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# ACCA Paper F1 Accountant in Business / (FAB) Foundations of Accounting in Business

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# Chapter 1

## The nature and structure of organisations

### 1. Organisations

An organisation can be defined as:

**“A social arrangement which pursues collective goals, which controls its own performance, and which is a boundary separating it from its environment.”**

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

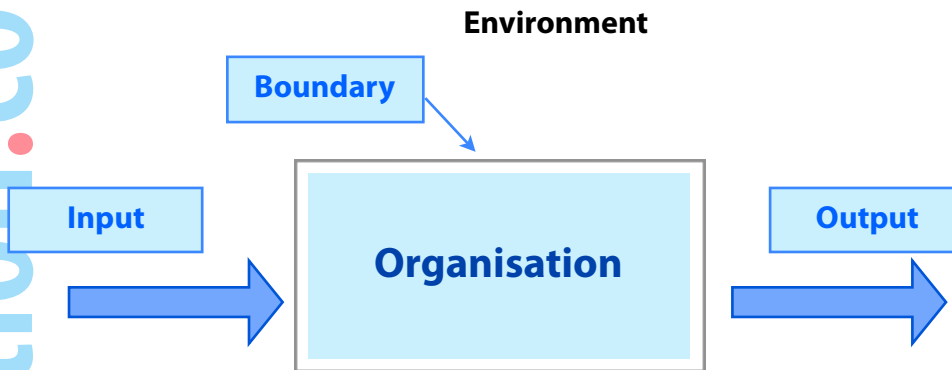
Early management theory tended to neglect the social side of organisations and management and had a rather cold, militaristic approach. Modern theories have changed this considerably.

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

## 2. System

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

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



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

Some systems are known as 'closed systems': they take no input from the environment and give no output to it. These are very theoretical and have no long life. It will be difficult to see an organisation continuing to compete successfully if it paid no heed to technological advances, or what its rivals were doing, or what its customers wanted.

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

### 3. Types of organisation

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

- Commercial organisations are profit-seeking. They can be sole traders, partnerships, limited liability partnerships and limited companies. The main advantage of limited liability partnerships and limited companies is that if the organisation hits hard times and has to go to liquidation, the owners of the organisation are protected. Creditors and banks can pursue only the assets which are in the company. Sole traders and partners, on the other hand, have unlimited liability for all the business's debts.
- The second type of organisation is a not-for-profit organisation. An example of a not-for-profit organisation could be a charity, such as a charitable hospital. Instead of producing a profit and loss account, they tend to produce income and expenditure accounts. Ultimately their income has to exceed their expenditure or they will run out of money.
- Public sector organisations are owned by the state either at a national level or at a local level. Examples could be the defence department, many health services and educational systems. In some economies other industries or businesses are also owned by the state. For example, many national airlines are state-owned.
- Non-governmental organisations tend to be not-for-profit organisations but with an international brief. Many United Nations organisations will fall into this category.
- Co-operatives are owned by the people who work in the organisation. Some farmers, for example, set up co-operatives to market their products more effectively than they could on their own. Usually they seek some sort of profit, but the ownership is shared widely amongst the people who are working in the organisation.

## 4. Organisation structures

**Organisation structures can be described as:**

- entrepreneurial,
- functional,
- divisional, or
- matrix.

**Entrepreneurial structures** are very simple; basically it's a boss and the workers. They are small, often family-owned, and are not large enough to be divided into separate departments.

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

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

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

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



## 5. Mintzberg's structure

Mintzberg divides organisations into five parts.

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

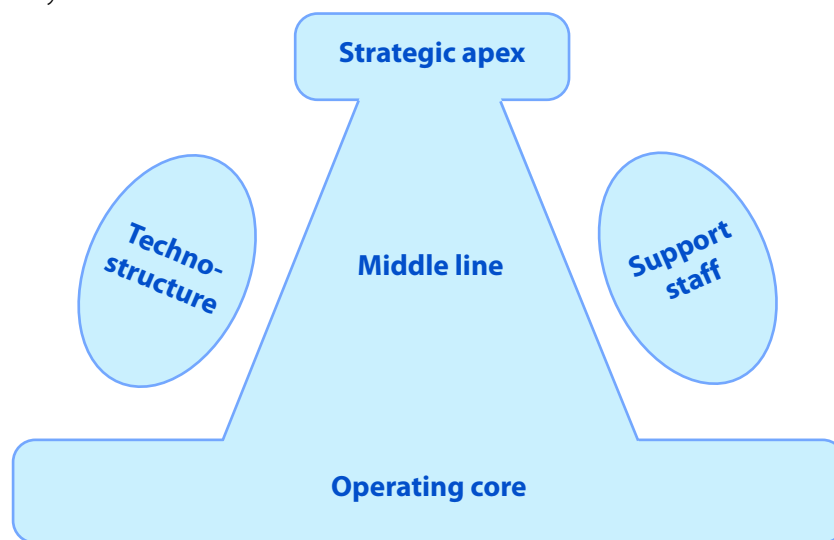
The middle line is the middle managers, sometimes called the scalar chain. This is the hierarchy as it passes down through the organisation.

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

Support staff would include the accounting staff and IT staff.

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

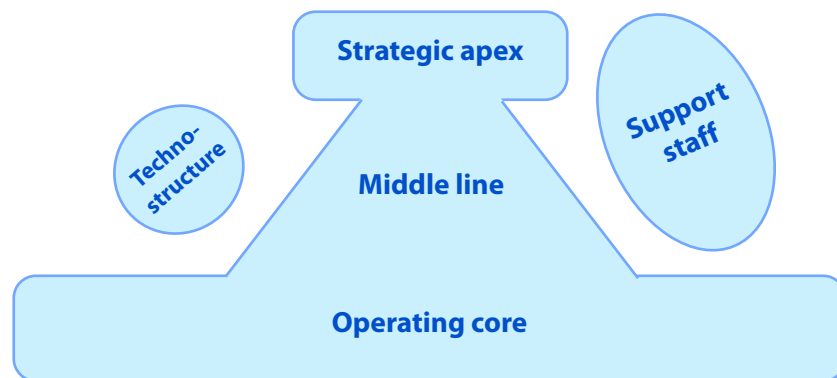
As drawn initially:



the diagrams show what Mintzberg would have called the machine bureaucracy which is basically a large mass manufacturing organisation.

The size and importance of the five parts of the organisation change as we change the organisation. In an entrepreneurial organisation there will be a strategic apex and the operating core. You may remember that entrepreneurial organisation was a basically a boss and the workers with little middle line and the organisation was so small that there was not much support staff and no need for technostructure.

One of the most interesting adaptations of the basic structure is what Mintzberg called professional organisation.



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

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

## 6. Levels

Organisations are often regarded as having three levels.



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

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

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

## 7. Tall/narrow, wide/flat

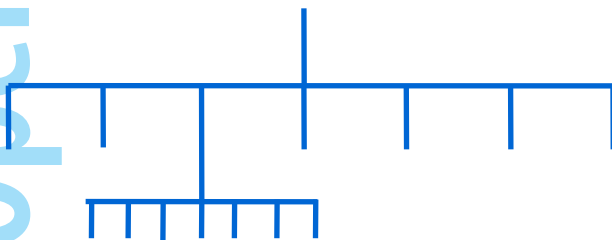
Organisations are often described as being tall-narrow or wide-flat.

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



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

In the wide flat organisation the span of control is much wider. In this diagram we've shown a span of control of seven, meaning that each supervisor or manager has seven people reporting directly to him or her.



You will see in a tall narrow structure there are many layers and because each manager looks after only a few people, there can be very close supervision. Indeed it might not be supervision; it might be closer to re-performance or interference.

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

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

First of all in the '90s there began to be very great cost pressure from Far Eastern manufacturers where manufacturing was relatively cheap. In response to this, Western businesses had to be somewhat ruthless. They had to ask, "Is any value being added by these people in the middle, or are they just managers, managing supervisors, managing assistant supervisors?" It was decided that often these people were not adding value and that they could safely be removed from the organisation.

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

## 8. Centralisation/decentralisation

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

**Claimed advantages are as follows.**

- If nothing is decentralised, all decisions have to remain at the top of the organisation, with the managing director or the board of directors for example. Those people would be overworked, they will be mixing up trivial decisions with important decisions, and really their skills should be reserved for making important decisions.
- Secondly, if requests have to be passed up through an organisation for a decision to be made and then the answers are passed down, decisions are likely to be much slower. So decentralisation adds speed.
- Third, it might be better to decentralise power to areas of expertise. For example the best person to make a decision about where to place advertising is somebody in the sales and marketing department, not the managing director who may have come from an accounting or engineering background. Similarly, perhaps the best person to deal with competitive pressures in South America is the head of the South American organisation, not somebody based in London or Paris. The person in South America has local or geographic expertise.
- Fourth, motivation: good employees like to make decisions and like running their own departments or divisions. If you don't decentralise and allow them to have power, the good people will leave.

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

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

## 9. Recent trends

There have been some recent trends in organisational structure.

- Downsizing has been necessary to keep costs down.
- Delayering, we have discussed recently, moving towards wider, flatter organisations, both to save costs and to achieve flexibility.
- Outsourcing means getting an outside firm to perform some of your operations. These operations will generally be your support operations. Therefore, it is relatively common to outsource your IT and perhaps your receivables ledger. Most businesses don't make money from the receivables ledger or from their IT. These are to them necessary evils. They may make their money from clever engineering or thinking up clever adverts if they are an advertising agency. The thought behind outsourcing is that firms should concentrate on what they are good at, their core activities, and try to outsource everything else, because those functions are liable to be management distractions. Management should concentrate on where it adds value: where the organisation can make its money.

## 10. Formal and informal organisations

In studying this paper, you will often come across the concepts of formal and informal organisations.

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

However, an enormous amount of the organisation is informal.



This diagram is supposed to depict that, because what it shows in the middle is an iceberg. Only a relatively small part of an iceberg is seen or is known about. By far the greater part of it is invisible, but dangerous. If management is unaware of the informal organisation then they are liable not to be able to manage very well. So, for example, if you have two people who hate each other but nevertheless, according to the organisation chart, are supposed to co-operate, then that department will not work well.

Similarly, despite lower management issuing newsletters and e-mails to all their staff, rumour and gossip gets around organisations very quickly. It's often inaccurate, but that doesn't mean it's not going to be believed.

Group norms is another important example. A group norm is an arrangement people come to, often slowly, about how they should behave. For example it might be the group norm that nobody ever works past 5 o'clock on a Friday. They have come to this arrangement somewhat informally but anyone new joining the organisation will generally fall in line; otherwise they are frightened they are not going to fit in. And once certain group norms

have been adopted by a number of people, it can be very difficult for management to shift those norms to something else as all of those people resist together.

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

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



## Chapter 2

# Information and information technology

### 1. Information

We now come to look at the importance of information technology in business.

First we need to decide what is meant by the term "information." The most normal definition is that information is data with meaning. Data is the raw fact and figures. But generally of itself it isn't very meaningful. For example, a list of all outstanding invoices in value order is not very useful to a credit controller. That data only becomes useful, if first of all it is sorted by customer, and then perhaps sorted and presented by the age of the invoice. Then it has become meaningful as the user can interpret it and do something with it.

One of the important considerations for an information processing system is that it does present the information in a way or in ways which are useful to the various users of that information.

**What are the characteristics of good information - and here the word "ACCURATE" can be used.**

- Accurate. High quality information should be accurate; that doesn't necessarily mean accurate to the very last cent. It means accurate enough for the purposes for which it is going to be used. And for example the board of directors may be perfectly happy with accounts rounded to nearest thousand or even the nearest million dollars.
- Complete. The information should be complete; it should include everything that needs to be included to make proper decisions.
- Cost-beneficial. It should be cost beneficial, there is no point in gaining information at a huge cost, if the benefits derived from that whether financial or otherwise are minimal. We are not in the business of information for information's sake. We either want to make more profit or to run an organisation more efficiently.
- User-targeted. It should be user-targeted. The information should be presented in a way which is useful to the user. For example senior managers may want summaries; account staff needs much more detailed information.
- Relevant. It should be relevant. You shouldn't supply people with more information than they need otherwise they may overlook the important information.

- Authoritative. It should be authoritative. The source of the information should be one which can be relied upon. Those of you who have used the Internet should be well aware of this. You put a term into a search engine, all sorts of material comes out. Some of it is from authoritative sources, others from amateurs, others from charlatans.
- Timely. It should be timely. Information should be supplied quickly enough to help you make a better decision. Some information has to be provided very quickly within seconds, or even fractions of a second in some industrial processes. For other purposes you might easily be able to wait for a week or even two weeks before the information is required to enable you to make a decision on time.
- Easy-to-use. Finally the information should be easy to use. It should be well presented, well documented. Easy to use might mean that it's more beneficial to see information in the form of graphs than in the form of tables.

## 2. Role of information technology

Information technology plays an enormous role in the way we work now. For example:

- Information and communications. Just think of the sort of information and communication that is easily obtained over the Internet, whether by looking up information, or whether nowadays by making telephone calls over the Internet through VOIP (voice over internet protocol) technologies such as Skype. E-mail can also be included under new communication channels.
- Office automation. Consider the enormous labour-saving that can be obtained from a simple spreadsheet, or from being able to look up a database, or from being able to enter an order which then initiates the dispatch and the invoicing of goods without further human involvement.
- Home-working. Good communication means that many people to work from home, at least some days of the week, or if not at home, at least from locations away from the main office. For example, sales personnel can communicate with the head office at the end of the day and transmit new orders, make inquiries, and so on.

### 3. Types of system

There are some fairly well-defined types of IT systems and generally these describe the historical development of IT systems.

#### Transaction processing systems

The earliest type of system was known as the transaction processing system. Essentially this was developed in the 1960s and it does what it says. It processes transactions such as sales, wages, salaries. It was essentially just automation of what had been done by armies of accountants. There was nothing very clever about it, but it took a lot of repetitive calculation out of organisations, speeded up processing and probably added to accuracy. It certainly saved costs.

#### Management information systems

Very soon after transaction processing was well established, people began to think that if, for example, we have the receivables ledger in a computerised system, we can use the data which is there to create useful management information, such as an aged receivables analysis. Management information came into its own in the 1970s. It was producing information which was going to be useful for management for making decisions. By and large, the information was for decisions which were fairly black and white, right or wrong. Either someone is above that credit limit or they are not, therefore we either authorise their order or we refuse it.

#### Decision support systems

In the 1980s decision support systems became more common. Again this does what it says. It helps and supports people when making decisions; the IT system doesn't make decisions. Very good example of the decision support system is how do you decide what next year's budget should be. Here there is no right or wrong way of deciding what next year's sales should be: it's a process which depends on judgment and experience. However something like a spreadsheet where you set up a budget is going to be extremely useful in helping you to come to a conclusion about what next year's budget should be. You can change the input assumptions and very quickly the results are calculated. The spreadsheet isn't drafting next year's budget but is giving you great help in arriving at next year's budget. It is supporting your decision-making.

#### Executive information systems

Finally, in the 1990s we had executive information systems. There is perhaps not a huge difference between decision support systems and executive information systems. But the characteristics you tend to find in the latter are the following:

- First of all it provides very flexible access to information.
- Secondly, executives often need information from outside the organisation. So an executive information system almost certainly has links to external databases or at least to the Internet.

- Third, it allows executives to drill down. The executive might see initially total receivables but if that figure is clicked on, then it will divide into the receivables from each of the major divisions. If one of those is clicked on, it will then begin to show the receivables from each of the major customers and so on. You are drilling down into successive levels of detail and more information as required.
- The final characteristic which is often talked about with executive information systems is that they are highly graphical. Executives need to see trends because they will often be using trends to project the future and to decide on how the organisation should move forward. It's very often easier to see a trend such as growth or decline by looking at a graph rather than looking at tables or figures.

#### 4. Information technology

IT systems can also be categorised by their hardware.

- Standalone systems are single computers not connected to any other computers.
- LANs or local area networks is a number of computers connected to other computers. Local area network means that the group of computers are in a relatively confined area, perhaps within a hospital, a school, a university or a single office block. Local area networks use a special cable link to allow the different computers to communicate with each other. The immediate benefit is that information can be shared between all users on the network. It also facilitates the transmission of e-mails. Usually one of the computers on the network is what's known as a file server. This is a computer with a large capacity disk, where much information is held centrally and then accessed by the various users of other computers.
- Wide area networks are somewhat similar to local area networks except that their geographical spread is much greater, typically over a number of different cities or perhaps over a number of different countries. This means that special cabling can't be used for all communications and use has to be made of commercial telecommunication networks such as the ordinary phone system. Typically, you might have a local area network, a LAN in London, another LAN in New York and these are connected over the satellite system to produce a WAN so that the London and Euro offices can be connected and share information.
- The Internet is a network of networks. The Internet comprises websites, each with a unique address, usually beginning "www" and when this is typed in, you are switched through the network, potentially using many different pathways, to access a computer which holds the information for that website. Navigation through the Internet is by use of something like Internet Explorer or Firefox.
- An intranet is an internal Internet. In many ways it's very similar to a LAN, the main difference is the human interface which again is through something like Internet Explorer or Firefox. Intranets are extremely good ways of sharing information throughout an organisation and often newsletters, personnel handbooks, product handbooks and customer information is shared in this way.

- An extranet is an intranet but which can also communicate with the intranet of another organisation. A good example would be an intranet belonging to a supermarket having access to the intranet belonging to a supplier. When goods in the supermarket fall below the re-order level, an electronic order is sent over the extranet to the supplier system and the order is then dispatched.

## 5. Levels – types of information

The different levels within an organisation require very different types of information.

Take the strategic level. This can be represented by the board of directors over senior managers. The information required by these people is usually highly summarised, forward looking, ad hoc, often external.



### Summarisation

They are looking at whole divisions or whole companies, and part of their summarisation will mean that they don't need the information in all its accuracy. It may be rounded to the nearest thousand or million.

### Forward-looking

Secondly, it is a very important function of top managers to look forward, to plan, to try to see where the business will be in one, three or five years' time. Therefore the type of information needed by these managers will often be future estimates of market size, interest rates, competition action. This information is needed for planning. Top managers are not so concerned with the retrospective recording of what's happened. That is of course important but there should be more concern with planning for the future: what will our cash flow budgets imply for our funding requirements: Do we need to borrow money or raise more share capital? Should we think now about building new factories?

### Ad hoc

Strategic information is often ad hoc, in other words non-routine. For example a one-off report might be required on the competition and market size in a particular country which the company might be thinking of expanding into. Having received that report, it may never be required again. Therefore there is a great need for flexibility in supplying the required information.

### External

Finally strategic managers have a high need for external information. They need to know what is happening in their environment, their competitors and the technical advances taking place in their area of business.

At the bottom of the organisation is the operational level. An example of someone at the operational level would be an accounts clerk. People at this level are usually dealing with very detailed information, they are recording transactions which had already happened, therefore the information is historical, it's retrospective. The information and the processing are often routine. Every month they do an aged receivables printout or a slow-moving inventory printout and finally the information is almost always internal. For example, they might be comparing actual results with budget results.

In between these two extremes you have the tactical level. By and large a tactical manager is concerned with a year's results. Are we going to hit budget? Are we going to stay within the expense constraints? They require some sort of mix of information, and some aspects of it will be like that required by the strategic level, and some more like that required by the operational levels.

## 6. Internal and external information

Here are some examples of internal and external information. Be aware of the very wide variety of information and information sources that might be useful to organisations.

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





# Chapter 3

## An organisation's environment

### 1. Environmental influences – PEST(EL)

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

#### Political

For example joining the EU, political tensions, war, alliances can all influence many businesses.

#### Economic

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

#### Social

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

#### Technological

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

## Ecological

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

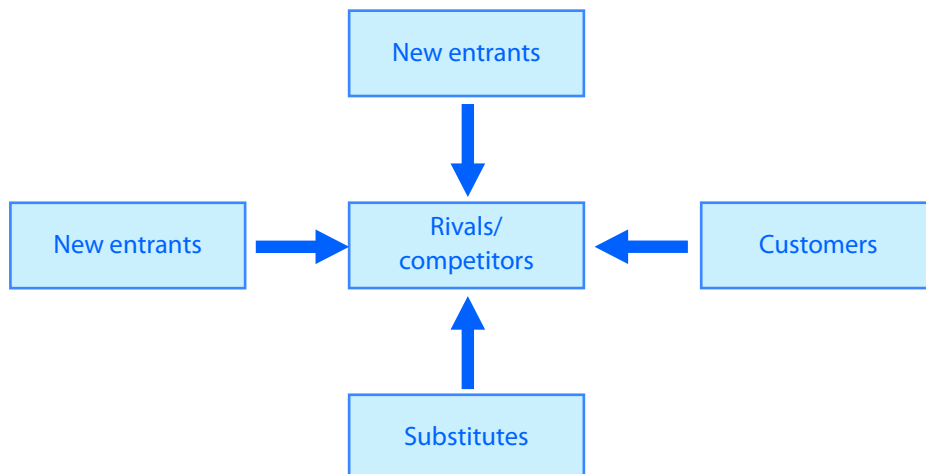
## Legal

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

## 2. Competitive forces

Porter's 5 Forces model is a popular and useful framework with which to analyse industry attractiveness.

Industry attractiveness refers to how easy a business will find it to make reasonable profits. And by reasonable profits we mean profits large enough to compensate investors for their risk, and also to make enough money to reinvest to keep the company successful.



The first of the forces is competition or rivalry. This can range from perfect competition where sellers have no choice as to the selling price that is charged (they are governed by the market price) all the way through to monopoly. A monopoly gives sellers much more choice as to what price can be charged, though the price will normally alter demand. And remember, just because you have a monopoly doesn't mean you will make profits - you might be the monopoly supplier of something nobody wants. However, by and large, the nearer an industry gets to monopoly, the easier a time its participants will have. Therefore, provided it's legal, it could be a useful strategy to take over a rival or to force it out of business by perhaps lowering prices temporarily.

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

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

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

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



# Chapter 4

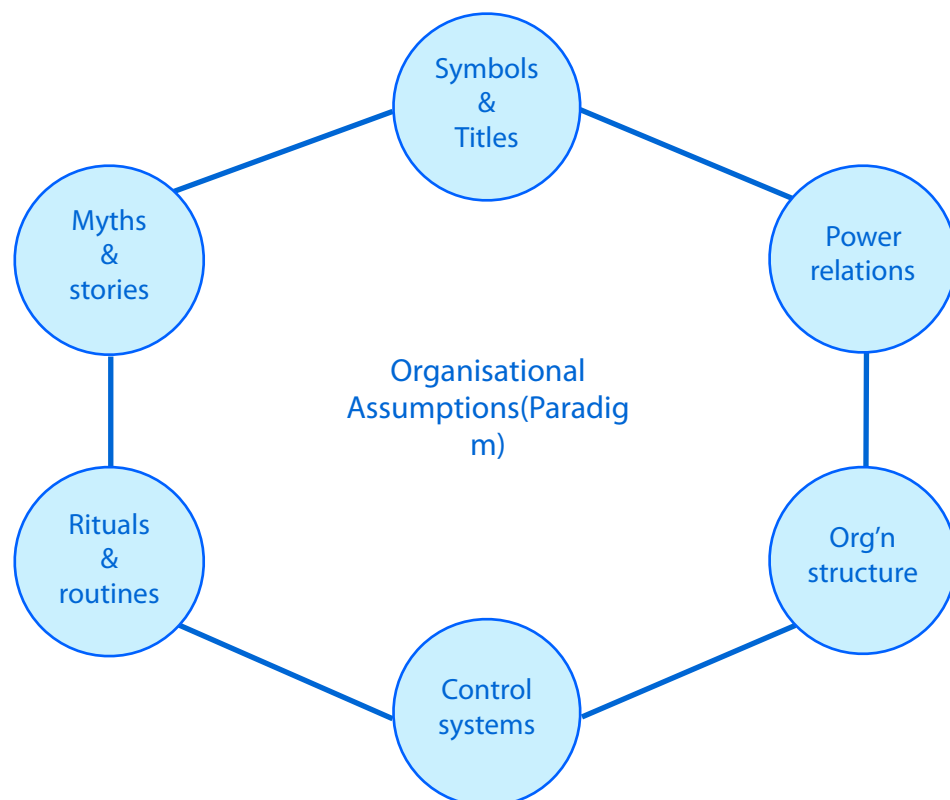
## Organisational culture

### 1. Cultural web

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

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

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



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

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

**Organisational structure.** Some organisations are what's known as 'tall narrow' with many layers, each layer being carefully supervised by the supervisor or manager above. Other organisations are what's known as 'flat wide' organisations, relatively few vertical layers and each manager therefore having to look after a relatively large number of people, but inevitably because they are looking after more people, people have to be better at looking after themselves.

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

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

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

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

## 2. Types of culture – Handy's classification

Charles Handy identified four types of organisational culture. Each of these categories was given the name of a Greek god. I don't think those names are very useful but you ought to know them for the exam anyhow.

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

**Role culture.** It becomes difficult to sustain a power culture as the business grows, there is simply too much to know, too much to do, and it may then change into a role culture (Apollo). In the role culture there is effectively a management structure with different people having different roles. The problem with the role culture is that sometimes the title, the job, is regarded as more important than actually getting the job done. Often associated

with role culture are very strict job specifications and if something isn't on the specification then people will refuse to do it even if it hurts a client or customer.

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

**Person culture.** A relatively rare type of culture is the person organisation (Dionysus). Here you have people who are essentially pursuing a private ambition in the context of an organisation. It's not very important in business. An example might be a surgeon in a hospital. The surgeon gets enormous job satisfaction from performing operations and making people better. To some extent surgeons might not be terribly interested in interacting with the rest of the organisation. They are there primarily to fill their personal ambitions and the rest of the organisation is almost an essential evil.

### 3. Schein - three levels of culture

Schein usefully identified three levels of culture.

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

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

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

## 4. National cultures

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

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

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

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

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



# Chapter 5

## An organisation's stakeholders

### 1. Stakeholders

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

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

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

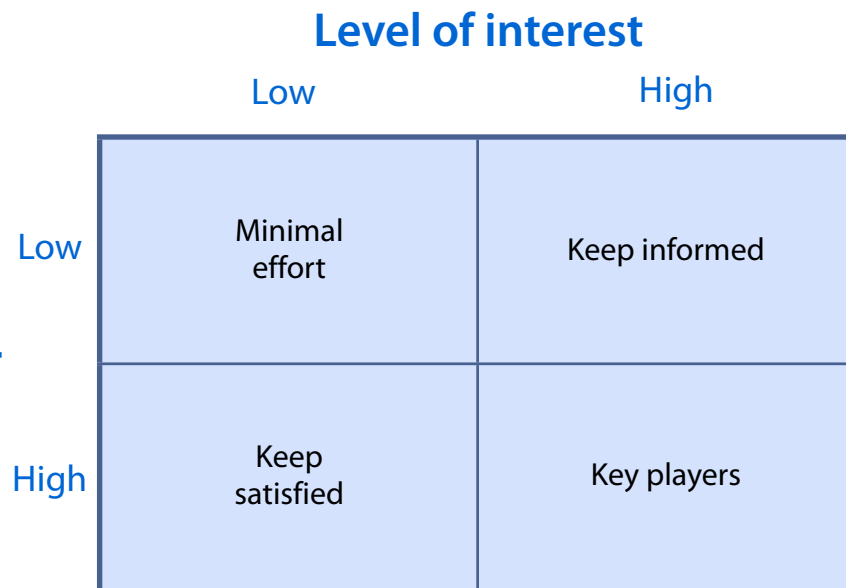
**External stakeholders** are entirely outside the organisation with no contractual relationship. The best example for this is will be the people living nearby a factory. They are obviously affected, but have very limited contractual rights over what the factory does.

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

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

## 2. Mendelow

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



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

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

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

Finally we have people with low power and low interest. Management can nearly ignore these people. After all, what are they going to do if they don't like what's happening?

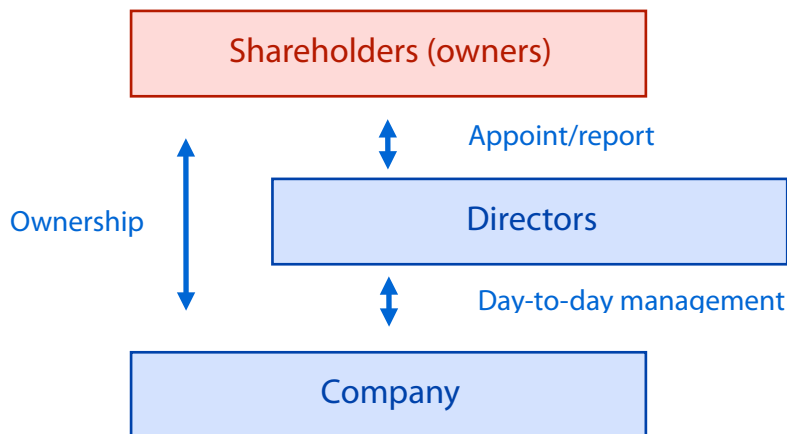
## Chapter 6

# Corporate governance and ethical considerations

### 1. Corporate governance

Corporate governance refers to how companies are directed and controlled.

The real problem is the separation of ownership and control.



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

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

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

## 2. The UK Corporate Governance Code

The UK Corporate Governance Code can be used as an example of best practice.

The code states that the purpose of corporate governance is to facilitate effective entrepreneurial and prudent management that can deliver long-term success of the company. It then goes on to list the main principles of the code:

### Main principles

- Leadership
- Effectiveness
- Accountability
- Remuneration
- Relations with shareholders

### Comply or explain

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

### Leadership

- Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.
- There should be a clear division ... between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision. This means that the roles of CEO and Chairman should not be performed by one person as that concentrates too much power in that person.
- The chairman is responsible for leadership of the board
- Non-executive directors (NEDs) must be appointed to the board and they should constructively challenge and help develop proposals on strategy. NEDs sit in at board meeting and have full voting rights, but do not have day-to day executive or managerial responsibility. Their function is to monitor, advise and warn the executive directors.

### Effectiveness

- The board should have an appropriate balance of skills, experience, independence and knowledge. In large companies NEDs should be at least 50% of the board; in small companies there should be at least 2 NEDs.
- New directors should be appointed by a Nomination Committee to ensure a formal, rigorous and transparent procedure for their appointment. The Nomination Committee consists of NEDs. This provision is to prevent directors appointing their friends and colleagues to the board and ensures that the best people for the job are considered and appointed.

- All directors should be able to allocate sufficient time to company business
- There should be induction on joining the board and a programme to update and refresh directors' skills and knowledge.
- The board should be supplied in a timely manner with necessary information
- The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- All directors should be submitted for re-election at regular intervals

### Accountability

- The board should present a balanced and understandable assessment of the company's position and prospects.
- The board is responsible for determining the ... significant risks ...and should maintain sound risk management and internal control systems.
- The board should establish formal and transparent arrangements for applying the corporate reporting, risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor. This means that an Audit Committee (NEDs again) should be established to liaise with both internal and external auditors. Before audit committees, the finance director liaised with auditors, but this was not satisfactory because the finance director was often the person responsible for accounting problems. Therefore auditors were often reporting problems to the person who caused them. The directors are responsible for establishing an internal control system and must review the need for internal audit.

### Remuneration

- Levels of remuneration should be sufficient to attract, retain and motivate directors of sufficient quality... but avoid paying more than is necessary.
- A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. In other words, profit related pay is encouraged. Directors should not receive high pay irrespective of company performance.
- There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. This means that a Remuneration Committee (NEDs) should be formed to fix directors' remuneration.

### Relations with shareholders

- One of the problems with achieving good corporate was encouraging shareholders to take an active interest in the company. Too often they did not fully participate at AGMs and would wave through motions. This passive attitude might well have been encouraged by directors to move power towards them and away from members.

The code therefore specifies:

- There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.
- The board should use the AGM to communicate with investors and to encourage their participation.

### 3. Corporate Social Responsibility

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

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

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

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

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

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

## 4. Ethical stances (Johnson and Scholes)

Johnson and Scholes identified four ethical stances. And indeed these stances also have something to do with corporate social responsibility.

The first stance says that it is the purpose of companies to look after shareholders, and in particular the short-term interests of shareholders. This will allow them to do almost anything which maximises short-term profits.

The second stance looks at the long-term interests of shareholders. This is more ethical simply because in the long run unethical behaviour is more likely to be punished. If you are found to have cheated, or your products harm people, then the short-term profits may be increased, but longer-term profits will be decreased when you are found out.

Third, multiple stakeholder obligations. In other words, widening obligations beyond just shareholders to stakeholders in general. So one has to take into account employees, suppliers, customers, the local population, and government when making decisions about the company.

Finally there is the shaper of society where a company or organisation sets out to fundamentally change the way society is run. Some companies, for example, may attempt to be very green and very ecologically respectable. But it's difficult to know to what extent they should be doing this. Are companies and individual organisations the proper bodies to shape society? Should that not be government? Nevertheless there have been some examples of companies which have taken particular ethical stances and which have had a profound influence on other companies in the economy.

## 5. Ethics - importance

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

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

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

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

A good reputation will tend to attract better employees. No one really wants to be associated if possible with a company which has a reputation which is poor.

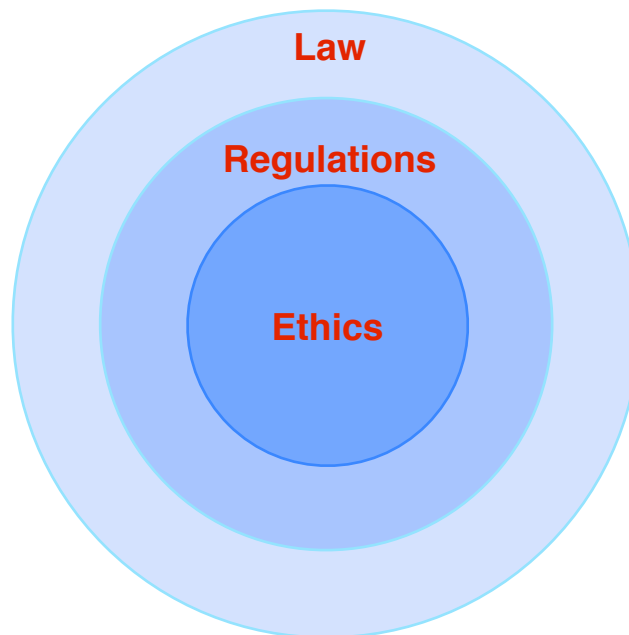
Finally, a good reputation should increase goodwill and increase sales. Companies which are regarded as being unethical tend not to be trusted and certainly not liked by customers. Customers will always be trying to find an alternative.

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

## 6. Ethics, the law and regulation

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

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





## 7. Ethical principles

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

### Consequentialism

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

### Duty (deontological approach)

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

## 8. Relativist or absolute?

### Relativism

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

### Absolutism

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

## 9. Examples of ethical problems facing managers.

- Profit/public good eg pharmaceuticals. Pharmaceuticals are expensive to develop and companies need profits. However, what approach should be taken to providing medicine to people who cannot afford to buy it at a price which yields a profit?
- Profit/health and safety eg aircraft. New aircraft (and new drugs) are tested very extensively, but at some point a line is drawn and the products are launched. If more testing were carried out the product might be slightly safer, but more testing takes more money and delays any benefits arising from the product.
- Equal opportunities eg recruitment. Increasingly laws, certainly in the EU are intervening in matters of employment to reduce the likelihood of racial, sex, religious, sexual orientation and age discrimination.
- Payments:
  - Extortion
  - Bribery
  - Grease money
  - Gifts

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

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

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

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

## 10. Promotion of ethical behaviour

The following values should promote ethical behaviour in organisations:

- **Openness**

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

- **Trust**

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

- **Honesty**

This does not need much expansion, but it is important that honesty with colleagues, suppliers and customers is encouraged.

- **Respect**

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

- **Empowerment**

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

- **Accountability**

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

## 11. Corporate code of ethics

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

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

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



## Chapter 7

# Accountancy and the accountancy profession

### 1. Influence of the accountancy profession

The accounting profession has the very wide-ranging influence.

- **Financial accounting.** The accountancy profession deals with how items should be shown in the accounts. In other words, they establish the accounting standards.
- **Auditing.** Once companies get to a particular size they have to be audited. An audit is an independent gathering of evidence that allows the accountants to report whether or not the accounts produced by the company show a true and fair view.
- **Management accounting.** Within companies there needs to be management accounting. This will be looking at budgets, future estimates and will be recording on a month-to-month basis how the company is doing, and investigating why it might not be on track to hit the required profits.
- **Consulting.** Many accountants also provide consultancy. For example relating to the IT system, particularly for the accounts function, and in setting up remuneration schemes and systems of internal control.
- **Taxation.** Accountants have a very important role in helping organisations to calculate their tax liabilities and reporting this to the government revenue authorities.
- **Government.** Within the public sector, that is government organisations, accountants are very important in tracking and recording the expenditure of public funds that have been raised by taxation.

## 2. Professional ethical codes

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

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

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

## 3. ACCA Code of Ethics and Conduct.

The ACCA's fundamental principles are as follows:

- **Integrity.** Basically, this means that the members should be honest and straightforward. If they see something is amiss, they should say so. They shouldn't try to conceal, they shouldn't try to be ambiguous. They should state things plainly.
- **Objectivity.** Members should be influenced by the facts and the facts only. They must avoid bias, conflict of interest, and undue influence.
- **Professional competence and due care.** Accountants must keep themselves up to date with legislation and recent developments. They shouldn't take on work which they are not qualified for or for which they have no skills. They must be diligent, they must be careful.
- **Confidentiality.** Members, particularly perhaps auditors, have access to information which is highly confidential and which is price-sensitive. That information must be held confidentially. Members should not disclose confidential information unless they have a legal or professional duty to do so. An example of the legal duty to disclose information can arise if a member thinks that a client or the person that they are working for is involved in money laundering. Many countries have very strong

regulations nowadays stating that money laundering suspects should be reported to the authorities.

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

#### 4. Users of accounting information

The potential uses of accounting information include:

- Managers of the company.
- Shareholders of the company.
- Trade contacts: suppliers and customers
- Providers of finance to the company.
- The Inland Revenue.
- Employees of the company.
- Financial analysts and advisers,.
- Government and their agencies.
- The public.

## 5. Management accounts and financial accounts

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

### Management accounts are:

- Internal.
- They can be in any format,
- They look to the future, for example setting budgets; and back, for example looking at performance to date.
- They are often what's known as 'ad hoc'. That means they can contain non-routine special reports.
- Their form and content is not governed by statute. Management accounts are governed simply by the need for information and how that can be best provided.
- Finally, they are not subject to audit or independent checking of any sort.

### Financial accounts are:

- The published accounts of a company, particularly provided for the members or shareholders of the company.
- The format and content is tightly regulated by statute.
- They always look back, what the balance sheet at a particular date was at what the profit and loss account for a period was.
- They are absolutely routine, normally appearing annually.
- They must comply with statutory and other accounting rules
- Often they are subject to audit, certainly are once a company becomes a significant size.



## 6. Audit

We have made several references to the term “audit.” So let’s just cover a little bit more about what that might entail.

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

We talk about ‘accounts’ but really we should talk about ‘financial statements’ and the financial statements comprise the:

- Profit and loss account or nowadays that will be called the income statement
- Balance sheet, probably nowadays called the statement of financial position,
- Cash flow statement,
- Notes to these documents
- Statement of reserves.

The external auditors look at these financial statements, do many checks, and come to a conclusion about them.

- ‘True’ means that the financial statements are more or less arithmetically accurate.
- ‘Fair’ is a slightly more difficult concept and means they are not misleading. Something can be arithmetically accurate, yet still give an incorrect impression.

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

## 7. The regulatory system

In the UK, accounts are regulated as follows:

- **Company law.** This, for example, insists that companies produce accounts roughly every year. Although there are certain statutory disclosures set out in company law, by and large company law doesn't go into huge amounts of detail about exactly how different elements of the financial statements must be shown. That's really too complex a matter to have in law because frequent changes and great expertise is needed to decide how things should best be shown.
- **Accounting standards.** The detailed regulations about disclosure and presentation are usually found in the accounting standards. The major bodies of accountants must subscribe to the accounting standards. The system for establishing accounting standards is headed up by the Financial Reporting Council and, in particular, the Accounting Standards Board issue accounting standards. Its standards are called the financial reporting standards or FRSs. In general, all sets of financial statements should comply with the financial reporting standards.
- **Urgent issues taskforce.** From time to time urgent issues arise, for example, the recent banking crisis could potentially have given rise to issues which had to be dealt with very quickly. Rather than going through the full and perhaps rather slow process of establishing financial reporting standards in the normal way, the Urgent Issues Task Force can deal with these urgent matters quickly.
- **Financial Reporting Review Panel.** Sometimes companies depart from the financial reporting standards and the Financial Reporting Review Panel is concerned with examining and questioning why that has taken place. Occasionally they may conclude the departure is justified, but this tends to be a relatively rare occurrence.

## 8. GAAP

GAAP stands for Generally Accepted Accounting Practice. This is a common set of accounting principles, standards and procedures that companies use to compile their financial statements.

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

## Chapter 8

# Internal control and the implications of fraud

### 1. Internal controls

The term 'internal controls' refers to the collection of mechanisms whereby an organisation tries to ensure that all its transactions are properly authorised and recorded, and that its assets are safeguarded. The proper management of a business (and indeed now part of corporate governance requirements) means that there has to be a good system of internal control in place if directors and other managers are going to exercise their stewardship responsibilities correctly.

The system of internal controls fall into two parts.

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

**Detailed control processes.** For example:

- If someone works overtime you expect this to be authorised by a manager.
- Once a supplier's invoice has been paid, you expect that to be cancelled in some way to prevent it being paid twice.
- Before you send goods to a new customer you should take up credit references, perhaps by writing to their bank and then setting a credit limit.
- It should be impossible to dispatch goods to that customer if it puts it over their credit limit
- There should be a system of reviewing receivables and following up slow payments to try to prevent the occurrence of bad debts.

## 2. Implications of fraud

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

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

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

If the finances of the company are incorrectly recorded then incorrect decisions could be made. The company might decide to expand when in fact the cash is not there or it may think a particular cost is very high, but that cost has artificially been boosted because of a fraud. And finally the

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

## 3. Detecting and preventing fraud

Preventing and detecting fraud depends on the following:

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

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

Both control systems and ethics depend on training. If training is not given, how will people know how to act appropriately, either to act in line with the internal control system as set down, or how to deal with ethical dilemmas - which can sometimes mean asking for help and advice.

## 4. Responsibility

Finally in this section we have to see who is responsible for what.

The directors are responsible for setting up a system of internal control for ensuring that the proper information for management control is provided, and for producing the financial statements.

The external auditors are responsible for auditing the financial statements. They will carry out their audit procedures to collect evidence that the financial statements are presenting a true and fair view. In the course of that examination they might rely on the system of internal control which is in place, and if this is inadequate, they will write a report to the directors advising them about how it could be changed.

The external auditors are *not* responsible for setting up and maintaining the system of internal control, nor are they responsible for providing management information, nor are they responsible for producing financial statements.



# Chapter 9

## Management

### 1. The purpose and process of management

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

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

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

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

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

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

### 2. Trait theory

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

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

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

### 3. Henri Fayol - Classical Management

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

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

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

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

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



## 4. Taylor – scientific management

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

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

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

### **Potential benefits arising from Taylorism are:**

- Increases in productivity,
- Fair and higher wage allocation based on output, and
- Workforce care programs because if you didn't care for your work force, you have to waste money through additional recruitment, training, and inefficiencies.

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

## 5. Human relations school

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

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

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

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

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

## 6. Style theories

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

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

- manage a business
- manage other managers
- manage the workers and the work.

He broke these down into five categories of activity.

## 7. Drucker

Drucker said that a manager's activities consist of:

- setting objectives,
- organising the group,
- motivating and communicating,
- measuring performance, and
- developing people.

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

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

## 8. Mintzberg – managerial functions

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

<b>Interpersonal roles</b>	arising from formal authority and status and supporting the information and decision activities	<ul style="list-style-type: none"> <li>● figurehead</li> <li>● liaison</li> <li>● leader</li> </ul>
<b>Information processing roles.</b>	For example, they monitor information maybe by looking at management accounts and they distribute information	<ul style="list-style-type: none"> <li>● monitor</li> <li>● disseminator</li> <li>● spokesman</li> </ul>
<b>Decisional roles</b>	making significant decisions, perhaps about how resources should be allocated, negotiating with suppliers or lead members of staff, and dealing with disputes; in other words, the disturbance handling role	<ul style="list-style-type: none"> <li>● improver/ changer</li> <li>● disturbance handler</li> <li>● resource allocator</li> <li>● negotiator</li> </ul>

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

## 9. Power, authority, responsibility, delegation

There are four important terms regarding management:

**Power.** Power is the ability to influence people or events. What gives people power?

- Rational-legal, that's the power your manager has. You do what your manager tells you because that person is called "manager" and part of your contract of employment implies that you should do what your manager tells you provided that it's legal.
- Coercive power - use of force.
- Reward power – offering you more pay or promotion if you do what you are told.
- Knowledge power - the power that some people have because they have specialist knowledge which they release selectively.
- Charismatic power - the power that some people have simply by their force of personality or their charm.

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

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

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



# Chapter 10

## Leadership

### 1. Ashridge Management College model

We have two further style theories to look at. First the Ashridge Management College model. This identified four types of leadership style, but remember these are only points in the continuum of management styles.



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

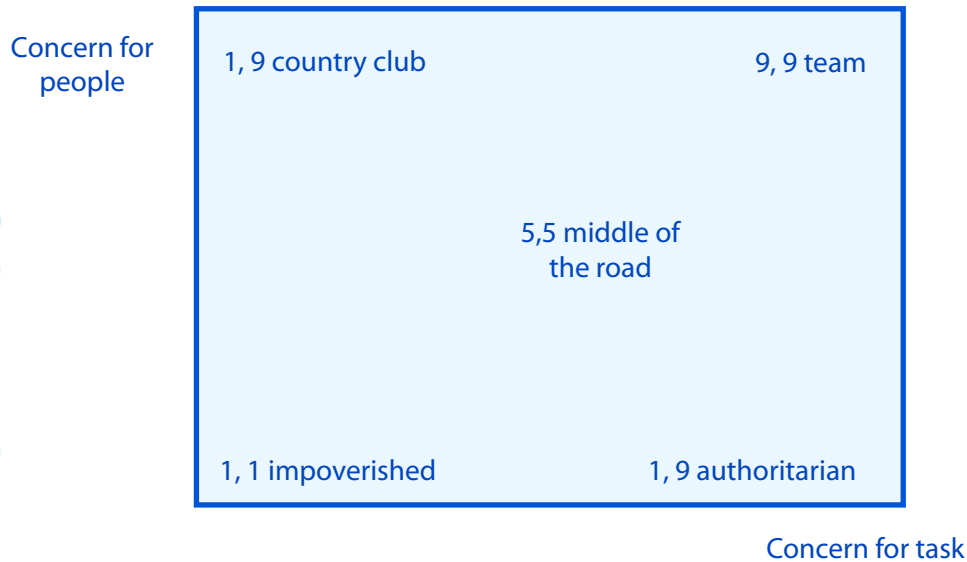
A slightly more liberal approach is “sells.” Here the manager tells people what to do but then sells that idea to them, convinces or persuades them, or explains why it has to be done that way.

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

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

## 2. Blake and Mouton's managerial grid

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



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

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

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

The best style is presumably at the top right, someone who has great concern for people and also great concern for the task. This is regarded as the team leadership style: someone who will be a very good leader simultaneously getting tasks accomplished as required but also making their staff feel wanted and needed, and having time for them.

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

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



### 3. Contingency theories

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

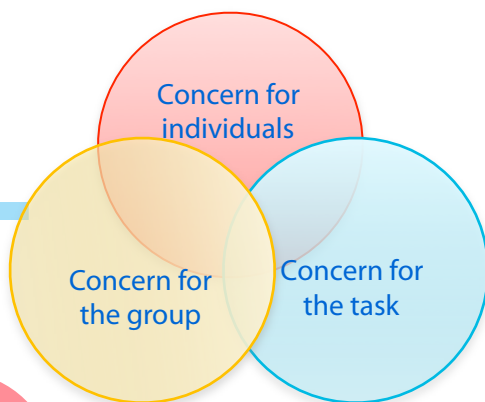
These are the most modern theories and are miles away from the original classical theories. If you remember, the idea behind classical theories was that they presented a set of golden rules which promised that if you manage like this, then you will manage successfully.

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

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

### 4. Adair – action-centred leadership

Adair is associated with action-centred leadership.



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

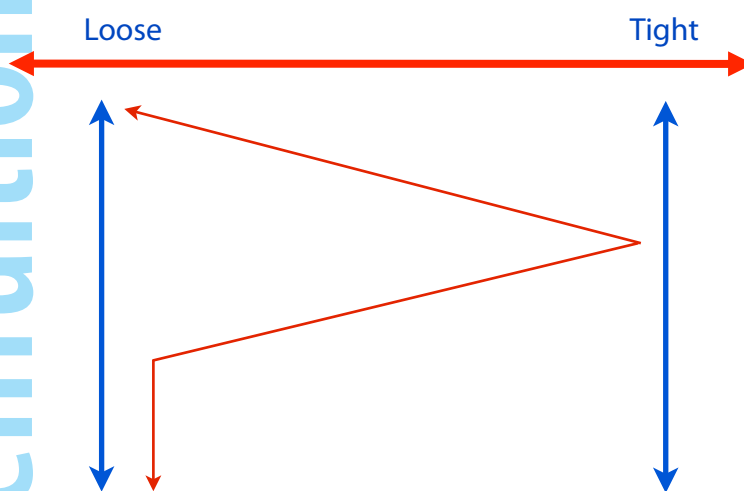
How shall we manage? Well, according to Adair, it depends. On some occasions there may be a very urgent task and we have to reduce our concern for individuals and the group and concentrate on the task. Sometimes there may be crisis within a group; perhaps their leader has left, perhaps there is disagreement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

## 5. Handy's best fit theory

**Handy's best-fit theory identified four variables:**

- Leader
- Subordinates
- Task
- Environment.

Handy said that each of these variables could be what he described as 'loose' or 'tight'.



A tight leader is very autocratic. Tight subordinates like being told what to do and want to avoid risk. They want repetitive tasks; tighter tasks are routine and well understood, relatively simple. And a tight environment would be one where, perhaps, time is short or there isn't much resource to go around.

'Loose' would mean that the leader is very participative or democratic; subordinates want to participate and contribute to solutions. The tasks are novel, complex, high risk; the environment is one which is more generous in time and resources to allow complex tasks to be dealt with.

Handy said that provided all four variables line up, either all loose or all tight, things will work fairly well. So an autocratic manager in charge of staff who want to be told what to do, doing routine, repetitive tasks in an environment which is rather constrained will tend to work. However, he said that once you get a crossover you are in trouble. If you put an autocratic leader in charge of highly trained subordinates who are used to contributing towards solutions or problems, and who are used to participation, and these people are given routine tasks with not much time to do them in, then it's not going to work very well. The subordinates will not get on with their leader; the subordinates will not enjoy the task.

So when it comes to "How shall we manage?"; Handy is saying it depends on the situation and the variables. The best way of managing is to make sure the leader, subordinates, task,

and environments all match. Note that this is quite different from saying that tight is better than loose or loose is better than tight. What we are saying is that either will work provided the four variables match.

## 6. Bennis

Bennis makes a distinction between the term “manager” and the term “leader.”

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

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

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

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

- Integrity – that really means honesty;
- Dedication;
- Magnanimity - magnanimity is like generosity, particularly when you have won a battle; humility;
- Openness, so that people can trust you;
- Creativity, so that you can think of novel solutions to difficult problems.

## 7. Heifetz – adaptive leadership

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

- Move between the balcony and the battlefield. In particular, make sure you move to the balcony where you get a long view, an overview of a whole problem. Make sure you don't concentrate purely on fine detail.
- Identify what the adaptive challenge is. This will be a challenge for which there is no ready solution and where there may be a gap between current behaviour and the behaviour required.
- Create a holding environment. That is a safe environment, an environment where you will agree to support those who are responsible for putting through the changes. Don't impose change but give it back to the people without problem.
- Protect the voices of leadership from below. Leaders are not always the top of a hierarchy, there could be important and influential leadership well down in a hierarchy and their views and interests must also be taken into account.
- Regulate the distress
- Sequence and pace the work so that it doesn't become too overwhelming.
- Pay disciplined attention to the issues, keep people focused, use conflict positively and ensure that people keep their eye on the ball.

## 8. Fiedler

Fiedler suggested that leadership effectiveness depends on:

- Leadership style - that's the leader's own attributes, and the leader can either be psychologically close or psychologically distant, and
- Situational favourableness, the degree to which a situation gives the leader control and influence.

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

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

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

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

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

## 9. Kotter

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

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

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

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

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

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

# Chapter 11

## The nature of groups

### 1. Groups

Knowledge of groups is an important aspect of management theory.

Groups can be formal or informal.

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

Handy defined a group as :

**“Any collection of people who perceive themselves to be a group.”**

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

- A sense of purpose or aim
- An identity; in another words, there is a feeling of who is within the group and who isn't within the group.
- Group norms, that is, accepted ways of behaving and if you don't fall in line with group norms, you are likely to be excluded from the group.
- Communication between the members of the group.

## 2. Team Roles

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

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

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

- **Chairman** (sometimes called, the **"coordinator."**) This person clarifies goals, promotes decision-making and is a good delegator.
- **Shaper.** Is someone who is someone driven, thrives under pressure, wants to overcome obstacles, tends to want to get their own way.
- **Monitor/evaluator.** Sees all options, judges things accurately and fairly objectively.
- **Company worker** (sometimes called an "implementer"). Turns ideas into practical actions. They're not particularly the theoretical person, more the "roll your sleeves up and get on with it" sort of person.
- **Resource-investigator.** Explores opportunities, examines contacts.
- **Team worker.** Listens, builds, tries to play down potential friction, calms the water.
- **PlantB** rather unusual unorthodox person - creative, imaginative, and is deliberately put into the team - planted in other words - with the hope that they will solve difficult problems and bring some slightly offbeat ideas into consideration.
- **Completer/finisher.** Is painstaking, conscientious, careful, looks for errors and is keen on finishing within the deadline. And then there is a
- **Specialist.** A single-minded person who provides particular knowledge and the skills which may be in rare supply otherwise.

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



### 3. Tuckman – Stages of team development

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

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

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

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

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

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

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

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

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

## 4. Teams and committees

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

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

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

# Chapter 12

## Theories of motivation

### 1. Motivation

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

### 2. Motivation

There are two groups of motivation theory.

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

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

### 3. Maslow's Hierarchy of Needs

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



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

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

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

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

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

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

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

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

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

#### 4. Hierarchy of needs - limitations

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

- First of all is the order in which we want to fulfil needs correct? Is that the only order?
- Secondly, we are all individuals, we may have different needs, they may be in different orders, and the importance of needs may well change throughout our lives.
- The theory might not properly explain altruistic behaviour; that is behaving in a way which doesn't fulfil our needs but which is more directed and fulfilling other people's needs first.
- Finally the theory is dominated by Western cultural values. Maslow developed his theory in America and it could well be that that culture is more interested in material well-being than some other cultures or perhaps social needs are more important. We certainly have to be careful when applying Maslow's hierarchy of needs internationally. It's well known that people from different cultures may have different priorities.

## 5. Herzberg

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

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

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

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

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

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

## 6. Vroom – Expectancy theory

Vroom suggested a process theory called expectancy theory.

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

$$\text{Motivating force} = \text{Valence} \times \text{Expectancy}$$

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

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

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

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

## 7. McGregor – Theory X and Theory Y

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

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

- The Theory X manager assumes that people really don't want to work, that they have to be watched very carefully, that they are lazy, that they only go to work with some reluctance because they have to earn money to live.
- The Theory Y manager believes that the workforce thinks that work is as natural as play, that they get enormous social rewards from going to work, that they get enormous interest from going to work, that they like being given problems to solve, and they like recognition.

So how do we motivate these people?

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

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

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

## 8. Intrinsic and extrinsic rewards

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

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



## 9. Increasing motivation

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

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

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

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

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

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

## 10. Pay as a motivator

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

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

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

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

# Chapter 13

## How an individual can develop

### 1. Personal development plans

A personal development plan is a clear developmental action plan for an individual. Usually this will incorporate a wide set of ambitions.

- It may require formal training or it may require informal training, such as simply getting the correct work experience. The aim of action plans for individuals is first to improve your performance in your existing job. Secondly, you'll be seeking to improve your skills and competences in future jobs or in future steps in your current career.

It's important to try to acquire transferable skills. A transferable skill increases your employability and will increase the chance that you'll be able to arrange a change in career direction if you wanted to. Finally, and importantly, there is personal growth. We all want to move towards jobs and occupations that we're interested in, that we feel is worthwhile and that is rewarding.

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

**Specific.**

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

**Measurable.**

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

**Agreed.**

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

**Realistic.**

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

**Time-bound.**

It has to be time-bound. In other words we're going to say how we're going on by six-months, one year, two years.

**Evaluate.**

We have to evaluate how we've gone on.

**Review.**

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

## 2. Time management

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

Remember that there is a difference between what is important and what is urgent. Important tasks have to be done but they don't necessarily have to be done today. Urgent tasks really ought to be done today but if they're not done the world isn't going to end. By considering tasks which are important and tasks which are urgent we can prioritise what we have to do. Certainly at the head of the list are those tasks which are both important and urgent.

Part of prioritisation is to sequence tasks but also the sequencing of task has a logic associated with it. There are some things that we simply can't do before other things have been accomplished.

## 3. Coaching, mentoring and counselling

Coaching, mentoring, and counselling are important aspects of many modern businesses.

Coaching is a way of providing training. Instead of going to a formal course you sit beside or watch or be supervised by an experienced employee who helps you in your day-to-day tasks in a work environment. For example, the first day the coach is likely to be with you most of the time. But once you've learned the task to the coach's satisfaction you'll be trusted to get on with it - although you're likely to be reviewed. Coaching is sometimes preferred to formal training because it is more likely to be very relevant to your job and your work situation. It's sometimes known as 'on-the-job' training.

A mentor isn't really someone who is training you in how to do your job. A mentor is like a friend at work, someone who looks after your interests. In particular a mentor shouldn't be your boss. You should feel free to be able to approach a mentor with problems you're having at work which could include problems with the relationship with your boss. There is a long-term relationship with your mentor, someone to whom you can go in times of difficulty.

A counsellor provides guidance; though much counselling is what's known as 'non-directional counselling'. Providing guidance is not quite the same as giving advice. A counsellor is unlikely to say 'I think you should do something'. A counsellor is more likely to say, 'Well, you could do A or you could B What do you feel about those two options, which do you prefer?' The aim of all of these is to increase productivity, efficiency, job satisfaction and comfort levels within the organisation.

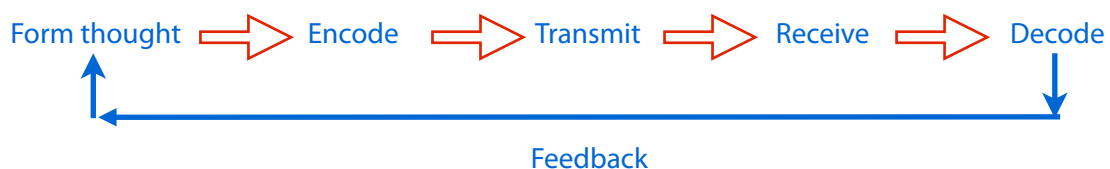
# Chapter 14

## The nature of communication

### 1. Communication

Communication within businesses is obviously important: in particular it's required for planning, coordination, and control.

- The communication pathway is more complex than you might think and you need to know what these steps are.



First of all, the person who wants to do the communicating forms the thought. Then they encode it; they find a way of expressing it, in other words. The thought is transmitted and that could be by sound, it could be by letter, it could be by email. It has to be received by the recipient and recipient has to decode it. On many occasions after it's decoded there will be some sort of feedback. Feedback could be an action, it could be nodding your head, it can be asking a question because you don't understand the message properly or it has provoked further queries.

The important thing to realise is that communication can break down at any of these stages. If the thought was garbled to start with, you are lost. If it's not encoded properly for example, if it's written down in a confusing way then that will interfere. Transmission can be messed up. We have all had, no doubt, examples of letters which have gone astray or emails which have gone to the wrong person. That person might not receive the message. One of the reasons it might not be received is they simply don't open their inbox and finally they might decode it incorrectly, they misunderstand what you are trying to communicate.

## 2. Communication

Communication within the organisation can be:

- Vertical, such as between subordinate and superior.
- Horizontal, between the people of the same levels and different departments.
- Diagonal when a subordinate in one department has to report or give information to a superior in another department.

And it can be formal or informal. Examples of informal communication would simply be chatting around the coffee machine. An example of a formal communication would be memorandum issued to all members of staff.

## 3. Barriers to communication

It's important to understand what can act as barriers to communication.

First, inappropriate language. Obviously this could mean speaking a foreign language to people who don't understand it, but in practice it is more likely to be using terminology which not everyone understands. So for example, if you are in a firm of accountants and you are writing to a client and you are talking about tax computations, terms such as "disallowable", "capital allowances", "adjustment of profits" and so on may not simply be understood by the client and if that's the case communication has not been successful.

Status. Differences in status can interfere. This can be in two ways. First of all it could be the person at the top of an organisation not wanting to hear what the people at the bottom are saying, perhaps not believing that people at the bottom have anything of value to say. It can happen the other way round where people at the bottom of the organisation are frightened to talk to people at the top of the organisation.

Emotion. If you go into an appraisal review and you are very angry or worked up about something or even just frightened about something, the chances are that communication will not be successful.

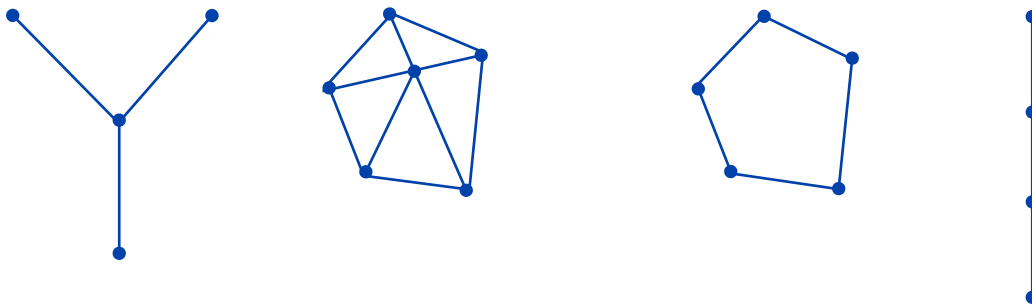
Wrong medium. If, for example, you wanted to give your employees information about the technicalities of their pension scheme, probably giving them a long lecture isn't going to be very useful. There is too much technical information in that for them to understand. Presenting the information in written form or perhaps a mix of communication, some lectures in outline and then the detailed material available in written form, will be more successful.

Not wanting to transmit and not wanting to receive can both occur. It could be that a manager doesn't want to point out shortcomings in a staff member's performance. It could be that the staff member is not willing to believe that there is anything wrong with their performance.

Finally a curse of the information age and emails: information overload. We are often bombarded with so much information that we really can't see the wood for the trees. We spend so much time looking at information, deciding whether or not we need to know the information or not, that there is a real danger we overlook the important material.

#### 4. Leavitt

Leavitt identified several other ways in which the patterns of communication could be organised. Shown here are the Y shape, the wheel shape, the circle and the chain.



What can we learn from this?

Well, the chain represents a typical hierarchal arrangement within an organisation. At one end you might have the managing director; at the other end you have staff at the bottom of the organisation. Clearly there is going to be rather slow communication between top and bottom.

In the wheel type of communication by contrast, assuming that the boss is at the centre then there's going to be very fast communication with the rest of the organisation. This is a highly centralised, almost entrepreneurial organisation with power at the centre. This enables organisation to move very quickly.

The circle type is relatively slow in communication; the Y is relatively fast in communication.





# Chapter 15

## The recruitment and selection process

### 1. Recruitment and selection

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

- The birth rate in many countries is lower
- The technical content of jobs is higher.

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

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

## 2. Job analysis, description and person specification

The process of recruitment starts with:

- job analysis
- job description, and
- person specification.

Job analysis is the process of finding out exactly what the job is. This may seem to be an odd step because you often know what the job is or at least you think you do. But if you are advertising, for example, for an accounts assistant, exactly what is that person supposed to do? In one organisation the accounts assistant could be looking after budgets and spreadsheets. In another one they could be responsible for getting out the monthly management accounts and in another one it might simply be looking after the receivables ledger. Will they be working on their own or under close supervision? Will they be in charge of anyone? To whom do they report? Will they have a lot of contact with customers? So before you can advertise for a job you have to know what the job is.

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

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

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

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

**Disposition** is a sort of attitude; are they ambitious, are they cheerful? If you are employing people who are to be welcoming to customers, there is no point really employing someone who is miserable.

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

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

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

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

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

### 3. Advertising vacancies

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

You have to describe the job in sufficient detail, so that the right sort of candidates are likely to apply. If you are too vague, you may get far too many candidates applying, many of whom are unsuitable. But if you are too restrictive you may not get enough applying. I suppose you want about 20 or 30 good applications coming in and from that you will reduce it down to maybe five or six people whom you will invite to an interview.

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

## 4. Selection methods

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

**Interviews.** It's very unlikely that you would ever employ someone whom you had not interviewed though you need to be warned that interviews, unless done well, are often very unreliable at picking the right candidate.

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

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

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

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

## 5. Interviews

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

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

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

## 6. Selection testing

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

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

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

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

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

## 7. Developing and training

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

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

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

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



# Chapter 16

## How people learn

### 1. The learning process

There are two approaches to learning theory.

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

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

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

### 2. Honey and Mumford

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

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

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

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

**Activists** are almost the reverse of theorists. If they had a new computer they would switch it on and try and work it before ever thinking of looking at the user guide. They are excited

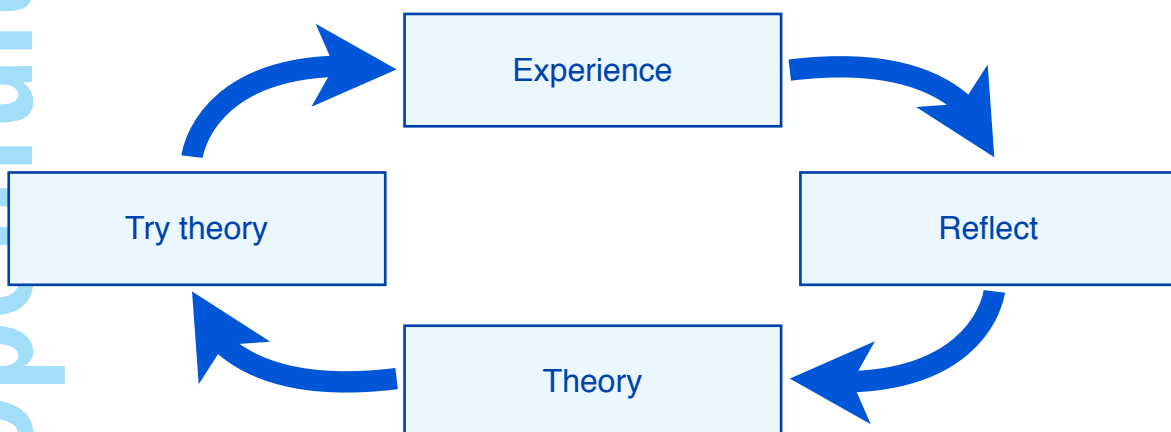
by pressure, by new projects. However they do tend to rush into things without adequate preparation.

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

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

### 3. Kolb – experiential learning

Kolb is associated with the idea of **experiential learning** - the idea that we go through a number of cycles, gradually learning by our experience.



Let's take as an example a situation where we have presented to a potential new client for a new contract, and we don't win it. That's the experience. So we go away and think why we didn't win it. It could be that our prices were too high; it could be that our presenters didn't do a very good job. Anyhow, from this reflection we develop a theory, and next time we make a presentation, we try it out. If we fail to win the next job, we need a bit more reflection but if we win the next job then we probably conclude that we have moved in the right direction, that we have learned better how to pitch for new work.



# Chapter 17

## Performance and appraisal interviews

### 1. Performance appraisal

We now come to look in another area of human resources management, performance appraisal.

- The purpose of performance appraisal is first to improve the organizational performance and secondly to develop individuals. This should be win-win.

Developing individuals should motivate them. They feel that they've recognized, they feel their skills maybe growing how we maybe getting towards the top of the Maslow's hierarchy of needs.

Of course, improving organizational performance is very important, but if you don't let people know how they're getting on, where they perhaps need to improve, or where they've done well, it is going to be relatively difficult to improve organizational performance, because ultimately that depends on the performance of the individuals in the organization.

### 2. Appraisal systems

It's often said that there are three elements to an appraisal interview.

First, **reward**. What are we going pay these people next year?

Secondly, **performance**, looking back over the previous year and seeing whether people hit their targets and met their objectives.

And finally, **potential**, looking forward to the next period, setting objectives, listening to people's preferences, deciding perhaps where they require training.

It must be said however that some human resources professionals suggest that the reward part of the appraisal should be kept quite separate from the other two parts. They argue that there is more to reward than simply basing it on performance. You have to look at what can the company afford (for example, the market rate and what the company can afford) and they say it doesn't look too good if you say someone has done really well and then you immediately say, "...but we can't give you much of a pay rise this year." Some people therefore suggest that the reward part of the review should be about six months away from the other parts of the review.

### 3. Appraisal interviews

If appraisal interviews are not conducted properly they will almost certainly do more harm than good. Remember, the employee may have waited a year and this is their chance to find out how they've been doing. If they go in and find you are not prepared and haven't thought about their future, they are likely to be very disappointed. So the first thing you must do is to prepare the appraisal interview: look at what was said at last year's appraisal interview; look at their job specification; look at any assessments which have been received from the colleagues or the superiors of that person. Make sure you know about any accomplishments such as examinations passed, and be prepared to say something about what they might be expected to be doing in the future.

There are a number of different ways of conducting the interview:

You can **tell and sell**. That's more or less one-way communication. The manager tells the employee what they've been doing well, what they've been doing badly, and they sell it to them. In other words, convince them that the manager's view is right.

**Tell and listen**. The manager tells the employee what their point of view is and then may listen to some responses.

Best of all however is **problem-solving** where you go through their performance together, jointly arriving at a conclusion as to whether or not it's been satisfactory or not.

Gain commitment about what the employee is expected to do in the future, make sure everyone agrees on that and summarise it. There should be a report, probably two-part. The top copy can go to the employee with agreed conclusions and perhaps objectives. The other part will go on the personnel file.

Finally there should be follow-up. If you have arranged for training then make sure it takes place. If you have arranged for that employee to spend three months in another department make sure that takes place. If the employee has been having difficulty you may want to monitor their progress continually before waiting a whole year till their next appraisal interview.

# Chapter 18

## Some legal obligations

### 1. Sources of law

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

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

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

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

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

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

## 2. Data Protection Act implements Directive 95/46/EC

One of the important European laws concerns data protection. The Data Protection Act in the UK relates to *personal* data. We are not talking here about data relating to companies: we are talking about data relating to people.

### The act sets out certain principles:

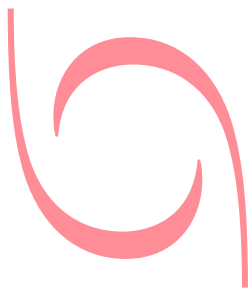
- Data shall be processed fairly and lawfully.
- It can only be obtained for one or more specified and lawful purposes.
- It mustn't be excessive to what's required.
- It must be accurate and kept up-to-date.
- It mustn't be kept for longer than necessary.
- Personal data shall be processed only in accordance with the rights of data subjects. The data **subject** is a person about whom the data is held and that person has certain rights. For example they have a right to see the data and they have a right to insist that it's corrected. The people holding the data have to register with a government body and there they have to say what data is held, why it is held and to whom it might be supplied.
- Appropriate measures shall be taken against unauthorized and unlawful processing and also care has to be taken over the accidental loss or damage to personal data.
- Finally personal data must not be transferred to a country or territory outside the European Economic Area unless there is similar legislation giving similar protection in that area.

### 3. Risks to data

**Data can be subject to a number of risks.**

- **Human error.** For example, someone deletes an important file or important information or indeed leaves a disk on the bus going home.
- **Technical problems.** Hard disks can crash and data can be lost.
- **Catastrophic events** would include events such as a fire or a flood destroying computers and the data they hold.
- **Malicious damage** occasionally occurs. Sometimes this is done by an employee who is unhappy or who has been sacked. Sometimes it is done by hackers, people from outside the organization who infiltrate the organization's data and change or steal it.
- **Industrial espionage or sabotage.** Rivals obtain any data for their own purpose or deleting your data to put you at a disadvantage.
- **Dishonesty or fraud.** For example, illegally causing cash to be transferred, goods to be delivered, receivables to be written off.

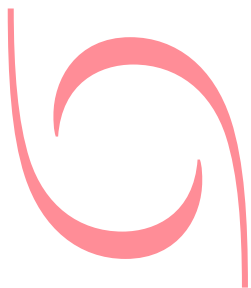
Organizations must try to safeguard their data. Not only can lost or stolen data cause financial loss and loss of reputation, but it can also in some cases leave them open to prosecution.



## 4. Health and safety – employer's duties

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

- Work practices and the work environment must be safe and healthy.
- The plant and equipment should be maintained to the necessary standard.
- There should be information, instructions, training and supervision so people know how to work the machinery and that safe working practices are adopted.
- People should know that there is a policy.
- People should be aware of the organization's safety policy
- Employers must carry out risk assessments, thinking ahead, identifying risks, seeing to what extent those risks need to be worried about, and providing training, guidance, and protection as necessary.
- Note there is a requirement to share hazards and risk information with others.
- You have to identify employees who are particularly at risk.
- You must employ competent safety and health advisors
- Within the organization there will be a safety representative effectively from the employee side, and probably a safety committee which meets regularly to consider health and safety matters.



## 5. Health and safety – employees' duties

Note here, some of the employee's duties.

- They have to take reasonable care of themselves and others and for example these duties could be breached by employees playing practical jokes with their colleagues.
- They must allow the employer to carry out the duties in relation to safety. They mustn't interfere intentionally or recklessly with machinery for example by taking off guards from machine.
- They must inform the employer of any situation which they think is a danger. For example if an employee sees that a machine has deteriorated and is now perhaps dangerous they have a duty to inform their employer.
- They have to use equipment properly, making use of all the safety features that it may incorporate.

## 6. Health and safety policy

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

- First, a statement of the principles.
- There will then be a section on certain procedures, perhaps relating to fire safety procedures.
- They may emphasize how important it is to comply with the law, and in some cases state what is necessary to comply with the law.
- There may be a section on the detailed instructions about operating machinery.
- A section dealing with the training requirements, and perhaps the qualifications needed to ensure that health and safety policies are properly implemented.

## 7. Employment protection

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

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

- A contract can be terminated. For example you could tell somebody that they are sacked.
- If someone has been employed on a fixed-term contract, let's say, three years and at the end of that term that contract is not renewed that also ranks as dismissal.
- Finally there is constructive dismissal. Constructive dismissal occurs when the employer breaches the contract of employment to such an extent that the employee is allowed to assume that he or she has been dismissed.

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



## 8. Fair/unfair dismissal

### Grounds for fair dismissal are as follows:

- Redundancy, provided that the selection for redundancy is fair and that the job disappears, then people may be made redundant. They may be entitled to some redundancy compensation.
- Legal impediment. For example, if to work in a particular organization you have to be of a certain nationality and it's discovered you are not, then you can be dismissed.
- Non-capability. Simply not being able to do the job. Provided you were given adequate chance of improvement and training, and you still can't do the job then you can be dismissed for non-capability
- Misconduct. Provided a suitable series of warnings have been issued to give you a chance to improve you can be dismissed if the behavior continues. There are certain cases of gross misconduct where you can be immediately dismissed.
- Other substantial reasons. For example, if you are married to a competitor your employer doesn't have to run the risk that commercial secrets are going to be transferred.

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

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

## 9. Remedies for unfair dismissal

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

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

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

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

## 10. Equal opportunities

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

**Anti-discrimination laws can relate to:**

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

**Equal opportunities legislation identifies three types of illegal behaviour.**

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

Indirect discrimination is more subtle and indeed often employers fall into this trap inadvertently. An example of rather obvious indirect discrimination would be if you advertised for a salesperson but then stipulated that that person had to be two meters tall

with a large, black beard. Most courts would assume that this would favour male applicants. Stipulating height minimums would probably be an example of indirect sex discrimination because men are, on average, taller than women.

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

## 11. Diversity

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

- First of all you're likely to attract a wider range of candidates if you are known as an employer who embraces diversity. Diversity means more than race or sexual diversity; it can also mean offering people part-time work or working from home. If you can offer part-time work or home working you may well get additional good candidates worthy of consideration. So why reduce the field by putting unnecessary restrictions?
- Secondly, a diverse workforce brings a variety of skills. If you employ people just like yourself you'll probably get skills just like yours.
- Third, the diverse workforce might better reflect customers and clients so your customers and clients are likely to feel more comfortable.
- And finally you may be able claim the moral high ground by having a diverse workforce and this of itself may be attractive to customers, clients, and potential employees.



# Chapter 19

## Economics

### 1. Macro-economic policies

The final section of the syllabus we consider is macroeconomics.

Macroeconomics deals with the big things in society, controlling inflation, trying to ensure that employment stays at reasonably high levels, stimulating economic growth or providing an environment in which economic growth can take place, distributing wealth according to your political beliefs, managing foreign exchange rates and deciding how much to spend on public services and how to raise the money for these.

### 2. Government influence on business

**Governments can have a huge influence on businesses:**

Policy	Affects:
Overall economic policy	demand, taxation, cost of finance (interest rates)
Industry policy	regulation, planning, grants, tariffs/quotas, free trade
Environmental and infrastructure policy	planning, costs (eg carbon or pollution tax), transport costs and efficiency
Social policy	education, retirement, pensions, employment protection
Foreign policy	EU compliance, World Trade Organisation, foreign aid, banned exports

### 3. Inflation - causes

We need to look at the terminologies associated with two pieces of macroeconomics – inflation and unemployment.

First, inflation. What causes inflation?

- **Demand pull.** This is where there is a lot of money in the economy, lots of people who want to spend money, and because demand is high, prices are pulled upward.
- **Cost push.** An example of cost push inflation is where people in the manufacturing industry, let's say coalmining, have a large wage rise. Inevitably that wage rise is passed on and will find itself reflected in the cost, say, of electricity. The cost of electricity goes up and that's an example of cost push inflation.
- **Import cost inflation.** A good example of that was the huge increase in the cost of oil that happened towards the end of 2008.
- **Expectation.** This is where people expect there to be inflation and because they expect inflation, they make higher wage demands and the higher wage demands inevitably push up the price of goods that are going to be sold.
- **Increase in the money supply.** An increase in the money supply will stimulate demand. More people have money to buy goods and this will cause demand pull inflation.

## 4. Unemployment

The second collection of terminology we need to look at is unemployment. What types of unemployment are there?

**Real wage unemployment.** This is where people are effectively being paid too much. Employers can't afford to keep them on and therefore they lose their jobs. They've priced themselves out of their markets. That tends to be self-correcting because once there is a large number of people looking for job with particular skills that will tend to bring down the real wage price.

**Frictional unemployment** refers to the temporary unemployment of people as they move from one job to another. There will always be some frictional unemployment and it's not terribly important socially because it is temporary.

**Seasonal unemployment** is obvious. It will refer to unemployment patterns in sectors such as building and agriculture where there tends to be high unemployment during the winter.

**Structural unemployment** is more permanent. It occurs where the structure of the industry has changed. An example of structural unemployment can be seen in the UK where we have closed most of our coalmines. It was thought to be cheaper to import coal from abroad.

**Technological unemployment** speaks for itself. It is unemployment brought about by changes in technology so the old skills and jobs disappeared.

**Cyclical unemployment** is a very long cycle of employment and unemployment as economies rise and fall. Towards the end of 2008 most of the world entered a recession. The recession is likely to last for some years and this causes high cyclical unemployment.

## 5. Monetary and fiscal policy

**Governments have two main ways in which to control or regulate their economies:**

- monetary policy, and
- fiscal policy.

### Fiscal policy

First we'll look at fiscal policy. And the word "fisc" is an old word which referred to the king's purse. Where does the state get the money from? Where does it spend it? If the state wants to spend money it either has to raise income through taxes or borrow money. If it wants to reduce taxes it either has to reduce expenditure or borrow money. The three have to be in balance.

In the current recession governments are seeking to spend more money. This is a way of putting money into the economy to try to stimulate it. However, if they spend more by raising taxes they may actually not end up putting very much more money into the economy. They are taking with one hand and giving away with the other. So what most governments are doing is increasing government borrowing. Keep taxes the same; borrow money, spend it, once it's spent it will be earned by people who will spend it again. And that's the way in which governments hope the recession will be brought to an end.

### Monetary policy

The second way in which governments attempt to control their economies is by their monetary policy: managing the supply of money in the economy. The more money in the economy the more economies are likely to be stimulated. There are two main weapons.

- **Interest rates.** If interest rates are very high people will tend not to want to borrow money. If you don't borrow money you can't spend it, and if you can't spend it then, for example, demand pull inflation will be relatively low. If however you greatly reduce the interest rates more people will be encouraged to borrow. They spend that borrowed money on televisions, cars, houses, whatever. And once it's spent the money is in the economy, other people earn it, demand goes up, and the economy is stimulated.

- **Credit controls.** This is a control over institutions, typically banks, on how much they are allowed to lend. So for example if you put \$1,000 into a bank and the reserve requirement was only 10%, that means that the bank could lend \$900 out of the \$1,000 deposited. That \$900 could be deposited again and the bank could lend on \$810 and so on. So the initial deposit of \$1,000 can create a much higher amount of money in the economy. Say however that the reserve requirement was 50% - \$1,000 in the bank; the bank only lend on \$500. That \$500 is put into another account, the bank can lend on only \$250 and so on. You can see that at the end of the cycles a much smaller amount of money will be created in the economy.



## 6. Functions of taxation

Taxation has many functions. We've already pointed out that it raises revenues for the government but it's also used for other purposes. For example:

to discourage certain activities regarded as being undesirable. And a good example here would be a tax on cigarettes.

It can also be used to cause certain products to be priced to take into account their social costs. There is increasing talk for example about a carbon tax of some sort because it is argued that if you drive a car or fly in a plane the release of carbon has a social cost that ought to be paid for.

Obviously, tax can be used to redistribute income and wealth. Frequently people with higher income and more wealth are taxed more highly and that is redistributed through government expenditure to people who have less wealth.

It can be used to protect home industries from foreign competition; examples are import duties, import tariffs where imports have a tax attached to them to make them more expensive relative to the home-produced products.

Finally it can provide a stabilizing effect on national income. Governments are often committed to long-term expenditure plans but if the economy falls somewhat governments might seek to increase the tax take so that the national income stays up and they don't have to borrow any more.

## 7. Types of taxation

**Taxes can be described as:**

- regressive,
- proportional, or
- progressive.

A **regressive tax** takes a higher proportion of a poor person's salary than it does for a rich person. A simple example is VAT. If the VAT rate is 20% it doesn't matter whether you are rich or poor you still pay 20% and that is proportionally more taken from a poor person's pay than it is from a rich person's income.

A **proportional tax** takes exactly the same proportion of income tax from all levels of income. So you could have a flat rate tax which taxes everyone at say 10% from the very first dollar earned, up to millions of dollars.

A **progressive tax** takes a higher proportion of income as income rises. So maybe for the first \$1,000 of income the tax rate is zero, for the next \$4,000 of income the tax rate is 20%, and anything beyond that is taxed at say 40%. A progressive tax would obviously be more effective at redistributing wealth and income than either a regressive or a proportional tax.

## 8. More terminology!

Finally, just a couple of more terms on tax.

- A direct tax is paid directly by a person to the revenue authority. A good example there would be income tax. A certain proportion of your income goes directly to the revenue authority.
- An indirect tax is collected by the revenue authority from an intermediary, normally a supplier of some sort. A good example of an indirect tax is VAT. You buy something, you pay over the total purchase price, and then the seller passes some of that on to the government.
- Some taxes are charged a fixed sum per unit sold. So if you were to buy a bottle of wine it doesn't matter whether it costs \$5, \$10 or \$25; a fixed sum will go to the government.
- An **ad valorem** tax is charged as a fixed percentage of the price of the good. A good example of an ad valorem tax is VAT.