs and behaviours, which may provide them the competitive advantage they seek in the retail banking industry.[2]

Financial technology (or "fintech" services) will continue to disrupt the banking industry and provide opportunities for banks and other institutions to work closely with fintech companies that can help them innovate and streamline their business practices. According to recent research by Goldman Sachs, fintech startups have the potential to take away billions of dollars in business from traditional investment and lending institutions. Some of the services offered by fintech firms include payment transaction processing, mobile and web payment services for e-commerce firms, peer-to-peer lending, and integrated financial software programs.[3]

Mobile financial apps will continue to be a strategic advantage that separates traditional banking approaches from innovative companies that can offer their clients a connected, digital experience when it comes to their money and investments. Consumers will expect personalization of bank products and services as part of their routine interaction with financial institutions. Otherwise, they will look elsewhere for a competitive platform to meet all of their financial and banking needs.[4]

Although most banks continue to offer local branch offices, the next few years will see branch banking become less prevalent as online and mobile services become more popular. Most banking institutions already offer apps that allow customers to move money between accounts or deposit a check via their smartphones, which happens almost instantaneously, rather than having to get in a car, drive to the bank, and deposit the check in person.

In addition, online payment platforms such as PayPal, Apple Pay, Google Wallet, Shopify, Stripe, and others continue to make personal and business transactions seamless. In this 24/7 world, consumers expect their banking and financial transactions to happen quickly and efficiently.[5]

Exhibit 7.3 Online payment platforms such as Google Wallet, Apple Pay, and others continue to make personal and business transactions seamless and efficient. *How can companies continue to leverage technology to make financial transactions as easy as a swipe or tap on a mobile device?* (Credit: Sergio Uceda/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Key Terms

commercial banks	Profit-oriented financial institutions that accept deposits, make business and consumer loans, invest in government and corporate securities, and provide other financial services.
credit unions	Not-for-profit, member-owned financial cooperatives.
currency	Cash held in the form of coins and paper money.
demand deposits	Money kept in checking accounts that can be withdrawn by depositors on demand.
discount rate	The interest rate that the Federal Reserve charges its member banks.
Canada Deposit Insurance Corporation (CDIC)	An independent, quasi-public corporation backed by the full faith and credit of the Canadian government that insures deposits in commercial banks and thrift institutions for up to a ceiling of $100,000 per account.
financial intermediation	The process in which financial institutions act as intermediaries between the suppliers and demanders of funds.
money	Anything that is acceptable as payment for goods and services.
open market operations	The purchase or sale of Canadian government bonds by the Bank of Canada to stimulate or slow down the economy.
pension funds	Large pools of money set aside by corporations, unions, and governments for later use in paying retirement benefits to their employees or members.
time deposits	Deposits at a bank or other financial institution that pay interest but cannot be withdrawn on demand.

Summary of Learning Outcomes

1. What is money, what are its characteristics and functions, and what are the three parts of the Canadian money supply?

Money is anything accepted as payment for goods and services. For money to be a suitable means of exchange, it should be scarce, durable, portable, and divisible. Money functions as a medium of exchange, a standard of value, and a store of value. The Canadian money supply consists of currency (coins and paper money), demand deposits (checking accounts), and time deposits (interest-bearing deposits that cannot be withdrawn on demand).

2. How does the Bank of Canada manage the money supply?

The Bank of Canada is an independent government agency that performs four main functions: carrying out monetary policy, setting rules on credit, distributing currency, and making check clearing easier. The two tools it uses in managing the money supply are open market operations and the discount rate.

3. What are the key financial institutions, and what role do they play in the process of financial intermediation?

Financial institutions can be divided into two main groups: depository institutions and nondepository institutions. Depository institutions include commercial banks and credit unions. Nondepository institutions include insurance companies, pension funds, brokerage firms, and finance companies. Financial institutions ease the transfer of funds between suppliers and demanders of funds.

4. How does the Canada Deposit Insurance Corporation (CDIC) protect depositors' funds?

The Canada Deposit Insurance Corporation insures deposits in commercial banks up to $100 000.

5. What role do Canadian banks play in the international marketplace?

Canadian banks provide loans and trade-related services to foreign governments and businesses. They also offer specialized services such as cash management and foreign-currency exchange.

6. What trends are reshaping financial institutions?

There will be a continued focus on regulatory and compliance issues, especially after the recent financial crisis, as well as on operational efficiency and technological advances. Banks will continue to tackle customer engagement and technology initiatives, as consumers will control more than 85 percent of their ongoing relationships with banks and other financial institutions. Fintech services will continue to disrupt the banking industry and will enable some banks to increase innovation and streamline operational efficiencies. Mobile financial apps will continue to provide banks with a strategic advantage, as well as enable them to collect and utilize customer data as part of their overall business strategy. Finally, online payment platforms will play an integral role in the banking and financial sector, as consumers' expectations continue to drive innovation in the banking industry.

Chapter 8

Financial Management and Securities Markets

Learning Outcomes

After reading this chapter, you should be able to answer these questions:

1. How do finance and the financial manager affect a firm's overall strategy?
2. What types of short-term and long-term expenditures does a firm make?
3. What are the main sources and costs of unsecured and secured short-term financing?
4. What are the key differences between debt and equity, and what are the major types and features of long-term debt?
5. When and how do firms issue equity, and what are the costs?
6. How do securities markets help firms raise funding, and what securities trade in the capital markets?
7. Where can investors buy and sell securities, and how are securities markets regulated?

In today's fast-paced global economy, managing a firm's finances is more complex than ever. For financial managers, a thorough command of traditional finance activities—financial planning, investing money, and raising funds—is only part of the job. Financial managers are more than number crunchers. As part of the top management team, chief financial officers (CFOs) need a broad understanding of their firm's business and industry, as well as leadership ability and creativity. They must never lose sight of the primary goal of the financial manager: to maximize the value of the firm to its owners.

Financial management—spending and raising a firm's money—is both a science and an art. The science part is analyzing numbers and flows of cash through the firm. The art is answering questions such as these: Is the firm using its financial resources in the best way? Aside from costs, why choose a particular form of financing? How risky is each option? Another important concern for both business managers and investors is understanding the basics of securities markets and the securities traded on them, which affect both corporate plans and investor pocketbooks.

This chapter focuses on the financial management of a firm and the securities markets in which firms raise funds. We'll start with an overview of the role of finance and of the financial manager in the firm's overall business strategy. Discussions of short and long-term uses of funds and investment decisions follow. Next, we'll examine key sources of short and long-term financing. Then we'll review the function, operation, and regulation of securities markets. Finally, we'll look at key trends affecting financial management and securities markets.

8.1 The Role of Finance and the Financial Manager

How do finance and the financial manager affect the firm's overall strategy?

Any company, whether it's a small-town bakery or General Motors, needs money to operate. To make money, it must first spend money—on inventory and supplies, equipment and facilities, and employee wages and salaries. Therefore, finance is critical to the success of all companies. It may not be as visible as marketing or production, but management of a firm's finances is just as much a key to the firm's success.

Financial management—the art and science of managing a firm's money so that it can meet its goals—is not just the responsibility of the finance department. All business decisions have financial consequences.

Managers in all departments must work closely with financial personnel. If you are a sales representative, for example, the company's credit and collection policies will affect your ability to make sales. The head of the IT department will need to justify any requests for new computer systems or employee laptops.

Revenues from sales of the firm's products should be the chief source of funding. But money from sales doesn't always come in when it's needed to pay the bills. Financial managers must track how money is flowing into and out of the firm (see Exhibit 8.1). They work with the firm's other department managers to determine how available funds will be used and how much money is needed. Then they choose the best sources to obtain the required funding.

For example, a financial manager will track day-to-day operational data such as cash collections and disbursements to ensure that the company has enough cash to meet its obligations. Over a longer time horizon, the manager will thoroughly study whether and when the company should open a new manufacturing facility. The manager will also suggest the most appropriate way to finance the project, raise the funds, and then monitor the project's implementation and operation.

Financial management is closely related to accounting. In most firms, both areas are the responsibility of the vice president of finance or CFO. But the accountant's main function is to collect and present financial data. Financial managers use financial statements and other information prepared by accountants to make financial decisions. Financial managers focus on **cash flows**, the inflows and outflows of cash. They plan and monitor the firm's cash flows to ensure that cash is available when needed.

The Financial Manager's Responsibilities and Activities

Financial managers have a complex and challenging job. They analyze financial data prepared by accountants, monitor the firm's financial status, and prepare and implement financial plans. One day they may be developing a better way to automate cash collections, and the next they may be analyzing a proposed acquisition. The key activities of the financial manager are:

- *Financial planning*: Preparing the financial plan, which projects revenues, expenditures, and financing needs over a given period.
- *Investment (spending money)*: Investing the firm's funds in projects and securities that provide high returns in relation to their risks.
- *Financing (raising money)*: Obtaining funding for the firm's operations and investments and seeking the best balance between debt (borrowed funds) and equity (funds raised through the sale of ownership in the business).

The Goal of the Financial Manager

How can financial managers make wise planning, investment, and financing decisions? The main goal of the financial manager is to maximize the value of the firm to its owners. The value of a publicly owned corporation is measured by the share price of its stock. A private company's value is the price at which it could be sold.

To maximize the firm's value, the financial manager has to consider both short and long-term consequences of the firm's actions. Maximizing profits is one approach, but it should not be the only one. Such an approach favours making short-term gains over achieving long-term goals. What if a firm in a highly technical and competitive industry did no research and development? In the short run, profits would be high because research and development is very expensive. But in the long run, the firm might lose its ability to compete because of its lack of new products.

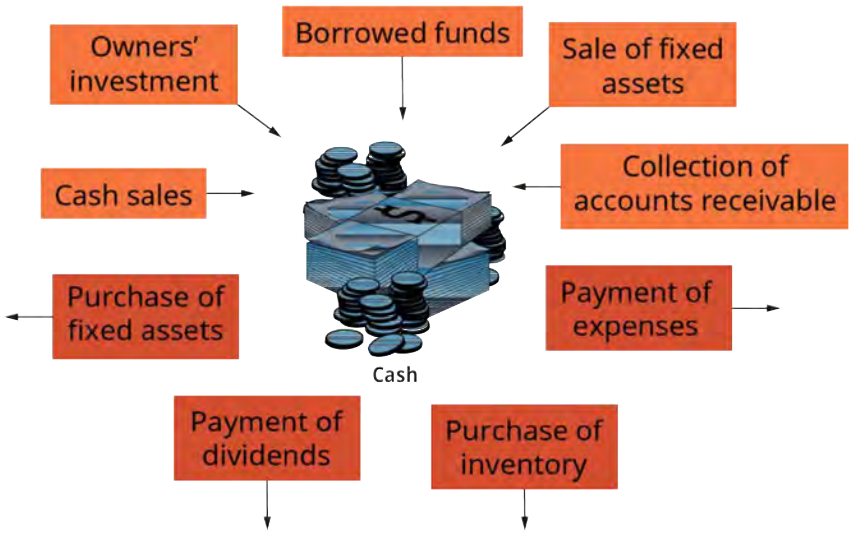


Exhibit 8.1 How Cash Flows through a Business (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

This is true regardless of a company's size or point in its life cycle. At Corning, a company founded more than 160 years ago, management believes in taking the long-term view and not managing for quarterly earnings to satisfy Wall Street's expectations. The company, once known to consumers mostly for kitchen products such as Corelle dinnerware and Pyrex heat-resistant glass cookware, is today a technology company that manufactures specialized glass and ceramic products. It is a leading supplier of Gorilla Glass, a special type of glass used for the screens of mobile devices, including the iPhone, the iPad, and devices powered by Google's Android operating system. The company was also the inventor of optical fiber and cable for the telecommunications industry. These product lines require large investments during their long research and development (R&D) cycles and for plant and equipment once they go into production.[1]

This can be risky in the short term but staying the course can pay off. In fact, Corning recently announced plans to develop a separate company division for Gorilla Glass, which now has more than 20 percent of the phone market—with over 200 million devices sold. In addition, its fiber-optic cable business is back in vogue and thriving as cable service providers such as Verizon have doubled down on upgrading the fiber-optic network across the United States. As of 2017, Corning's commitment to repurposing some of its technologies and developing new products has helped the company's bottom line, increasing revenues in a recent quarter by more than 16 percent.[2]

As the Corning situation demonstrates, financial managers constantly strive for a balance between the opportunity for profit and the potential for loss. In finance, the opportunity for profit is termed **return**; the potential for loss, or the chance that an investment will not achieve the expected level of return, is **risk**. A basic principle in finance is that the higher the risk, the greater the return that is required. This widely accepted concept is called the **risk-return trade-off**. Financial managers consider many risk and return factors when making investment and financing decisions. Among them are changing patterns of market demand, interest rates, general economic conditions, market conditions, and social issues (such as environmental effects and equal employment opportunity policies).

8.2 How Organizations Use Funds

What types of short-term and long-term expenditures does a firm make?

To grow and prosper, a firm must keep investing money in its operations. The financial manager decides how best to use the firm's money. Short-term expenses support the firm's day-to-day activities. For instance, athletic-apparel maker, Nike, regularly spends money to buy raw materials such as leather and fabric and to pay employee salaries. Long-term expenses are typically for fixed assets. For Nike, these would include outlays to build a new factory, buy automated manufacturing equipment, or acquire a small manufacturer of sports apparel.

Short-Term Expenses

Short-term expenses, often called operating expenses, are outlays used to support current production and selling activities. They typically result in current assets, which include cash and any other assets (accounts receivable and inventory) that can be converted to cash within a year. The financial manager's goal is to manage current assets, so the firm has enough cash to pay its bills and to support its accounts receivable and inventory.

Cash Management: Assuring Liquidity

Cash is the lifeblood of business. Without it, a firm could not operate. An important duty of the financial manager is **cash management** or making sure that enough cash is on hand to pay bills as they come due and to meet unexpected expenses.

Businesses estimate their cash requirements for a specific period. Many companies keep a minimum cash balance to cover unexpected expenses or changes in projected cash flows. The financial manager arranges loans to cover any shortfalls. If the size and timing of cash inflows closely match the size and timing of cash outflows, the company needs to keep only a small amount of cash on hand. A company whose sales and receipts are fairly predictable and regular throughout the year needs less cash than a company with a seasonal pattern of sales and receipts. A toy company, for instance, whose sales are concentrated in the fall, spends a great deal of cash during the spring and summer to build inventory. It has excess cash during the winter and early spring, when it collects on sales from its peak selling season.

Because cash held in checking accounts earns little, if any, interest, the financial manager tries to keep cash balances low and to invest the surplus cash. Surpluses are invested temporarily in **marketable securities**, short-term investments that are easily converted into cash. The financial manager looks for low-risk investments that offer high returns. Three of the most popular marketable securities are **Treasury bills**, certificates of deposit, and commercial paper. (**Commercial paper** is unsecured short-term debt—an IOU—issued by a financially strong corporation.) Today's financial managers have new tools to help them find the best short-term investments, such as online trading platforms that save time and provide access to more types of investments. These have been especially useful for smaller companies who don't have large finance staffs.

Companies with overseas operations face even greater cash management challenges.

Developing the systems for international cash management may sound simple in theory, but in practice it's extremely complex. In addition to dealing with multiple foreign currencies, treasurers must understand and follow banking practices and regulatory and tax requirements in each country. Regulations may impede their ability to move funds freely across borders. Also, issuing a standard set of procedures for every office may not work because local business practices differ from country to country. In addition, local managers may resist the shift to a centralized structure because they don't want to give up control of cash generated by their units. Corporate financial managers must be sensitive to and aware of local customs and adapt the centralization strategy accordingly.

In addition to seeking the right balance between cash and marketable securities, the financial manager tries to shorten the time between the purchase of inventory or services (cash outflows) and the collection of cash from sales (cash inflows). The three key strategies are to collect money owed to the firm (accounts receivable) as quickly as possible, to pay money owed to others (accounts payable) as late as possible without damaging the firm's credit reputation, and to minimize the funds tied up in inventory.

Managing Accounts Receivable

Accounts receivable represent sales for which the firm has not yet been paid. Because the product has been sold but cash has not yet been received, an account receivable amounts to a use of funds. For the average manufacturing firm, accounts receivable represents about 15 to 20 percent of total assets.

The financial manager's goal is to collect money owed to the firm as quickly as possible, while offering customers credit terms attractive enough to increase sales. Accounts receivable management involves setting credit policies, guidelines on offering credit, credit terms, and specific repayment conditions, including how long customers have to pay their bills and whether a cash discount is given for quicker payment. Another aspect of accounts receivable management is deciding on collection policies, the procedures for collecting overdue accounts.

Setting up credit and collection policies is a balancing act for financial managers. On the one hand, easier credit policies or generous credit terms (a longer repayment period or larger cash discount) result in increased sales. On the other hand, the firm has to finance more accounts receivable. The risk of uncollectible accounts receivable also rises. Businesses consider the impact on sales, timing of cash flow, experience with bad debt, customer profiles, and industry standards when developing their credit and collection policies.

Companies that want to speed up collections actively manage their accounts receivable, rather than passively letting customers pay when they want to. According to recent statistics, more than 90 percent of businesses experience late payments from customers, and some companies write off a percentage of their bad debt, which can be expensive.[3]

Technology plays a big role in helping companies improve their credit and collections performance. For example, many companies use some type of automated decision-making, whether that comes in the form of an Enterprise Resource Planning system or a combination of software programs and supplemental modules that help companies make informed decisions when it comes to credit and collection processes.[4]

Other companies choose to outsource financial and accounting business processes to specialists rather than develop their own systems. The availability of cutting-edge technology and specialized electronic platforms that would be difficult and expensive to develop in-house is winning over firms of all sizes. Giving up control of finance to a third party has not been easy for CFOs. The risks are high when financial and other sensitive corporate data are transferred to an outside computer system: data could be compromised or lost, or rivals could steal corporate data. It's also harder to monitor an outside provider than your own employees. One outsourcing area that has attracted many clients is international trade, which has regulations that differ from country to country and requires huge amounts of documentation. With specialized IT systems, providers can track not only the physical location of goods, but also all the paperwork associated with shipments. Processing costs for goods purchased overseas are about twice those of domestic goods, so more efficient systems pay off.[5]

Inventory

Another use of funds is to buy inventory needed by the firm. In a typical manufacturing firm, inventory is nearly 20 percent of total assets. The cost of inventory includes not only its purchase price, but also ordering, handling, storage, interest, and insurance costs.

Production, marketing, and finance managers usually have differing views about inventory. Production managers want lots of raw materials on hand to avoid production delays. Marketing managers want lots of finished goods on hand, so customer orders can be filled quickly. But financial managers want the least inventory possible without harming production efficiency or sales. Financial managers must work closely with production and marketing to balance these conflicting goals. Techniques for reducing the investment in inventory are inventory management, the just-in-time system, and materials requirement planning.
For retail firms, inventory management is a critical area for financial managers, who closely monitor inventory turnover ratios. This ratio shows how quickly inventory moves through the firm and is turned into sales. If the inventory number is too high, it will typically affect the amount of working capital a company has on hand, forcing the company to borrow money to cover the excess inventory. If the turnover ratio number is too high, it means the company does not have enough inventory of products on hand to satisfy customer needs, which means they could take their business elsewhere.[6]

Long-Term Expenditures

A firm also invests funds in physical assets such as land, buildings, machinery, equipment, and information systems. These are called **capital expenditures**. Unlike operating expenses, which produce benefits within a year, the benefits from capital expenditures extend beyond one year. For instance, a printer's purchase of a new printing press with a usable life of seven years is a capital expenditure and appears as a fixed asset on the firm's balance sheet. Paper, ink, and other supplies, however, are expenses. Mergers and acquisitions are also considered capital expenditures.

Firms make capital expenditures for many reasons. The most common are to expand, to replace or renew fixed assets, and to develop new products. Most manufacturing firms have a big investment in long-term assets. Boeing Company, for instance, puts billions of dollars a year into airplane-manufacturing facilities. Because capital expenditures tend to be costly and have a major effect on the firm's future, the financial manager uses a process called **capital budgeting** to analyze long-term projects and select those that offer the best returns while maximizing the firm's value. Decisions involving new products, or the acquisition of another business are especially important. Managers look at project costs and forecast the future benefits the project will bring to calculate the firm's estimated return on the investment.

8.3 Obtaining Short-Term Financing

What are the main sources and costs of unsecured and secured short-term financing?

How do firms raise the funding they need? They borrow money (debt), sell ownership shares (equity), and retain earnings (profits). The financial manager must assess all these sources and choose the one most likely to help maximize the firm's value.

Like expenses, borrowed funds can be divided into short and long-term loans. A short-term loan comes due within one year; a long-term loan has a maturity greater than one year. Short-term financing is shown as a current liability on the balance sheet and is used to finance current assets and support operations. Short-term loans can be unsecured or secured.

Short-term Financing video:
https://youtu.be/GlabOH78TMM

Unsecured Short-Term Loans

Unsecured loans are made based on the firm's creditworthiness and the lender's previous experience with the firm. An unsecured borrower does not have to pledge specific assets as security. The three main types of unsecured short-term loans are trade credit, bank loans, and commercial paper.

Trade Credit: Accounts Payable

When Goodyear sells tires to General Motors, GM does not have to pay cash on delivery. Instead, Goodyear regularly bills GM for its tire purchases, and GM pays at a later date. This is an example of **trade credit**: the seller extends credit to the buyer between the time the buyer receives the goods or services and when they pay for them. Trade credit is a major source of short-term business financing. The buyer enters the credit on its books as an **account payable**. In effect, the credit is a short-term loan from the seller to the buyer of the goods and services. Until GM pays Goodyear, Goodyear has an account receivable from GM, and GM has an account payable to Goodyear.

Bank Loans

Unsecured bank loans are another source of short-term business financing. Companies often use these loans to finance seasonal (cyclical) businesses. Unsecured bank loans include lines of credit and revolving credit agreements. A **line of credit** specifies the maximum amount of unsecured short-term borrowing the bank will allow the firm over a given period of time, typically one year. The firm either pays a fee or keeps a certain percentage of the loan amount (generally 10 to 20 percent) in a checking account at the bank. Another bank loan, the **revolving credit agreement**, is basically a guaranteed line of credit that carries an extra fee in addition to interest. Revolving credit agreements are often arranged for a period of two to five years.

Commercial Paper

As noted earlier, commercial paper is an unsecured short-term debt—an IOU—issued by a financially strong corporation. Thus, it is both a short-term investment and a financing option for major corporations.

Corporations issue commercial paper in multiples of $100,000 for periods ranging from 3 to 270 days. Many big companies use commercial paper instead of short-term bank loans because the interest rate on commercial paper is usually 1 to 3 percent below bank rates.

Secured Short-Term Loans

Secured loans require the borrower to pledge specific assets as collateral, or security. The secured lender can legally take the collateral if the borrower doesn't repay the loan. Commercial banks and commercial finance companies are the main sources of secured short-term loans to business. Borrowers whose credit is not strong enough to qualify for unsecured loans use these loans. Typically, the collateral for secured short-term loans is accounts receivable or inventory. Because accounts receivable are normally quite liquid (easily converted to cash), they are an attractive form of collateral. The appeal of inventory—raw materials or finished goods—as collateral depends on how easily it can be sold at a fair price.

Another form of short-term financing using accounts receivable is **factoring**. A firm sells its accounts receivable outright to a factor, a financial institution (often a commercial bank or commercial finance company) that buys accounts receivable at a discount. Factoring is widely used in the clothing, furniture, and appliance industries. Factoring is more expensive than a bank loan because the factor buys the receivables at a discount from their actual value.

Exhibit 8.2 For businesses with steady orders but a lack of cash to make payroll or other immediate payments, factoring is a popular way to obtain financing. In factoring, a company sells its invoices to a third-party funding source for cash. The

factor purchasing the invoices then collects on the due payments over time. Trucking companies with voluminous accounts receivable in the form of freight bills are good candidates for the use of short-term financing such as factoring. *Why might firms choose factoring instead of loans?* (Credit: Mike's Photos/ flickr/ Creative Commons Zero (CC0) license)

8.4 Raising Long-Term Financing

What are the key differences between debt and equity, and what are the major types and features of long-term debt?

A basic principle of finance is to match the term of the financing to the period over which benefits are expected to be received from the associated outlay. Short-term items should be financed with short-term funds, and long-term items should be financed with long-term funds. Long-term financing sources include both debt (borrowing) and equity (ownership). Equity financing comes either from selling new ownership interests or from retaining earnings. Financial managers try to select the mix of long-term debt and equity that results in the best balance between cost and risk.

Debt versus Equity Financing

Say that the Boeing Company plans to spend $2 billion over the next four years to build and equip new factories to make jet aircraft. Boeing's top management will assess the pros and cons of both debt and equity and then consider several possible sources of the desired form of long-term financing.

The major advantage of debt financing is the deductibility of interest expense for income tax purposes, which lowers its overall cost. In addition, there is no loss of ownership. The major drawback is **financial risk**: the chance that the firm will be unable to make scheduled interest and principal payments. The lender can force a borrower that fails to make scheduled debt payments into bankruptcy. Most loan agreements have restrictions to ensure that the borrower operates efficiently.

Equity, on the other hand, is a form of permanent financing that places few restrictions on the firm. The firm is not required to pay dividends or repay the investment. However, equity financing gives common stockholders voting rights that provide them with a voice in management. Equity is more costly than debt. Unlike the interest on debt, dividends to owners are not tax-deductible expenses. Table 8.1 summarizes the major differences between debt and equity financing.

Debt Financing

Long-term debt is used to finance long-term (capital) expenditures. The initial maturities of long-term debt typically range between 5 and 20 years. Three important forms of long-term debt are term loans, bonds, and mortgage loans.

Major Differences between Debt and Equity Financing		
	Debt Financing	Equity Financing
Have a say in management	Creditors typically have none unless the borrower defaults on payments. Creditors may be able to place restraints on management in event of default.	Common stockholders have voting rights.
Have a right to income and assets	Debt holders rank ahead of equity holders. Payment of interest and principal is a contractual obligation of the firm.	Equity owners have a residual claim on income (dividends are paid only after paying interest and any scheduled principal) and there's no obligation to pay dividends.
Maturity (date when debt needs to be paid back)	Debt has a stated maturity and requires repayment of principal by a specified date.	The company is not required to repay equity, which has no maturity date.
Tax treatment	Interest is a tax-deductible expense.	Dividends are not tax-deductible and are paid from after-tax income.

Table 8.1

A **term loan** is a business loan with a maturity of more than one year. Term loans generally have maturities of 5 to 12 years and can be unsecured or secured. They are available from commercial banks, insurance companies, pension funds, commercial finance companies, and manufacturers' financing subsidiaries. A contract between the borrower and the lender spells out the amount and maturity of the loan, the interest rate, payment dates, the purpose of the loan, and other provisions such as operating and financial restrictions on the borrower to control the risk of default. The payments include both interest and principal, so the loan balance declines over time. Borrowers try to arrange a repayment schedule that matches the forecast cash flow from the project being financed.

Bonds are long-term debt obligations (liabilities) of corporations and governments. A bond certificate is issued as proof of the obligation. The issuer of a bond must pay the buyer a fixed amount of money—called **interest**, stated as the *coupon rate*—on a regular schedule, typically every six months. The issuer must also pay the bondholder the amount borrowed—called the **principal**, or *par value*—at the bond's maturity date (due date). Bonds are usually issued in units of $1,000—for instance, $1,000, $5,000, or $10,000—and have initial maturities of 10 to 30 years. They may be secured or unsecured, include special provisions for early retirement, or be convertible to common stock.

Bonds video:
https://youtu.be/luyejHOGCro

A **mortgage loan** is a long-term loan made against real estate as collateral. The lender takes a mortgage on the property, which lets the lender seize the property, sell it, and use the proceeds to pay off the loan if the borrower fails to make the scheduled payments. Long-term mortgage loans are often used to finance office buildings, factories, and warehouses. Life insurance companies are an important source of these loans. They make billions of dollars' worth of mortgage loans to businesses each year.

8.5 Equity Financing

When and how do firms issue equity, and what are the costs?

Equity refers to the owners' investment in the business. In corporations, the preferred and common stockholders are the owners. A firm obtains equity financing by selling new ownership shares (external financing), by retaining earnings (internal financing), or for small and growing, typically high-tech, companies, through venture capital (external financing).

Selling New Issues of Common Stock

Common stock is a security that represents an ownership interest in a corporation. A company's first sale of stock to the public is called an *initial public offering (IPO)*. An IPO often enables existing stockholders, usually employees, family, and friends who bought the stock privately, to earn big profits on their investment. (Companies that are already public can issue and sell additional shares of common stock to raise equity funds.)

Stocks video:
https://youtu.be/oVVt6P2q-6c

But going public has some drawbacks. For one thing, there is no guarantee an IPO will sell. It is also expensive. Big fees must be paid to investment bankers, brokers, attorneys, accountants, and printers. Once the company is public, it is closely watched by regulators, stockholders, and securities analysts. The firm must reveal such information as operating and financial data, product details, financing plans, and operating strategies. Providing this information is often costly.

Going public is the dream of many small company founders and early investors, who hope to recoup their investments and become instant millionaires. Google went public in 2004 at $85 a share and soared to $475 in early 2006 before settling back to trade in the high-300 range in August 2006. More than a decade later, in October 2017, Google continues to be a successful IPO, trading at more than $990 per share.

In recent years, the number of IPOs has dropped sharply, as start-ups think long and hard about going public, despite the promise of millions of dollars for investors and entrepreneurs. For example, in 2017, Blue Apron, a meal-kit delivery service, went public with an opening stock price of $10 per share. Several months later, the share price dropped more than 40 percent. Some analysts believe that Amazon's possible entry into the meal-kit delivery sector has hurt Blue Apron's value, as well as the company's high marketing costs to attract and retain monthly subscribers.[7]

Some companies choose to remain private. Cargill, SC Johnson, Mars, Publix Super Markets, and Bloomberg are among the largest U.S. private companies.

Exhibit 8.3 Snap Inc., the parent company of Snapchat, went public in 2017 under the ticker symbol "SNAP." The much-anticipated IPO was popular at an opening price of $17 per share and rose that same day by more than 40 percent, which initially put the company's market capitalization at about $30 billion. *What are the pros and cons of going public?* (Credit: Tim Savage/ pexels/ Creative Commons Zero (CC0) license)

Dividends and Retained Earnings

Dividends are payments to stockholders from a corporation's profits. Dividends can be paid in cash or in stock. **Stock dividends** are payments in the form of more stock. Stock dividends may replace or supplement cash dividends. After a stock dividend has been paid, more shares have a claim on the same company, so the value of each share often declines. A company does not have to pay dividends to stockholders. But if investors buy the stock expecting to get dividends and the firm does not pay them, the investors may sell their stocks.

At their quarterly meetings, the company's board of directors (typically with the advice of its CFO) decides how much of the profits to distribute as dividends and how much to reinvest. A firm's basic approach to paying dividends can greatly affect its share price. A stable history of dividend payments indicates good financial health. For example, cable giant Comcast has increased its dividend more than 20 percent over the past five years, giving shareholders a healthy return on their investment.[8]

If a firm that has been making regular dividend payments cuts or skips a dividend, investors start thinking it has serious financial problems. The increased uncertainty often results in lower stock prices. Thus, most firms set dividends at a level they can keep paying. They start with a relatively low dividend payout ratio so that they can maintain a steady or slightly increasing dividend over time.

Retained earnings, profits that have been reinvested in the firm, have a big advantage over other sources of equity capital: They do not incur underwriting costs. Financial managers strive to balance dividends and retained earnings to maximize the value of the firm. Often the balance reflects the nature of the firm and its industry. Well-established and stable firms and those that expect only modest growth, such as public utilities, financial services companies, and large industrial corporations, typically pay out much of their earnings in dividends. For example, in the 2016 fiscal year, ExxonMobil paid dividends of $3.08 per share, Altria Group paid $2.64 per share, Apple paid $2.23 per share, and Costco paid $2.00 per share.

Most high-growth companies, such as those in technology-related fields, finance much of their growth through retained earnings and pay little or no dividends to stockholders. As they mature, many decide to begin paying dividends, as Apple decided to do in 2012, after 17 years of paying no annual dividends to shareholders.[9]

Preferred Stock

Another form of equity is **preferred stock**. Unlike common stock, preferred stock usually has a dividend amount that is set at the time the stock is issued. These dividends must be paid before the company can pay any dividends to common stockholders. Also, if the firm goes bankrupt and sells its assets, preferred stockholders get their money back before common stockholders do.

Like debt, preferred stock increases the firm's financial risk because it obligates the firm to make a fixed payment. But preferred stock is more flexible. The firm can miss a dividend payment without suffering the serious results of failing to pay back a debt.

Preferred stock is more expensive than debt financing because preferred dividends are not tax-deductible. Also, because the claims of preferred stockholders on income and assets are second to those of debtholders, preferred stockholders require higher returns to compensate for the greater risk.

Venture Capital

Venture capital is another source of equity capital. It is most often used by small and growing firms that aren't big enough to sell securities to the public. This type of financing is especially popular among high-tech companies that need large sums of money.

Venture capitalists invest in new businesses in return for part of the ownership, sometimes as much as 60 percent. They look for new businesses with high growth potential, and they expect a high investment return within 5 to 10 years. By getting in on the ground floor, venture capitalists buy stock at a very low price. They earn profits by selling the stock at a much higher price when the company goes public. Venture capitalists generally get a voice in management through seats on the board of directors. Getting venture capital is difficult, even though there are hundreds of private venture-capital firms in this country. Most venture capitalists finance only about 1 to 5 percent of the companies that apply. Venture-capital investors, many of whom experienced losses during recent years from their investments, are currently less willing to take risks on very early-stage companies with unproven business concepts or technology. As a result, other sources of venture capital, including private foundations, and wealthy individuals (called *angel investors*), are helping start-up firms find equity capital. These private investors are motivated by the potential to earn a high return on their investment.

8.6 Securities Markets

How do securities markets help firms raise funding, and what securities trade in the capital markets?

Stocks, bonds, and other securities trade in securities markets. These markets streamline the purchase and sales activities of investors by allowing transactions to be made quickly and at a fair price. **Securities** are investment certificates that represent either *equity* (ownership in the issuing organization) or *debt* (a loan to the issuer). Corporations and governments raise capital to finance operations and expansion by selling securities to investors, who in turn take on a certain amount of risk with the hope of receiving a profit from their investment.

Securities markets are busy places. On an average day, individual and institutional investors trade billions of shares of stock in more than 10,000 companies through securities markets. *Individual investors* invest their own money to achieve their personal financial goals. **Institutional investors** are investment professionals who are paid to manage other people's money. Most of these professional money managers work for financial institutions, such as banks, mutual funds, insurance companies, and pension funds. Institutional investors control very large sums of money, often buying stock in 10,000-share blocks. They aim to meet the investment goals of their clients. Institutional investors are a major force in the securities markets, accounting for about half of the dollar volume of equities traded.

Types of Markets

Securities markets can be divided into primary and secondary markets. The **primary market** is where *new* securities are sold to the public, usually with the help of investment bankers. In the primary market, the issuer of the security gets the proceeds from the transaction. A security is sold in the primary market just once—when the corporation or government first issues it. The Blue Apron IPO is an example of a primary market offering.

Later transactions take place in the secondary market, where *old* (already issued) securities are bought and sold, or traded, among investors. The issuers generally are not involved in these transactions. The vast majority of securities transactions take place in secondary markets, which include broker markets, dealer markets, the over-the-counter market, and the commodities exchanges. You'll see *tombstones*, announcements of both primary and secondary stock and bond offerings, in the *Wall Street Journal* and other newspapers.

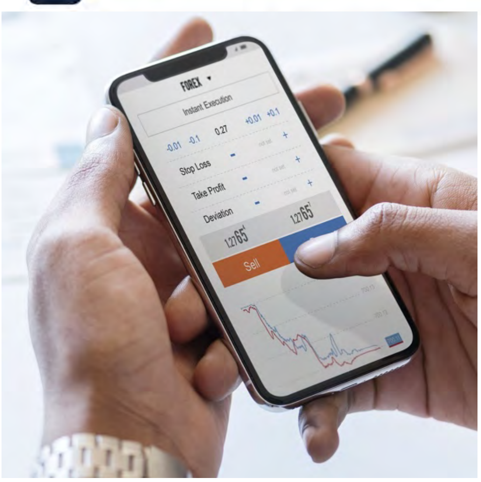
The Role of Investment Bankers and Stockbrokers

Two types of investment specialists play key roles in the functioning of the securities markets. **Investment bankers** help companies raise long-term financing. These firms act as intermediaries, buying securities from corporations and governments and reselling them to the public. This process, called **underwriting**, is the main activity of the investment banker, which acquires the security for an agreed-upon price and hopes to be able to resell it at a higher price to make a profit. Investment bankers advise clients on the pricing and structure of new securities offerings, as well as on mergers, acquisitions, and other types of financing. Well-known investment banking firms include Goldman Sachs, Morgan Stanley and JP Morgan. In Canada some well-known institutions include BMO Capital Markets, TD securities and Cannacord Genuity.

A **stockbroker** is a person who is licensed to buy and sell securities on behalf of clients. Also called *account executives*, these investment professionals work for brokerage firms and execute the orders customers place for stocks, bonds, mutual funds, and other securities. Investors are wise to seek a broker who understands their investment goals and can help them pursue their objectives.

Brokerage firms are paid commissions for executing clients' transactions. Although brokers can charge whatever they want, most firms have fixed commission schedules for small transactions. These commissions usually depend on the value of the transaction and the number of shares involved.

Online Investing



Improvements in internet technology has made it possible for investors to research, analyze, and trade securities online. Today almost all brokerage firms offer online trading capabilities. Online brokerages are popular with "do-it-yourself" investors who choose their own stocks and don't want to pay a full-service broker for these services. Lower transaction costs are a major benefit. Fees at online brokerages range from about $4.95 to $8.00, depending on the number of trades a client makes and the size of a client's account.

Although there are many online brokerage firms, the four largest—Charles Schwab, Fidelity, TD Ameritrade, and E*Trade—account for more than 80 percent of all trading volume and trillions in assets in customer accounts.[10] The internet also offers investors access to a wealth of investment information.

Investing in Bonds

When many people think of financial markets, they picture the equity markets. However, the bond markets are huge—the Securities Industry and Financial Markets Association (SIFMA) estimates that the global bond market is nearly $88 trillion.

Bonds can be bought and sold in the securities markets. However, the price of a bond changes over its life as market interest rates fluctuate. When the market interest rate drops below the fixed interest rate on a bond, it becomes more valuable, and the price rises. If interest rates rise, the bond's price will fall. *Corporate bonds*, as the name implies, are issued by corporations. They usually have a par value of $1,000. They may be secured or unsecured (called *debentures*), include special provisions for early retirement, or be convertible to common stock. Corporations can also issue *mortgage bonds*, bonds secured by property such as land, buildings, or equipment. Approximately $1.5 trillion in new corporate bonds were issued in 2016.[11]

In addition to regular corporate debt issues, investors can buy *high-yield*, or *junk bonds*—high-risk, high-return bonds often used by companies whose credit characteristics would not otherwise allow them access to the debt markets. They generally earn 3 percent or more above the returns on high-quality corporate bonds.

Corporate bonds may also be issued with an option for the bondholder to convert them into common stock. These *convertible bonds* generally allow the bondholder to exchange each bond for a specified number of shares of common stock.

Exhibit 8.4 Elon Musk and his electric car company, Tesla, issued high-yield junk bonds in August 2017 and raised nearly $1.8 billion to help finance the production and launch of Tesla's new Model 3. Tesla has spent billions of dollars in its efforts to develop electric cars in the past few years. *What are the risks and rewards of buying junk bonds?* (Credit: Steve Jurvetson/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Canadian Government Securities and Municipal Bonds

Both the federal government and local government agencies also issue bonds. The Bank of Canada sells three major types of federal debt securities: Treasury bills, Treasury notes, and Treasury bonds. All three are viewed as default-risk-free because they are backed by the Canadian government. Treasury bills mature in less than a year and are issued with a minimum par value of $1,000. Treasury notes have maturities of 10 years or less, and Treasury bonds have maturities as long as 25 years or more. Both notes and bonds are sold in denominations of $1,000 and $5,000. The interest earned on government securities is subject to federal income tax but is free from provincial and local income taxes.

Municipal bonds are issued by provinces, cities, counties, and other provincial and local government agencies. These bonds typically have a par value of $5,000 and are either general obligation or revenue bonds. *General obligation bonds* are backed by the full faith and credit (and taxing power) of the issuing government. *Revenue bonds*, on the other hand, are repaid only from income generated by the specific project being financed. Examples of revenue bond projects include toll highways and bridges, power plants, and parking structures. Because the issuer of revenue bonds has no legal obligation to back the bonds if the project's revenues are inadequate, they are considered riskier and therefore have higher interest rates than general obligation bonds.

Municipal bonds are attractive to investors because interest earned on them is exempt from federal income tax. For the same reason, the coupon interest rate for a municipal bond is lower than for a similar-quality corporate bond. In addition, interest earned on municipal bonds issued by governments within the taxpayer's home state is exempt from state income tax as well. In contrast, all interest earned on corporate bonds is fully taxable.

Bond Ratings

Bonds vary in quality, depending on the financial strength of the issuer. Because the claims of bondholders come before those of stockholders, bonds are generally considered less risky than stocks. However, some bonds are in fact quite risky. Companies can default—fail to make scheduled interest or principal payments—on their bonds. Investors can use **bond ratings**, letter grades assigned to bond issues to indicate their quality or level of risk. Ratings for corporate bonds are easy to find. The two largest and best-known rating agencies are Moody's and Standard & Poor's (S&P), whose publications are in most libraries and in stock brokerages. Table 8.2 lists the letter grades assigned by Moody's and S&P. Dominion Bond Rating Service (DBRS) provides bond ratings for the Canadian market. A bond's rating may change if a company's financial condition changes.

Other Popular Securities

In addition to stocks and bonds, investors can buy mutual funds, a very popular investment category, or exchange-traded funds (ETFs).

Mutual Funds

Suppose that you have $1,000 to invest but don't know which stocks or bonds to buy, when to buy them, or when to sell them. By investing in a mutual fund, you can buy shares in a large, professionally managed portfolio, or group of stocks and bonds. A **mutual fund** is a financial-service company that pools its investors' funds to buy a selection of securities—marketable securities, stocks, bonds, or a combination of securities—that meet its stated investment goals. Each mutual fund focuses on one of a wide variety of possible investment goals, such as growth or income. Many large financial-service companies sell a wide variety of mutual funds, each with a different investment goal. Investors can pick and choose funds that match their particular interests. Some specialized funds invest in a particular type of company or asset: in one industry such as health care or technology, in a geographical region such as Asia, or in an asset such as precious metals.

Mutual funds are one of the most popular investments for individuals today: they can choose from about 9,500 different funds. Investments in mutual funds are more than $40 trillion worldwide. Mutual funds appeal to investors for three main reasons:

- They are a good way to hold a diversified, and thus less risky, portfolio. Investors with

Mutual Funds video:
https://youtu.be/ngfKXvfzC74

Types of Planning		
Moody's Ratings	S&P Ratings	Description
Aaa	AAA	**Prime-quality investment bonds:** Highest rating assigned; indicates extremely strong capacity to pay.
Aa, A	AA, A	**High-grade investment bonds:** Also considered very safe bonds, although not quite as safe as Aaa/AAA issues; Aa/AA bonds are safer (have less risk of default) than single As.
Baa	BBB	**Medium-grade investment bonds:** Lowest of investment-grade issues; seen as lacking protection against adverse economic conditions.
Ba B	BB B	**Junk bonds:** Provide little protection against default; viewed as highly speculative.
Caa Ca C	CCC CC C D	**Poor-quality bonds:** Either in default or very close to it.

Table 8.2

Exchange-Traded Funds

Another type of investment, the **exchange-traded fund (ETF)**, has become very popular with investors. ETFs are similar to mutual funds because they hold a broad basket of stocks with a common theme, giving investors instant diversification. ETFs trade on stock exchanges, so their prices change throughout the day, whereas mutual fund share prices are calculated once a day, at the end of trading. Worldwide, ETF assets in 2016 were more than $3.5 trillion.[12]

Investors can choose from more than 1,700 ETFs that track almost any market sector, from a broad market index such as the S&P 500 (described later in this chapter), industry sectors such as health care or energy, and geographical areas such as a particular country (Japan) or region

(Latin America). ETFs have very low expense ratios. However, because they trade as stocks, investors pay commissions to buy and sell these shares.

8.7 Buying and Selling at Securities Exchanges

Where can investors buy and sell securities, and how are securities markets regulated?

When we think of stock markets, we are typically referring to secondary markets, which handle most of the securities trading activity. Securities trades can also take place in alternative market systems exchanges.

We present the basics of securities exchanges in this section and discuss the latest trends in the global securities markets later in the chapter.

Broker Markets

The **broker market** consists of securities exchanges that bring buyers and sellers together through brokers on a centralized trading floor. In the broker market, the buyer purchases the securities directly from the seller through the broker. Broker markets account for about 60 percent of the total dollar volume of all shares traded in the U.S. securities markets.

New York Stock Exchange

The oldest and most prestigious broker market is the *New York Stock Exchange (NYSE)*, which has existed since 1792. Often called the Big Board, it is located on Wall Street in downtown New York City. The NYSE, which lists the shares of some 2,400 corporations, had a total market capitalization (domestic and foreign companies) of $25.8 trillion at year-end 2016. On a typical day, more than 3 billion shares of stock are traded on the NYSE.[13] It represents 90 percent of the trading volume in the U.S. broker marketplace. Major companies such as IBM, Coca-Cola, AT&T, Procter & Gamble, Ford Motor Co., and Chevron list their shares on the NYSE. Companies that list on the NYSE must meet stringent listing requirements and annual maintenance requirements, which give them creditability. The NYSE is also popular with non-U.S. companies. More than 490 foreign companies with a global market capitalization of almost $63 trillion now list their securities on the NYSE. [14]

Until recently, all NYSE transactions occurred on the vast NYSE trading floor. Each of the companies traded at the NYSE is assigned to a trading post on the floor. When an exchange member receives an order to buy or sell a particular stock, the order is transmitted to a floor broker at the company's trading post. The floor brokers then compete with other brokers on the trading floor to get the best price for their customers.

In response to competitive pressures from electronic exchanges, the NYSE created a hybrid market that combines features of the floor auction market and automated trading. Its customers now have a choice of how they execute trades. In the trends section, we'll discuss other changes the NYSE is making to maintain a leadership position among securities exchanges.

Another national stock exchange, the American Stock Exchange (AMEX), lists the securities of more than 700 corporations but handles only 4 percent of the annual share volume of shares traded on U.S. securities exchanges. Because the AMEX's rules are less strict than those of the NYSE, most AMEX firms are smaller and less well known than NYSE-listed corporations. Some firms move up to the NYSE once they qualify for listing there. Other companies choose to remain on the AMEX. Companies cannot be listed on both exchanges at the same time. The AMEX has become a major market, however, for exchange-traded funds and in options trading.

Exhibit 8.5 The New York Stock Exchange (NYSE) is the largest securities market in the world. Its market capitalization dwarfs both foreign and domestic markets. Unlike other financial markets, the NYSE trades mostly through specialists, financial professionals who match up buyers and sellers of securities, while pocketing the spread between the bid and ask price on market orders. *How does the NYSE's hybrid trading system differ from fully automated, electronic trading?* (Credit: Kevin Hutchison/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

Exhibit 8.6 The New York Stock Exchange (NYSE) named Stacy Cunningham the first female head of the exchange in its 226-year history. Outside the exchange, the statue "Fearless Girl" by Kristen Virbal staring down the "bull" statue represents the need for more female representation on the world's most important exchange. *How does the naming of Stacy Cunningham as head of the NYSE demonstrate that the glass ceiling has been shattered?* (Anthony Quintano/ Flickr/ Attribution 2.0 Generic (CC BY 2.0)

NASDAQ

The largest dealer market is the **National Association of Securities Dealers Automated Quotation system**, commonly referred to as NASDAQ. The first electronic-based stock market, the NASDAQ is a sophisticated telecommunications network that links dealers throughout the United States. Founded in 1971 with origins in the over-the-counter (OTC) market, today NASDAQ is a separate securities exchange that is no longer part of the OTC market. The NASDAQ lists more companies than the NYSE, but the NYSE still leads in total market capitalization. An average of 1.6 billion shares were exchanged daily in 2016 through NASDAQ, which is now the largest electronic stock market.[15] It provides up-to-date bid and ask prices on about 3,700 of the most active OTC securities. Its sophisticated electronic communication system provides faster transaction speeds than traditional floor markets and is the main reason for the popularity and growth of the OTC market.

In January 2006, the SEC approved NASDAQ's application to operate as a national securities exchange. As a result, the NASDAQ Stock Market LLC began operating independently in August 2006.[16] The securities of many well-known companies, some of which could be listed on the organized exchanges, trade on the NASDAQ. Examples include Amazon, Apple, Costco, Comcast, JetBlue, Microsoft, Qualcomm, and Starbucks. The stocks of most commercial banks and insurance companies also trade in this market, as do most government and corporate bonds. More than 400 foreign companies also trade on the NASDAQ. More than a decade ago, the NASDAQ changed its structure to a three-tier market:

- The NASDAQ Global Select Market, a new tier with "financial and liquidity requirements that are higher than those of any other market," according to NASDAQ. More than 1,000 NASDAQ companies qualify for this group.
- The NASDAQ Global Market (formerly the NASDAQ National Market), which will list about 1,650 companies.
- The NASDAQ Capital Market will replace the NASDAQ Small Cap Market and list about 550 companies.

All three market tiers adhere to NASDAQ's rigorous listing and corporate governance standards.[17]

The Over-the-Counter Market

The **over-the-counter (OTC) markets** refer to those other than the organized exchanges described above. There are two OTC markets: the *Over-the-Counter Bulletin Board (OTCBB)* and the Pink Sheets. These markets generally list small companies and have no listing or maintenance standards, making them attractive to young companies looking for funding. Investing in OTC companies is highly risky and should be for experienced investors only.

Global Trading and Foreign Exchanges

Improved communications and the elimination of many legal barriers are helping the securities markets go global. The number of securities listed on exchanges in more than one country is growing. Foreign securities are now traded in the United States. Likewise, foreign investors can easily buy U.S. securities.

Stock markets also exist in foreign countries: more than 60 countries operate their own securities exchanges. NASDAQ ranks second to the NYSE, followed by the London Stock Exchange (LSE) and the Tokyo Stock Exchange. Other important foreign stock exchanges include Euronext (which merged with the NYSE but operates separately) and those in Toronto, Frankfurt, Hong Kong, Zurich, Australia, Paris, and Taiwan.[18] The number of big U.S. corporations with listings on foreign exchanges is growing steadily, especially in Europe. For example, significant activity in NYSE-listed stocks also occurs on the LSE. The LSE also is gaining a share of the world's IPOs. Emerging markets such as India, whose economy has been growing 6 percent or more a year, continue to attract investor attention. The Sensex, the benchmark index of the Bombay Stock Exchange, increased close to 40 percent between 2013 and 2017 as foreign investors continue to pump billions into Indian stocks.[19]

Why should Canadian investors pay attention to international stock markets? Because the world's economies are increasingly interdependent, businesses must look beyond their own national borders to find materials to make their goods and markets for foreign goods and services. The same is true for investors, who may find that they can earn higher returns in international markets.

Key Terms

accounts payable	Purchases for which a buyer has not yet paid the seller.
accounts receivable	Sales for which a firm has not yet been paid.
bond ratings	Letter grades assigned to bond issues to indicate their quality or level of risk; assigned by rating agencies such as Moody's and Standard & Poor's (S&P).
bonds	Long-term debt obligations (liabilities) issued by corporations and governments.
broker markets	National and regional securities exchanges that bring buyers and sellers together through brokers on a centralized trading floor.
capital budgeting	The process of analyzing long-term projects and selecting those that offer the best returns while maximizing the firm's value.
capital expenditures	Investments in long-lived assets, such as land, buildings, machinery, equipment, and information services, that are expected to provide benefits over a period longer than one year.
cash flows	The inflow and outflow of cash for a firm.
cash management	The process of making sure that a firm has enough cash on hand to pay bills as they come due and to meet unexpected expenses.
commercial paper	Unsecured short-term debt—an IOU—issued by a financially strong corporation.
common stock	A security that represents an ownership interest in a corporation.
dividends	Payments to stockholders from a corporation's profits.
exchange traded fund (ETF)	A security similar to a mutual fund; holds a broad basket of stocks with a common theme but trades on a stock exchange so that its price changes throughout the day.
factoring	A form of short-term financing in which a firm sells its accounts receivable outright at a discount to a factor.
financial management	The art and science of managing a firm's money so that it can meet its goals.
financial risk	The chance that a firm will be unable to make scheduled interest and principal payments on its debt.
institutional investors	Investment professionals who are paid to manage other people's money.
interest	A fixed amount of money paid by the issuer of a bond to the bondholder on a regular schedule, typically every six months; stated as the coupon rate.
investment bankers	Firms that act as intermediaries, buying securities from corporations and governments and reselling them to the public.
line of credit	An agreement between a bank and a business that specifies the maximum amount of unsecured short-term borrowing the bank will allow the firm over a given period, typically one year.

Key Terms

marketable securities	Short-term investments that are easily converted into cash.
mortgage loan	A long-term loan made against real estate as collateral.
municipal bonds	Bonds issued by states, cities, counties, and other state and local government agencies.
mutual fund	A financial-service company that pools investors' funds to buy a selection of securities that meet its stated investment goals.
National Association of Securities Dealers Automated Quotation system (NASDAQ)	The first and largest electronic stock market, which is a sophisticated telecommunications network that links dealers throughout the United States.
over-the-counter market (OTC)	Markets, other than the exchanges, on which small companies trade; includes the Over-the-Counter Bulletin Board (OTCBB) and the Pink Sheets.
preferred stock	An equity security for which the dividend amount is set at the time the stock is issued and the dividend must be paid before the company can pay dividends to common stockholders.
primary market	The securities market where new securities are sold to the public.
principal	The amount borrowed by the issuer of a bond; also called par value.
retained earnings	Profits that have been reinvested in a firm.
return	The opportunity for profit.
revolving credit agreement	A guaranteed line of credit whereby a bank agrees that a certain amount of funds will be available for a business to borrow over a given period, typically two to five years.
risk	The potential for loss or the chance that an investment will not achieve the expected level of return.
risk-return trade-off	A basic principle in finance that holds that the higher the risk, the greater the return that is required.
secondary market	The securities market where old (already issued) securities are bought and sold, or traded, among investors; includes broker markets, dealer markets, the over-the-counter market, and the commodities exchanges.
secured loans	Loans for which the borrower is required to pledge specific assets as collateral, or security.
securities	Investment certificates issued by corporations or governments that represent either equity or debt.
stock dividends	Payments to stockholders in the form of more stock; may replace or supplement cash dividends.
stockbroker	A person who is licensed to buy and sell securities on behalf of clients.
term loan	A business loan with a maturity of more than one year; can be unsecured or secured.
trade credit	The extension of credit by the seller to the buyer between the time the buyer receives the goods or services and when it pays for them.
underwriting	The process of buying securities from corporations and governments and reselling them to the public; the main activity of investment bankers.
unsecured loans	Loans for which the borrower does not have to pledge specific assets as security.

Summary of Learning Outcomes

1. How do finance and the financial manager affect the firm's overall strategy?

Finance involves managing the firm's money. The financial manager must decide how much money is needed and when, how best to use the available funds, and how to get the required financing. The financial manager's responsibilities include financial planning, investing (spending money), and financing (raising money).

Maximizing the value of the firm is the main goal of the financial manager, whose decisions often have long- term effects.

2. What types of short-term and long-term expenditures does a firm make?

A firm incurs short-term expenses—supplies, inventory, and wages—to support current production, marketing, and sales activities. The financial manager manages the firm's investment in current assets so that the company has enough cash to pay its bills and support accounts receivable and inventory. Long-term expenditures (capital expenditures) are made for fixed assets such as land, buildings, equipment and information systems. Because of the large outlays required for capital expenditures, financial managers carefully analyze proposed projects to determine which offer the best returns.

3. What are the main sources and costs of unsecured and secured short-term financing?

Short-term financing comes due within one year. The main sources of unsecured short-term financing are trade credit, bank loans, and commercial paper. Secured loans require a pledge of certain assets, such as accounts receivable or inventory, as security for the loan. Factoring, or selling accounts receivable outright at a discount, is another form of short-term financing.

4. What are the key differences between debt and equity, and what are the major types and features of long-term debt?

Financial managers must choose the best mix of debt and equity for their firm. The main advantage of debt financing is the tax-deductibility of interest. But debt involves financial risk because it requires the payment of interest and principal on specified dates. Equity—common and preferred stock—is considered a permanent form of financing on which the firm may or may not pay dividends. Dividends are not tax-deductible.

The main types of long-term debt are term loans, bonds, and mortgage loans. Term loans can be unsecured or secured and generally have maturities of 5 to 12 years. Bonds usually have initial maturities of 10 to 30 years. Mortgage loans are secured by real estate. Long-term debt usually costs more than short-term financing because of the greater uncertainty that the borrower will be able to make the scheduled loan payments.

5. When and how do firms issue equity, and what are the costs?

The chief sources of equity financing are common stock, retained earnings, and preferred stock. The cost of selling stock includes issuing costs and potential dividend payments. Retained earnings are profits reinvested into the firm. For the issuing firm, preferred stock is more expensive than debt because its dividends are not tax-deductible and its claims are secondary to those of debtholders but less expensive than common stock.

Venture capital is often a source of equity financing for young companies.

Summary of Learning Outcomes

6. How do securities markets help firms raise funding, and what securities trade in the capital markets?

Securities markets allow stocks, bonds, and other securities to be bought and sold quickly and at a fair price. New issues are sold in the primary market. After that, securities are traded in the secondary market.

Investment bankers specialize in issuing and selling new security issues. Stockbrokers are licensed professionals who buy and sell securities on behalf of their clients.

In addition to corporate securities, investors can trade government securities and municipal bonds, mutual funds. Mutual funds are managed by financial-service companies that pool the funds of many investors to buy a diversified portfolio of securities. Investors choose mutual funds because they offer a convenient way to diversify and are professionally managed. Exchange-traded funds (ETFs) are similar to mutual funds but trade on stock exchanges similar to common stock.

7. Where can investors buy and sell securities, and how are securities markets regulated?

Securities are resold in secondary markets. The broker market consists of securities exchanges, such as the New York Stock Exchange, that bring buyers and sellers together through brokers on a centralized trading floor. In addition to the U.S. markets, more than 60 countries have securities exchanges. The largest non-U.S. exchanges are the London, Tokyo, Toronto, Frankfurt, Hong Kong, and Taiwan exchanges.

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