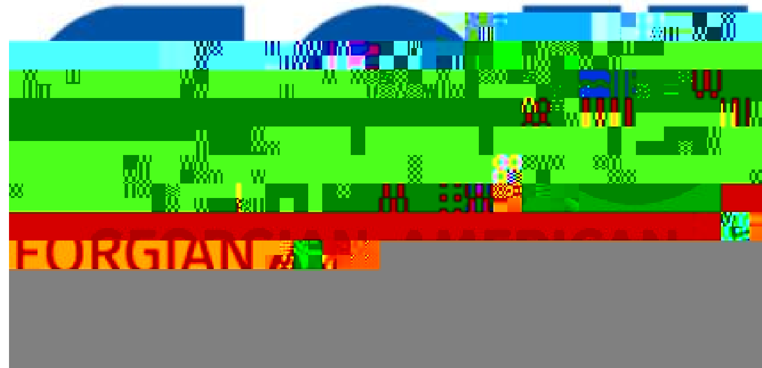

Modern Business Administration

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FINANCE

MAIN ISSUES OF FINANCE

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

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

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

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

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

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

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

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

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

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

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

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

TIME VALUE OF MONEY

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

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

1. Risk
2. Preference for Liquidity

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

No one can predict with certainty either the future of the U.S. economy or economic and financial trends in other parts of the world. It is impossible to predict accurately whether money invested today will be available tomorrow. There is no assurance that a financially sound firm

Example: Liquidity versus Future Returns

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

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

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

Finance, 5thed; Groppelli, EhsanNikbakht; Barron's Inc 2006, Chapter 3,

Where

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

Example: Future Value after Any Number of Years

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

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

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

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

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

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

Algebraically, we can write this as

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

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

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

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

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

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

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

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

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

$$\frac{1}{(1 + \quad)}$$

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

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

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

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

Where

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

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

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

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

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

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

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

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

$$= \frac{}{(1+\quad)} + \frac{}{(1+\quad)^2} + \frac{}{(1+\quad)^3} +$$

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

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

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

$$= \frac{}{}$$

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

$$= \frac{}{} \times \quad =$$

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

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

An annuity is a series of equal payments (or receipts) made at any regular interval of time. An annuity can be a payment or an investment each year, each half-year (semiannually), each

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

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

cash flows at the end of period

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

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

So, we have:

$$= - - \frac{-}{(1+\quad)} = -(1 - \frac{1}{(1+\quad)})$$

You can easily see this on timeline as follows:

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

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

$$= \quad + -(1 - \frac{1}{(1+\quad)^{\ -1}})$$

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

$$= -(1 - \frac{1}{(1+\quad)}) \times (1+\quad) \quad =$$

- growing perpetuity
- growing annuity

$$= \frac{}{(1 + \ )} + \frac{}{(1 + \ )^2} + \frac{}{(1 + \ )^3} + \quad = -$$

$$= \frac{}{-}$$

$$= -(1 -$$

A random variable $_{[0,1]}$ can be characterized by mathematical expectation and variance. Let use denote $= \; _{[0,1]}$

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

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

The formula assumes that you can earn the *APR* each period. Therefore, after one year (when *n* periods have passed), your cumulative return would be (1 + *APR*/*n*)x*n*. Note that one needs

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

In finance, higher risks are generally associated with higher possible gains — but there is also a greater chance of loss. The same principle applies to Aunt Jane or John Doe. Both would like to strike it rich, but they know that to do so they must be willing to face the dangers of

The following example m

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

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

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

VALUATION AND CAPITAL BUDGETING

24. What is the general definition of the value of an asset? List the steps of calculating value of an asset

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

An increase in the amount of cash flow tends to raise the price of an asset. Conversely, the price declines if cash flow becomes more uncertain. These relTd[(2h(be)12(bshi)-5p4(t2)6(e)-32(nce)23und(ou)1en(ai)

is tTJETQq0.00000912 0 612 792 reW*nBT0 0 0 rg0 0 0 RG/F1 10.56 Tf126.02 575.485.7[(w)6(-JETQq0.00000912 0 612 792 reW*nBT0 0 0 rg0

$$= \frac{-}{}$$

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

Traditional valuation technique - NPV (net present value)- with ($_0$) investment $80,000, monthly cash flows ( ) $8,153 during the 12 months (T=12), and discount rate (r) recalculated for monthly data 0.8 %, shows us

$$= - \ _0 + \ _{=1} \frac{}{(1+\ )} = \$12 \quad 6$$

27. Define IRR

The internal rate of return, or IRR, is a popular measure used in capital budgeting. The IRR is a measure of the rate of profitability. By definition, IRR is a discount rate that makes the present value of cash flows equal to the initial investment. According to the definition, NPV is a function of interest rate *r*. In simple terms, the IRR is an interest rate that makes the NPV equal to zero. So, IRR is the solution to the following equation for *r*

$$0 = - \ _0 + \sum_{=1} \frac{}{(1+ \ )}$$

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

Project A: $_0 < 0, \quad > 0, \quad = 1,2, \quad ,$ (first cash flow is negative and all remaining cash flows are positive);

Project B: $_0 > 0, \quad < 0, \quad = 1,2, \quad ,$ (first cash flow is positive and all remaining cash flows are negative);

Project C: $_0 < 0, \quad > 0, \quad < 0 \quad , \ , \quad = 1,2, \quad ,$ (some cash flows after first are positive and some cash flows after first are negative).

These three cases can be visualized graphically as follows

Note that on the first two ghraps (project A and B) the IRR equals 30 percent while on the third ghraph (project C) there are two intercection points,10 and 20 percents.

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

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

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

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

3) *Calculate NPV on Incremental Cash Flows.* Finally, one could calculate the NPV on

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

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

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw-Hill, 2003; Chapter 6, pp. 149-159

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

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

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

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

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

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

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

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

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

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

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

The CAPM starts by dividing risk into two major components: diversifiable risk and non-diversifiable risk. The premise is that there is a close relationship between the returns of individual securities and the returns of the market. The volatility of the market provides a common denominator for evaluating the degrees of risk of individual assets and securities. This

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

$$= \quad + \quad ($$

future dividends. Since a company is considered to operate forever, the price of common stock is not influenced by the number of years an investor wants to maintain ownership.

The price of common stock is largely determined by three factors: the annual dividends, growth of dividends, and discount rate. The rate an0 0 0 rw0 hich future dividends are to be discounted is called the required rate of return. If a company has a high level of risk, a high required rate of return is expected by investors. To encourage investors to invest their money in a risky venture, a higher payoff must be offered. The following are the procedures to determine the value of common stock in three possible cases:

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

$$_0 = \frac{_1}{(1 + \quad)} + \frac{_2}{(1 + \quad)^2} + \quad = \frac{\quad}{\quad}$$

Here

ASSET TYPES AND CLASSES

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

The material wealth of a society is ultimately determined by the productive capacity of its economy, that is, the goods and services its members can create. This capacity is a function of the real assets of the economy: the land, buildings, equipment, and knowledge that can be used to produce goods and services. In contrast to such real assets

36. Describe money market instruments

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

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

A certificate of deposit (CD) is a time deposit with a bank. Time deposits may not be withdrawn on demand. The bank pays interest and principal to the depositor only at the end of the fixed term of the CD.

Large, well-known companies often issue their own short-term unsecured debt notes directly to the public, rather than borrowing from banks. These notes are called commercial paper (CP).

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

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

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

37. Describe long term debt secChapter

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

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

Corporate bonds are the means by which private firms borrow money directly from the public. These bonds are structured much like Treasury issues in that they typically pay semiannual coupons over their lives and return the face value to the bondholder at maturity. Where they differ most importantly from Treasury bonds is in risk. Default risk is a real consideration in the purchase of corporate bonds. Corporate bonds sometimes come with options attached. Callable bonds give the firm the option to repurchase the bond from the holder at a stipulated call price. Convertible bonds give the bondholder the option to convert each bond into a stipulated number of shares of stock.674.(m)5(on)- and i-44(or)3( )-44(equ)-10reW0 0 0 rL0 0E691 Tt nds(y)-1

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

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

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

The two most important characteristics of common stock as an investment are its residual claim and its limited liability fe56 13e4 of com53(000912 0 612 792 reW*nBT0 0 0 rg0 0 0 RG/F1 10.56 Tf288.89 520.

holder voting power regarding the firm's management. Preferred stock is an equity investment, however. The firm retains discretion to make the dividend payments to the preferred stockholders: It has no contractual obligation to pay those dividends. Instead, preferred dividends are usually cumulative; that is, unpaid dividends cumulate and must be paid in full before any dividends may be paid to holders of common stock. In contrast, the firm does have a contractual obligation to make timely interest payments on the debt. Failure to make these payments sets off corporate bankruptcy proceedings.

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

39. List and describe the stock indexes known to you

Indexes are taken as a measure of the performance of the stock market. The Dow Jones Industrial Average (DJIA) of 30 large, "blue-chip" corporations has been computed since 1896. Its long history probably accounts for its pre-eminence in the public mind. Originally, the DJIA was calculated as the simple average of the stocks included in the index. So, if there were 30 stocks in the index, one would add up the value of the 30 stocks and divide by 30 (divisor).

Ú = 30 =1 / ___

where

= prices of the component stocks at time *t*
d = Dow Divisor.

The percentage change in the DJIA would then be the percentage change in the average price of the 30 shares. The amount of money invested in each company represented in the portfolio is proportional to that company's share price, so the Dow is called a price-weighted average. Because the Dow Jones averages are based on small numbers of firms, care must be taken to ensure that they are representative of the broad market. As a result, the composition of the average is changed every so often to reflect changes in the economy. In the same way that the divisor is updated 82.77 39e34(n)-G/ave(n)34(i)5(39e34(n)-G/a)5(ve(n)34(i)5(39e34(n)-G/a)5(ve(n)34(i)5(3

Certificate of deposit (CD)

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

Treasury bill (T-bill)

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

Repurchase agreement (repo)

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

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

FINANCIAL INSTITUTIONS AND THEIR RISKS

41. Why are financial institutions important?

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

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

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

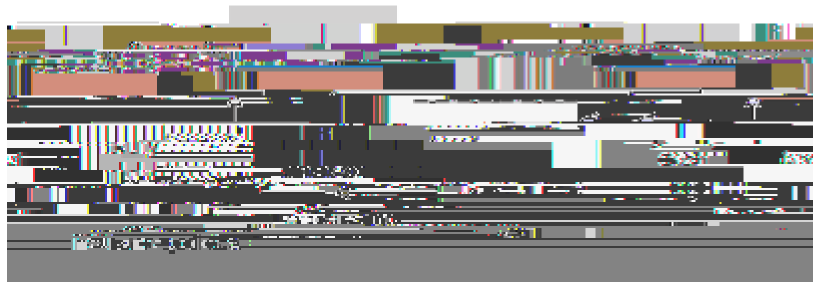
Because of (1) monitoring costs, (2) liquidity costs, and (3) price risk, the average household saver may view direct investment in corporate securities as an unattractive proposition and prefer either not to save or to save in the form of cash.

The first function is the brokerage function. When acting as a pure broker, an FI acts as an agent for the saver by providing information and transaction services.

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

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

value added to their clients is the transformation of financial risk. Graphically, this could be illustrated as follows:



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

42. Risks of Financial Intermediation

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

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

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

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

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

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

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

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

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

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

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

BOND TYPES, PRICING AND RETURN

43. What is bond?

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

The U.S. government regularly borrows from the public by issuing government bonds to cover its budget deficit. Corporations issue bonds to raise the capital required to expand their operations. In this manner, the U.S. government and borrowing corporations commit themselves to pay a certain amount of money in i

- Corporate bonds
- Municipal bonds

U.S Treasury securities are backed by the full faith and credit of the U.S. government and

$$= \frac{}{(1 + \quad)}$$

$$= \frac{}{(1 + \quad)^1} + \frac{}{(1 + \quad)^2} + (1 + \quad)^3$$

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

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

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

$$= \frac{}{(1+\ )^{1}} + \frac{}{(1+\ )^{2}} + \frac{}{(1+\ )^{3}} + \quad + \frac{}{(1+\ )} + \frac{}{(1+\ )}$$

Where

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

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

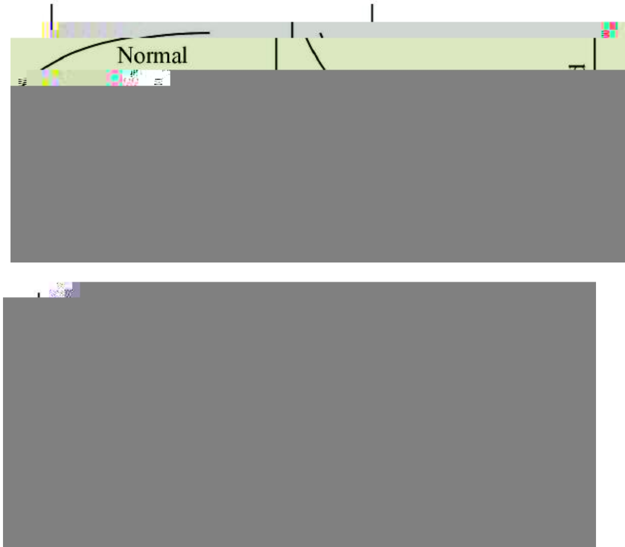
We can express this relationship as follows:

$$= \ _{=1}\frac{}{(1+\ )} + \frac{}{(1+\ )}$$

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

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

Four Hypothetical Yield Curves:



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

CAPITAL STRUCTURE AND MANAGEMENT

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

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

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

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

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

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

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

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

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

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

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

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

Corporate Finance, 6th ed., Ross, Westerfield, Jaffe; McGraw

globalization, financial markets have reached the point where trading in many investments never stops; it just travels around the world.

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

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

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

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

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

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

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

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

Final group of measures is based, in part, on information not necessarily contained in financial statements –

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

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

= ——— = ——— × ——— = ——— × ———

= ——— × ——— ×

= +

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

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

58. Define the optimal capital structure for a firm

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

Changes in capital

expect dividends, they are not legally entitled to dividends in the way bondholders are legally entitled to interest and principal payments.

Direct costs of financial distress are legal and administrative costs of liquidation or reorganization. Lawyers are involved throughout all the stages before and during bankruptcy.

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

stock obligations. While stockholders like and expect dividends, they are not legally entitled to dividends in the way bondholders are legally entitled to interest and principal payments.

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

Direct Costs *of Financial Distress*

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

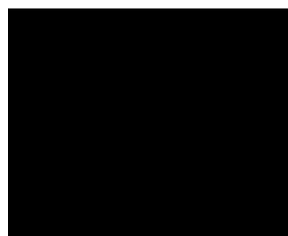
Indirect Costs of Financial Distress

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

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

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

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



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

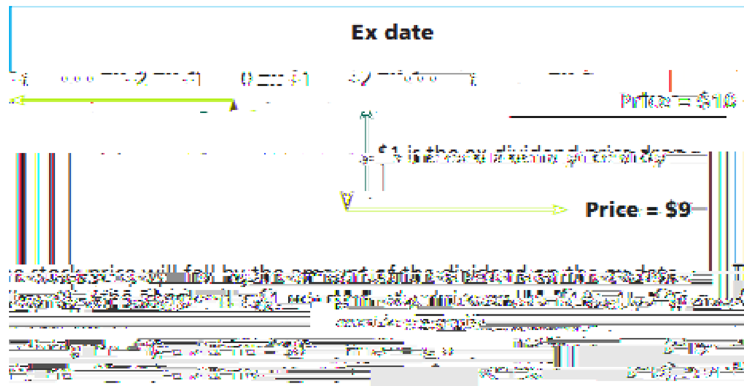
62. Explain the importance of dividend policy and what effect it has on a stock price

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

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

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

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



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

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

63. Name the reasons for issuing preferred stock

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

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

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

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

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

65. Explain the market and book of a firm

Market value is a concept distinct from market price, which is "the price at which one can transact", while market value is "the true underlying value" according to theoretical standards. The concept is most commonly invoked in inefficient markets or disequilibrium situations where prevailing market prices are not reflective of true underlying market value. For market price to equal ma

Finance

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

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

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

68. What is factoring in credit management?

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

Graphically, this could be illustrated as follows:

BASICS OF DERIVATIVES

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

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

- Obligates the seller to sell and the buyer to buy, subject to the above specifications

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

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

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

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

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

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

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

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

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

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

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

Expiration: the **expiration** of the option is the date by which the option must either be exercise

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

$$= \quad [0, \quad - \quad]$$

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

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

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

$$= - \quad [0, \quad - \quad]$$

$$= - \quad [0, \quad - \quad] +$$

FINANCIAL ACCOUNTING

THE FINANCIAL STATEMENTS

1. Who are the main users of accounting?

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

Accounting information is used by

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

Accounting information can be classified in two general categories:

1. **Financial accounting** which provides information to **external users**

1. **Proprietorship –**

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

1. **Paid-in** or **contributed capital**, which represents the amount invested in the corporation by its owners, and
2. **Retained earnings**, which represents the amount of profit that has been reinvested in the business. Profit, or

business or to pay dividends. A Company paid dividends in 2003 and 2002. The amount of dividends is deducted from beginning retained earnings.

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

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

4. What is balance Sheet?

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

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

Owners' Equity, or *stockholders' equity,* for A Company consists of common stock and retained earnings. Common stock refers to the amount that owners have paid into the company. The owners have a claim equal to the amount they paid in plus the earnings that have been41e(i)912 0o1h9 0 rg0 0 0

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

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

PROCESSING ACCOUNTING INFORMATION

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

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

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

Single-entry records one side of the transaction.

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

1. **Owners' investment of cash**

The type of account determines the side on which increases and decreases are recorded; the **rules of debit and credit** keep the accounting equation in balance. 10.56 Tf204.77 611.59.33[442T63e)14(aQq0.00

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

, Double-entry bookkeeping and the rules of debit and credit are based on the **accounting equation, A = L + SHE**. After each transaction iA ntio

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

An **accrual,**

9. What are temporary accounts and permanent accounts?

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

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

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

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

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

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

1. The formula is: **Debt ratio =** ―――――――

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

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

SHORT-TERM INVESTMENTS AND RECEIVABLES

10. What does short term investment mean?

Key terms for short term investments are:

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

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

The purpose of a **trading investment**

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

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

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

   Uncollectible-Account Expense XX
   Accounts Receivable XX

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

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

13. What is notes receivable?

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

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

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

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

   Interest Receivable XX
   Interest Revenue XX

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

   Cash XX
   Note Receivable XX

MERCHANDISE INVENTORY AND COST OF GOODS SOLD

14. What is cost of goods sold?

The transition from service entities to **merchandisers** can be summarized as follows: “Service revenue” is replaced by “**Sales revenue**” on the merchandising company’s income statement. Rather than just list “Expenses,” the merchandising income statement lists “**Cost of goods sold**” and “**Operating expenses.**”

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

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

PLANT ASSETS, NATURAL RESOURCES, AND INTANGIBLES

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

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

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

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

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

A **revenue expenditure** is one made to keep the asset in its existing condition or restore it to good working order. Revenue expenditures are recorded with a debit to an **expense** account.

A Depreciation is the process of allocating a plant asset's cost to expense over the asset's useful life.

1. Depreciation is based on the **matching principle**, because the depreciation expense is recorded in the period(s) that an asset is used.
2. Depreciation is based on the historical cost of an asset, and therefore is not a process of valuation.
3. Depreciation does not represent a fund of cash set aside to replace worn or obsolete assets. **Accumulated depreciation,** a contra-asset account, is the portion of the asset's cost that has already been depreciated (or expensed).

Causes of depreciation include physical deterioration and obsolescence. To calculate depreciation, cost, the estimated useful life, and the estimated residual value must be known.

1. The **useful life** is an estimate of the years the asset will be useful to the business, not an estimate of its physical life.
2. The **residual value** (also called scrap or salvage value) is the estimated cash value at the end of the asset's useful life. This amount will not be depreciated.

1. The **SL** formula is:

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

SL allocates equal amounts of expense to each year of the asset's life. **Book value (or carrying amount)** is the cost of the asset less accumulated depreciation.

The **UOP** formula is:

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

The UOP method assigns a fixed amount of depreciation to each unit of output or production. Depreciation each period will vary based on the units of output.

DDB is an accelerated depreciation method. **Accelerated depreciation methods** depreciate higher amounts of the asset's cost in the early years of the asset's life, and lower amounts of the asset's cost are depreciated in the later years of the asset's life. **DDB** depreciation is calculated using the following steps

Step 1: compute the SL rate.

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

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

DDB rate = SL rate x 2

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

Depreciation expense = Book value x DDB rate

Regardless of the method used, the **total amount of depreciation recorded will be the same** under all three methods. Any of the three methods may be used. A company may select one method for certain assets while using a different method for other assets. All three methods are considered GAAP. The type of method chosen may depend upon the type of asset being depreciated.

a. UOP best fits assets that wear out due to physical use.
b. DDB best fits assets that generate greater revenue earlier in their useful lives.

The **SL method** is most often used for financial reporting. Accelerated depreciation methods are most often used for tax purposes.

1. The higher depreciation in earlier years leads to lower taxable income and, therefore, lower taxes.
2. Lower taxes mean greater cash flow. Exhibit 7-10 illustrates the **cash-flow advantage** of DDB over SL.

Natural resources are assets such as timber, petroleum, natural gas, coal, and other mineral deposits. The process of allocating the cost of a natural resource to expense over its useful life is called **depletion. Depletion expense** represents the portion of the cost of the natural resource that has been extracted during the period. Depletion is calculated in the same way as UOP depreciation:

Cost – residual value / **Estimated units of resource**	=	**Depletion per unit**	x	**Units extracted**	=	**Annual depletion expense**

The depletion entry is as follows:

Depletion Expense	XX	
Accumulated Depletion		XX

Accumulated Depletion is a contra account similar to Accumulated Depreciation.

Financial Accounting, 7/8th ed., Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 363

17. What are intangible assets?

Intangible assets, such as patents, copyrights, and franchises, are long-lived assets that generally are valued for the special rights that they carry. The process of allocating the cost of an intangible asset to expense over its useful life is called **amortization.** Amortization is calculated using the **straight-line method** over the asset's estimated useful life (not to exceed its legal life).

Examples of intangible assets include:

1. **Patent**— an exclusive right to manufacture and/or sell a product or process for a period of 20 years.
2. **Copyright**— an exclusive right to publish and/or sell an artistic or literary work, a musical composition, or a film. It extends for 70 years after the author's death.
3. **Trademark** and **trade name**— an exclusive right to use a name, symbol, or other product identification.
4. **Franchise** and **license**— an agreement in which one party grants another party the right to sell a product or service.
5. **Goodwill**— the excess of the cost of an acquired company over the market value of its net assets (assets minus liabilities). Goodwill is recorded by the acquiring company. It is recorded *only* as the result of the purchase of another company. Goodwill is not amortized because the goodwill of many entities increases in value.

Financial Accounting, 7/8th ed., Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 385

CURRENT AND LONG-TERM LIABILITIES

18. What are current liabilities?

A **current liability** is a liability due within the longer of one year or the operating cycle if longer than a year. The amount of some current liabilities is known.

1. **Accounts payable** are amounts owed for goods or services purchased "on account."
2. **Short-term notes payable** are notes due within one year and have the interest paid at maturity. The **credit to Note Payable** for the maturity value equals the cash received. If the maturity date of the note occurs in the next accounting period, the following **adjusting entry** must be recorded to accrue the interest expense.

Account	Debit	Credit
Interest Expense	XX	
Interest Payable		XX

If an **adjusting entry was not necessary** (because the maturity date did not occur in the next accounting period), the following entry is required when the note is paid.

Account	Debit	Credit
Note Payable	XX	
Interest Expense	XX	
Cash		XX

If an **adjusting entry was necessary**, the following entry is required when the note is paid.

Account	Debit	Credit
Note Payable	XX	
Interest Expense	XX	

3. Refer to Appendix B for a more detailed discussion of the time value of money, including both present and future value. Additionally, the appendix includes illustrations of how the present value concept applies to bonds payable.

Two interest rates work to set the price of a bond—the contract rate and the market rate.

1. The **contract (stated) interest rate** determines the amount of cash interest the borrower pays; it is a set amount over the life of the bonds.
2. The **market (effective) interest rate** is the return investors demand for lending their money; the market rate changes daily, depending on various market factors.
3. If the **contract rate exceeds the market rate** when a bond is issued, the bond sells for a **premium**.
4. If the contract rate is less than the market rate when a bond is issued, the bond sells at a discount.
5. If the contract rate equals the market rate when a bond is issued, the bond sells at par.

Bonds sold at par on an interest date are recorded with this entry:

Cash	XX

premium is preferable to the straight-line method; it follows the matching principle, according to GAAP.

Straight-line amortization means that an equal amount of the discount (or premium) is amortized (written off) each semiannual interest period; this method is useful for quick analysis or estimate

STOCKHOLDERS' EQUITY

21. What is company's equity?

The corporation is the dominant form of business organization in the United States. The **advantages of the corporation** include the following:

Corporations are **separate legal entities.** Corporations are granted **charters** by the state that authorizes the organization of the corporation. The corporation is separate from its owners, who are called **stockholders** or **shareholders.** The corporation has many rights that a person has, such as the right to buy, own, and sell property; the right to sue and be sued; and the right to enter into contracts. The owners' equity of a corporation is divided into **shares of stock.** The charter indicates how many shares the corporation can sell. Most corporations have **continuous lives**; that is, the corporation does not terminate, as a proprietorship or partnership does, when ownership changes. Ownership may be transferred easily. It is simply a matter of selling stock. Stockholders have **limited liability** for debts of the corporation. (A shareholder can lose no more than his investment in the business.)

Disadvantages of the corporation include the following: There is a separation of ownership and management. Corporations pay taxes on their earnings. They pay both federal and state taxes not borne by other business forms. **Corporate earnings** are subject to **double taxation.** After corporate earnings are taxed to the corporation, the net income distributed to stockholders as dividends is subject to personal income tax. Corporations are subject to **government regulations** that do not apply to proprietorships and partnerships. The cost of compliance is often expensive.

Stockholders have **four basic rights**. Those are the rights to

1. **Vote –** to participate in management by voting. Each share receives one vote.
2. **Receive dividends –** Each share of stock of a particular class receives an equal dividend.
3. Receive a proportionate share of assets remaining upon **liquidation** of the corporation.
4. Maintain one's proportionate ownership in the corporation. This right is called the **preemptive right** and is often withheld from stockholders.

Stockholders' equity is divided into two main parts--**paid-in (or contributed) capital** , and **retained earnings**.

1. **Paid-in capital** is the amount that stockholders had contributed to the corporation.
2. **Retained earnings** is the amount of net income not paid to stockholders as dividends.

Stock certificates are issued to stockholders in exchange for their investment.

a. These shares are often referred to as **capital stock.**
b. The number of shares that the corporation is **authorized** to issue is listed in the corporation's charter.
c. **Issued stock** is that stock that has been sold.
d. **Outstanding stock** is that stock held by shareholders.

The two **classes of stock** are common stock and preferred stock.

All corporations issue **common stock**. Common stockholders assume risks when they buy common stock and therefore demand increases in stock prices, dividends, or both, or they will sell the stock.

Preferred stock is considered less risky than common because preferred stockholders receive their dividends before the common stockholders and receive assets before the common stockholders in the event of corporate liquidation.

(1) Preferred stock pays a fixed dividend similar to interest on debt.

(2)

equity account with a debit balance. The Common Stock account is **not** used because the number of shares **issued** has **not changed--**just the number of shares **outstanding.**

Corporations may purchase stock to **retire** it by canceling the stock certificates, thus reducing the number of shares issued and outstanding.

1. Retired stock may not be reissued.
2. The balance of all paid-in capital accounts (common or preferred as well as paid in capital in excess of par) related to the retired shares are removed from the books.

Financial Accounting, 7/8th ed., Walter T. Harrison, Jr.; Charles T. Horngren / Pearson Edition, p. 488

23.

A **stock split** is an increase in the number of shares coupled with a proportionate reduction in the par value of the stock. Stock splits are recorded with a **memorandum entry** because no account balances are affected. Stock splits **reduce the par value** of the stock. Stock splits
reduce the market price of the stock.

The **market value** of a stock is its current selling price. Market value is more important to stockholders than any of the other values mentioned here. The **redemption value** of a stock is the price the corporation pays to buy back its preferred stock. Redeemable preferred stock is a liability, because the corporation has the obligation to redeem preferred stock at the option of the stockholder. The **book value** of a stock measures the amount of net assets or stockholders' equity per share. Book value is based on historical cost of the net assets and is not market value. **Common book value** = (

ACCOUNTING FOR LONG-TERM INVESTMENTS

25. What are the long term investments? What are the different types of long-term investments?

Stock investments are shares of stock of a corporation (the **investee**) that have been purchased by an **investor**.

Short-term stock investments or marketable securities are current assets. These investments must be liquid and management must intend to sell them within one year.

Long-term investments are all other investments, including available-for

investment would account for various transactions. Both parent and subsidiaries keep their own separate set of books. On the **consolidated balance sheet**, **elimination entries** are necessary to correctly report the financial statements of the consolidated entity and avoid double-counting. They are prepared on the consolidation work sheet but are not recorded on the books of either the parent or the subsidiary. **Elimination entries** must: Eliminate the stockholders' equity of the subsidiary. Since the parent and subsidiary are considered one entity for financial reporting, the parent company's stockholders' equity represents ownership of the consolidated entity. The stockholders' equity of the subsidiary must be eliminated.

Goodwill and minority interest are reported on a consolidated balance sheet:

Goodwill arises if the parent company's purchase price of the subsidiary is greater than the market value of its net assets, calculated as assets minus liabilities.

Minority interest arises if the parent company purchases less than 100% of the subsidiary's stock. Minority interest is reported as a long-term liability on the *parent* company's balance sheet.

The **consolidated income statement** will show the net income of the parent plus the parent's proportionate share of each subsidiary's net income. The dollar amounts of bond transactions are the same for both issuer and investor; only the accounts differ. Short-term investments in bonds are rare.

Held-to-maturity investments are usually (**long-term**) noncurrent assets. This type of bond investment is accounted for by the **amortized cost method**.

1. Record the investment at **cost** and report the carrying amount of the investment on the balance sheet at **amortized cost**, that is, its cost less unamortized discount or cost plus unamortized premium.
2. The

THE STATEMENT OF CASH FLOWS

26. What are the different methods to calculate Cash flows from operating activities?

The

(1) Proceeds from the issuance of long-term debt
(2) Proceeds from the issuance of stock
(3) Proceeds from the sale of treasury stock

b. Cash

Transfer - when A party gives something to B party and does not receive anything tangible in return. Transfer also can be understood as the concept of exchange.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 3-4

6. List the key tasks to be undertaken and implemented by marketing managers

Marketing management undergoes significant changes forcing marketers to rethink their concepts and marketing tools. At the background of highly competitive and changing environment those companies capable of adjusting their marketing concepts and marketplaces will survive and remain competitive. There are several key tasks that marketers should consider and implement:

- Develop marketing strategies and plan

- Establish long term relationship with the target group

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 15-17

8. Discuss the term Integrated Marketing

Integrated Marketing: - is aimed at devising marketing activities and marketing programs in order to maximize the ability to create, communicate and deliver customer value. M0912 0 612 792 reTf108.0030004

- Marketing Concept - the key to achieving the success is performing better than competitors by understanding the market demand and delivering superior customer value to a chosen target group.
- Societal marketing concept – considers that organization has to determine needs, wants and interests of target market and deliver desired satisfaction in a way that enhances the well being of a society.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 17-25

13. Explain the difference between Needs/Wants/Demands

Marketers must understand customers needs, wants and demands.

Need – include basic *physical* needs for food, clothing, warmth and safety; *social* needs for belonging and affection; individual needs for knowledge and self-expression. Marketers do notcreate needs. Wants are shaped by the surrounding society, a person needs food but may want mango. Demands are wants for the specific products, supported with the ability to pay.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey, 2000, pp. 8-9

14. What is Holistic Marketing?

Holistic marketing can be considered as the development of design, implementation of different marketing programs and activities that recognizes breadth and interdependencies involved in today's marketing . Holistic marketing has four key dimensions:

- Internal marketing – ensuring everyone in the organization has the same marketing principles
- Integrated marketing – ensuring multiple means of delivering value is employed in an optimal manner
- Relationship marketing - having beneficial relationship with customers
- Socially responsible marketing – understanding ethical environmental and legal issues

Kotler, P.& Kel& 0 . # er .

- Goods - refers to all types of goods
- Services – many market offerings consist of a variable mix of goods and services
- Events – marketers promote one time events e,g trade shows, company anniversaries etc.
- Experiences – there is a huge market for customized experiences
- Persons – celebrity marketing is a major business
- Places – e,g cities , states , regions etc.
- Properties – e,g real estate or financial property
- Organizations - organizations work actively in order to create strong brand in the minds of customers
- Information – production, packaging and distribution of information is one of our society’s major industries
- Ideas – every market offering offers a basic idea.

Kotler, P.& Keller, K. “A framewo Ma Maaem & ”, 3rd edition, Prentice Hall, 2007, pp. 4-5

16. Explain the concept Total Quality Management (TQM)

Total Quality Management – represents an organization wide approach to continuously improving the quality of the processes, products and services within the organization. Product and service quality, customer satisfaction and company profitability are extremely connected. The higher the level of offered product, the higher the level of customer satisfaction directly connected to company profitability. Companies initially need to correctly identify the cu

18. What is Marketing Mix?

The term marketing mix refers to a unique mix of product, place, promotion and pricing strategies designed to produce mutually satisfying exchange with a target market. usually referred to as four 4Ps. Marketing manager has to control each component of marketing mix. Successful marketing mixes are designed to satisfy target market

Lamb, Ch., Hair, J. & McDaniel, C. "Marketing 8",Thomson South Western, 2006, pp. 51-52

19. Explain the meaning of Elastic Demand/Inelastic Demand?

Elasticity of demand refers to consumers responsiveness or sensitivity to changes in price. Elastic demand occurs when consumers buy more or less of a product when the price changes.

Inelastic demand means that an increase or a decrease in price does not significantly affect the product.

Lamb, Ch., Hair, J. & McDaniel, C. "Marketing 8",Thomson South Western, 2006

20. Explain the notion of Knowledge Management and types of knowledge

Knowledge management represents an umbrella term comprising of a range of organizational processes and practices having common concern of generating value from knowledge. The term knowledge management cannot be distinguished with a long history, it encounters R &D, management information system, employee training and managing intellectual property - strategic planning is also considered as knowledge management activity. Knowledge management initially comprised of information technology –

21. Explain Market Penetration Strategy

A market penetration strategy considers product introduction to the market at a low price in order to attract a large pool of buyers as quickly as possible. It tends to create a low price barrier to market entry. The intend is to attain a high or even total, initial market share and maintain this share high during the further stages of the product's life cycle.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 220

22. Explain Market Skimming Strategy

A market skimming policy considers that a company initially puts the highest price that the market will bear, and promotional effort is aimed at a small percentage of the potential market. These customers are most often innovators, willing to purchase during the introduction stage of the product's life cycle, followed closely by the early adopters who are also more receptive to new concepts and products.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007

23. Describe the company's marketing environment

A company's marketing environment consists of the actors and forces outside marketing that affect marketing management's capability to develop and preserve successful transactions with its target customers. The marketing environment encounters both opportunities and threats. The marketing environment consists of task environment and broad environment.

Task environment encounters immediate actors involved in producing, distributing and promoting the offering such as the company, suppliers, distributors, dealers, and the target customers.

The broad environment encounters six major components: demographic environment, economic environment, physical environment, technological environment, political environment and social- cultural environment. These environments encompass forces that may greatly influence actors in the task environment. Market actors must pay attention to trends and developments in the environment.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 15

24. Explain Production Concept

A: production concept holds that consumers prefer highly affordable and available products, and therefore management should therefore focus on improving production and distribution efficiency. This concept makes sense in developing countries, where consumers are more interested in obtaining the product than in its features.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey, 2000, p.

environment and competitors strength and weakness is an important part of market orientation. The marketing concept takes an outside-in perspective. It commences with definite market, focuses on customer needs, coordinates all the marketing activities affecting customers and makes profits by ensuring long-term customer relationships based on customer value and satisfaction.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006, p. xxxi

27. Discuss Marketing Communication and Marketing Communication Mix

Marketing communications are means applied by companies aimed at, informing, persuading and reminding consumers- directly or indirectly about the brand / product they offer to a market. Marketing mix consists of six major models of communication

- Advertising any paid form of presentation and promotion of ideas
- Sales promotion incentives to boost sales
- Events and experiences company sponsored activities designed to create brand related interactions
- Public relations and Publicity
- Direct marketing Mail, telephone , fax
- Personal selling face-to face interaction with purchasers in order to market the offered product

Companies usually apply other means such as product styling and price, shape and color of the package, sales people dresses and manners.

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 279-280

28. Explain the Concept of Societal Marketing

The Societal Marketing Concept – This marketing concept considers that indeed the major directions should be aimed at not only determining the needs and wants of the target markets in order to deliver the desired satisfaction but also at preserving and enhancing the overall well being of our society.

This concept calls upon marketers to build social, ethical and environmental considerations into their marketing practices. Recent years have witnessed lots of complaints about products and packaging that are harmful to health and ecology. Marketers must come forward to protect

the interest of both the customers and the environment and this can be achieved by adopting or following the societal marketing concept.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey, 2000, p. 25

29.

32. Explain the meaning of Positioning

Initial step comprises of defining the target market, once identified a strong competitive position must be ensured. Product positioning represents the place a product holds In a certain market, Market positioning gives product a clear, distinguishing and attractive place in the minds of target consumers compared to competing products. Marketers plan positioning in such a way that distinguishes their products from competing brands and give them the greatest strategic advantage in their target markets.

Hutt, M. D. & Speh, T. W. "Business Marketing Management: B2B", Maiami University, Thomson South Western, 2007, p. 227

33. Discuss benefits of Segmentation

Market segmentation represents a process of dividing a market into an important, moderately similar and identifiable segment or groups. The purpose of segmentation is to enable the marketers to tailor marketing mix aimed at meeting their chosen target group needs.

Segmentation helps identify the group of customers having similar needs in order to analyze characteristics and buying behavior of this group. It also gives relevant information to marketers enabling the design of effective marketing mix. And, finally, segmentation is consistent with the marketing concept of satisfying customer wants and needs while meeting the organization's objectives. Segmentation scheme must meet four basic criteria:

1. Substantiality – market segment needs many potential customers in order to make commercial sense,
2. Identifiability and measurability – segment must be identifiable and measurable,
3. Accessibility – targeted segment must be reachable with customized marketing mixes,
4. Responsiveness – different segments are having different response to marketing mix, segments need not be treated separately.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006, pp. 224-226

34. Discuss the steps involved in segmenting markets

Market segmentation represents a process of dividing a market into an important, moderately similar and identifiable segment or groups. The purpose of segmentation is to enable the marketers to tailor marketing mix aimed at meeting their chosen target group needs. The purpose of segmentation in both customer and business market is to identify the marketing opportunities. There are six steps to be considered when segmenting the market:

- Select a market or product category for study

- Choose a basis or bases for segmenting the market
- Select segmentation descriptors identify specific segmentation variables
- Profile and analyze segments
- Select target market
- Design, implement and maintain appropriate marketing mixes.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8", Thomson South Western, 2006, pp. 238-239

35. Discuss how to position a firm effectively

The success of a company is hinged on effective positioning. Positioning refers to perception the company builds in the minds of customers concerning their ng6.00000912 0 612 792 reW*nBT0 0 0 rg

39. Discuss bases for segmentation

Segmentation implies dividing a market into separate groups of buyers with different needs, characteristics or behavior, that may need separate products or marketing. Market segmentation must be redone periodically since market segment change.

Two broad variables are used in order to segment the consumers market. First focuses on consumer characteristics such as; geographic, de

- Supplies and business services – short lasting goods or services that facilitate the development and management of finished goods e,g. lubricant paint, etc.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 397-398

42. Consumer Goods Classification

Consumer products are those bought by final consumers for personal consumption. Consumer goods include the following:

- Convenience goods- consumer usually buys frequently, immediately and with a minimum of efforts and comparison Examples are soap, sweets
- Shopping goods - purchased frequently and consumers spend time on gathering information on product in order to compare the alternative options. E.g furniture, clothing,
- Specialty goods– goods with unique characteristics or brand
- Unsought goods - consumer either does not know about or knows about but does not normally think of buying

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 397

43. Explain New Product Development Stages

The new-product development process consists of nine steps

1. Idea generation - The new idea about the product is coming from customers, competitors, scientists, employees, R&D, sales personnel, brainstorming, discussions, distributors, suppliers.
2. Idea Screening - The purpose is to attract good ideas out of multiple choices.
3. Concept development – concept is more comprehensive option of a product
4. Concept testing – presenting the product concept to appropriate target consumers in order to get their reaction
5. Marketing strategies - depicts the target market, the planned product positioning, sales, market share and profit goals for the first few years
6. Business analyses – analyzing the financial viability of a product
7. Product development – this is the stage where the product has already passed through previous stages and prototypes will be developed that will be assessed
8. Test marketing is the second to last stage. The new product is introduced and put to a market test in order to learn how the market will react and how consumers and dealers react to handling, using and repurchasing the product.

9. Commercialization is where the product is about to be launched on the market. All of the various filters have taken place, but even at this stage success is not guaranteed.

Kotler, P. The Millennium Edition, “Marketing Management”, Northwestern University, Prentice Hall, New Jersey,2000, pp. 334-351

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Kotler, P. The Millennium Edition, “Marketing Management

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- *Imitative products* – often represent innovative product that has been successfully established. Marketing slang refers to them as 'me too' products.
- *Re-launched products* – it takes place when an original product has undertaken a decline stage, but still sufficient potential for sale is available if the image of the product is changed through marketing mix tools.

Geoff Lancaster, London School of Commerce. Lecture notes, 2009

47. Explain Product Life Cycle

The product life cycle has four stages:

1. Introduction - a period of slow sales growth as the product is introduced in the market. Profits are non-existent in this stage because of the heavy expenses of product introduction.
2. Growth - a period of rapid market acceptance and profit improvement.
3. Maturity - a period of slowdown in sales growth because the product has achieved acceptance by most potential buyers. Profits stabilize or decline because of increased marketing outlays to defend the product against competition
4. Decline is the period when sales fall off and profits drop.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 303-304

48. Explain the concept of Product Life Cycle (PLC)

Every product has a life cycle, which implies that the following four things need to be considered:

- Products have limited life time
- Product sales pass through distinctive stages, each posing different challenge, opportunities and problems to sellers
- Profits rise and fall at different stages of the product life cycle
- Product require different marketing, financial manufacturing, purchasing and human resources strategies in each stage of their life cycle

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey, 2000, p. 303

49. What are the critiques of the Product Life Cycle ?

The product life cycle concept (PLC) is applied to interpret the product and market dynamics. It helps managers to identify at what stage the product is and what actions and

54. Define marketing research and its importance to marketing decision

Marketing research can be classified as a process of collecting, assessing and analyzing data with the aim to solve a specific posed problem. Marketers use marketing research in order to investigate profitability of marketing strategies. It helps to analyze why certain strategies fail and analyze characteristics of specific market segment. Marketing research enables the company to keep proactive position, rather than reactive, to identify fresh emerging patterns in the environment. The task of marketing is

57. Discuss the Marker Followers Strategies

Firms applying the market follower strategies seek stable market shares and profit by following competitors' product offers, prices and effective marketing programs. Many companies prefer to follow rather than challenge the leader. One broad strategy for followers is to be a counterfeit, copying the leaders product, package and selling it on the black market. Another strategy is cloner - imitating the leaders product, the third strategy is imitator – copying some things from leader. The fourth strategy is adapter – adapting or improving the leaders product. Normally followers ear less than the leaders

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

58. Discuss the Marker Challenger Strategies

Market challengers first define strategic objective. Market challengers first identify whom to attack and then apply aggressive attack on competitors. market challengers also attack firms of their own size that are under performing, have aging products, charge excessive prices or fail to satisfy customers in any other way. Five general market-challenger attack options are the followings:

- Frontal attack - match the opponents products, advertizing, price and distribution
- Flank attack – Identifying shifts in market segments that cause gaps to develop, then filling the gaps and developing them into strong segment
- Encirclement attack – launching a grand offensive on several fronts
- Bypass attack – bypassing the enemy and attacking easier markets
- Guerilla warfare – small intermittent attacks to harass the opponents

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, pp. 170-171

59. The tools of IMC Integrated Marketing Communication

Integrated Marketing Communications can be viewed as a careful coordination of all prom(f)3( )- toh 0 R 9.96 Tf485.863 Td>

promotional mix. Generally, the promotional mix included four elements: advertising, sales

rry out transactions with potential buyers

Kotler, P.& Keller, K. "A framework for Marketing Management", 3rd edition, Prentice Hall, 2007, p. 14

63. What is Marketing Communication and 6 major models of marketing communication ?

Marketing communications – referred to those means applied by the companies in order to inform, to increase awareness, persuade, and remind consumers directly or indirectly about the products they offer.

Marketing communication mix consist of 6 major models of communication

1. Advertising – paid form of non-personal presentation and promotion of ideas, goods or services
2. sales promotion – short term incentive to stimulate and promote purchase of
3. Events and experiences – company sponsored activities and programs aimed at creating the brand related connections
4. PR and publicity – programs protecting and promoting the company or product image.
5. Direct marketing – use of mail, phone, fax, internet to communicate directly to customers
6. Personal selling – face-to-face interaction with prospective purchasers.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 550

64. Discuss the role of marketing communications

Marketing communications – aö% bŃXöAbPa(6

65.

68. Explain the Corporate Social Responsibility CSR

The Corporate Social Responsibility – represents a business concern regarding the welfare of the society. CRS can be discharged across five dimensions: physical environment, social, consumer, supply chain and employee relations.

The newest theory in social responsibility is called sustainability. Sustainability – implies that socially responsible companies will outperform their peers by focusing on the worlds social problems and view them as the opportunity to build profits and help the world in the meantime. The pyramid of corporate social responsibility is a model –suggesting that CSR is composed of economic, legal, and philanthropic responsibilities and that the firm's economic performance supports the entire structure.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006, p. 70

69. Explain the meaning of Licensing

Another extremely effective way of moving into a global market offered to companies is licensing, which bears relatively low risk. Licensing is a process where a licensor permits another company to use its manufacturing process, trademarks, patents, trade secrets, or other proprietary knowledge. The licensee has to pay licensor a royalty or fee, which is preliminary agreed between the parties.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006, p. 124

70. What is Franchising?

Franchising represents a business model uniting different owners in a single brand name. Franchising is type of licensing where certain package of services is offered by the franchisor to franchisee in return of payment. There are two types of franchising: Product & Trade Name Franchising, the best example is coca. A parent company permits entrepreneurs to apply the company's strategies and trademarks and in exchange, the franchisee pays an initial fee and royalties based on revenues. The parent company also provides the franchisee with support, including advertising and training, as part of the franchising agreement.

Franchising represents faster and cheaper form of growth and expansion, since opening of a new store costs much more. Though it should be mentioned that potential for revenue growth is limited since the parent company will only earn a percentage of the earnings from each new store.

Lamb, Ch., Hair, J. & McDaniel, C. "Marketing 8", Thomson South Western, 2006, p. 437
http://www.wikinvest.com/concept/Franchising

STRATEGIC MANAGEMENT

71. What is Mission Statement?

The basis of the marketing plan is mission statement, addressing the questions of what business is the company in. Business mission influences the firm's long –run resources allocation, profitability and survival. Mission Statement represents a statement of Firm's business based on cautious analysis of benefits sought by present and potential customers and analysis of current and possible future environment.

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006, p. 40

72. Discuss the drivers of uniqueness when applying the differentiation strategy

Differentiatio

The success of a company is hinged on effective positioning. Positioning refers to perception the company builds in the minds of customers concerning their product. Strong positioning influences customers.

Differentiation offers more secure basis for competitive advantage than low cost, since cost advantage is highly vulnerable to unpredictable external forces.

Sometimes customers' perception creates basis for product differentiation which is neither designed by the company nor desired. Successful differentiation strategy involves matching

1. Successful differentiation sends a signal to a new entrant that the costs of overcoming the incumbent company’s differentiation will be too costly and may easily prevent the new entrant decision to join the market.
2. Successful differentiations reduce threat from rivalry, by curving out unique product niche. Indeed, competition is still on for a common set of customers though it is somewhat attenuated.
3. Product differentiation reduces threat from substitute product by making the initial product more attractive than the substitute one.
4. Product differentiation reduces threat from suppliers. When suppliers increase prices of service, this price surge must be offset by increasing the cost of a product. Highly differentiated product is more likely to be accepted by loyal customers with a high price.
5. Product differentiation - can reduce the threat of buyers by enjoying quasi monopoly in that segment of the market. So, buyers wanting this product must buy it from a particular firm.

Barney, J. B. “Gaining and acce

- Strategy implementation – putting various plans into action
- Strategy evaluation – evaluation how strategy has been implemented. A company representatives have to monitor both the implementation process and performance outcomes. If the outcome fails to deliver the desired outcome, a strategy must be modified or amended.

http://www.koellay.com/2009/05/strategic-management-and-planning.html

77. Why external analysis is important?

Marketing managers have to understand the external environment in order to effectively plan for future. The evaluation process commences with scanning in order to identify opportunities and threats. There are many benefits associated with the external environment assessment such as ability to better plan for future, to set up smart strategy capable of delivering the desired outcome, to be more flexible in terms of responding to unexpected developments triggered by changing environment, to identify threats and opportunities and forecast trends, to be proactive rather than reactive. At the background of fluctuating environment marketers have to act as adapters rather than agents of change. The external environment comprises of competitors, technological developments, social changes, political and legal factors, economic condition, and demography. Consideration and assessment of all those factors is of high importance, having immense influence on the successful development of a company.

Lamb, Ch., Hair, J. & McDaniel, C. "Marketing 8", Thomson South Western,
2006,5(th)-4([illegible]

If it is supposed here that each player is only concerned with lessening his time in jail, the game becomes a non-zero sum game where the two players may either assist or betray the other. In the game, the sole worry of the prisoners seems to be increasing his own reward. The interesting symmetry of this problem is that the logical decision leads both to betray the other, even though their individual 'prize' would be greater if they cooperated.

In the regular version of this game, collaboration is dominated by betraying, and as a result, the only possible outcome of the game is for both prisoners to betray the other. Regardless of

80. Explain Resource Based View and its importance

83. Discuss M&A and categories of mergers and acquisitions

A merger – implies combination of two similar size companies in order to form a new company. An acquisition takes place when one company clearly purchases another and turns into a new owner.

- Vertical merger – a firm acquires former suppliers or customers. When it vertically integrates either forward or backward through its acquisition efforts
- Horizontal merger – a firm acquires a former competitor
- Product extension merger – a firm gains access to complimentary products though an acquisition
- Market extension merger – a firm gains access to complimentary markets though an acquisition
- Conglomerate merger – there is no relationship between a bidding and a target firm

Barney, J. B. "Gaining and Sustaining Competitive Advantage", 2nd edition, Prentice-Hall, NJ, 2002, pp. 485-486

84. Discuss the role of analysis in strategy formulation

The intuition, creativity and spontaneity – do represent those vital qualities the absence of which may result into unfavorable outcome. Those are the essential qualities of a successful strategy. Whether the strategy formulation is formal or informal, deliberate or emergent systematic analysis of the strategy is a vital input into the strategy process. Without analysis strategic decision would be susceptible to power battles, individual whims, and wishful thinking. Concepts, different theories and analytical tools are the compliments not substitutes for experience commitment and creativity. They aim at creating frameworks for organizing decisions, processing information and options and facilitating agreement. The purpose of strategy analysis is not to provide answers but to help understanding the issue. Increased understanding of the fundamental issues concerning competitive advantage, customers needs and general frameworks can greatly facilitate the innovation and flexibility and the formulation of an accurate strategy capable of delivering the desired outcome.

Grant, Robert M. "

87. What are the major Growth Strategies?

- Market penetration strategy (grow by selling more of an organization's existing products to existing customers)
- Market development strategy (grow by selling more of an organization's existing products to new customers)
- Product development strategy (develop new product)
- Diversification (grow by serving new customers through delivering new products).

Based on Geoff Lancaster, London School of Commerce. Lecture notes, 2009

88.

Competitive disadvantage – when company actions in the industry or market fail to create any economic value

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey & Sons Ltd Publication, 2010, pp. 9-22

95. Identify the sources of competitive advantage

Competitive advantage – when a company experiences strategic advantage over competitors, when its actions in the industry or market create value and few competing firms are engaged in the similar actions. Company gains competitive advantage when the theory of how to compete within an industry is consistent with the economic processes in that industry and market and only few other firms share it.

There are three types of competitive advantage: Cost, Product/Service Differentiation and Niche Strategy.

Sources of cost competitive advantage are – experience curve, efficient labor, no-frill goods and services, government subsidies, product design, reengineering, product innovation and new methods of service delivery

A product /service differentiation source is uniqueness that is valuable to a customer

Niche competitive advantage comes from targeting unique segments with specific needs and wants

Lamb, Ch., Hair, J. &McDaniel, C. "Marketing 8",Thomson South Western, 2006, p. 58

96. Explain the meaning of Core Competence and Distinctive Organizational Capabilities

Core competences has been defined by Harnel and Prahalad as "The collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies", Core competence can be considered as a set of resources and capabilities that connects different businesses in a diversified company through managerial and technical know-how experience and wisdom. Distinctive organizational capabilities – are the particular and exceptional capabilities that differentiate an organization from its competitors and three features are characterizing for them:

1 - greatly contributes to delivering superior customer value.

2 - facilitates to create product which is diff[illegible] competitors to imitate [illegible] TJETQq0.00000912 0 61[illegible]

99. Explain Porter's Five Forces

5 forces help the marketer to contrast a competitive environment. It has similarities with other tools for environmental audit, such as PESTEL analysis, but tends to focus on the single business or SBU Strategic Business Unit rather than a single product or range of products.

1. Threat of new entrant

C. Cost advantage independent of scale – cost advantage can deter the entry. There are 5 cost advantages 1 proprietary technology 2 know –how 3 favorable access to raw material 4 favorable geographic location 5 learning curve cost advantage

- 1 proprietary technology – the development of this technology can be expensive as well as copying will be expensive step
- 2 know –how - is practical knowledge of how to get something done, Know-how is often tacit knowledge, which means that it is difficult to transfer to another person by means of writing it down or verbalizing it. Acquiring this know how will be costly and will take too much time for new entrants
- 3 Favorable access to raw material – e.g. being closer to raw material resource is a big advantage ,
- 4 Favorable geographic location
- 5 learning curve advantage. e.g. airplane benefit over the new entrant is the gained experience and knowledge

D. contrived deterrence -

102. Discuss four part framework identified by M. Porter for predicting the competitors behavior

Competitive intelligence is not only about gathering information. The problem is gathering relevant and required information and identifying the purpose of using this information. The objective is to understand the rival, their weaknesses and strengths. Michael Porter proposed a four part framework for predicting competitors' behavior. It comprises of the following:

- Competitors current strategy – predict how a competitor is competing now and how it will act in future, identifying the main strategy for competition
- Competitors' objectives – identifying competitors current goals, to what degree whose goals are met and how likely they are to change
- Competitors' assumptions about the industry – identifying the competitors assumptions regarding the industry and environment in general
- Competitors' resources and capabilities – identifying the likelihood and seriousness of competitors' strength, resources and capabilities, what are the key strengths and weaknesses of the rival company.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition,
John Willey & Sons Ltd Publication, 2010, pp. 105-106

103. Discuss SWOT analysis

SWOT analysis draws the critical strengths, weaknesses, opportunities and threats SWOT from the strategic audit. The audit contains data of diffe

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ention houelnfcusf(i)5(t)5(s)] TJETQq0.00000912 0 612 792 reWnBT0 0 0 rg0 0 0 RG/F1 10.56 Tf476662 136.73 Td[s

SWOT 314(anal)7(ysi)8(s 2)5(di)5(st)8(i)5(l)5(s 2)5(t)5(hsr)3(e)35(dat)6(a 247(t)5(o)23(ho)44(w16( )23(t)5(he)24(

as the education of the workforce, the health of the nation and the quality of the infrastructure of the economy such as the road and rail system.

- *Economic factors.* These include interest rates, taxation changes, economic growth, inflation and exchange rates
- *Social factors.* Changes in social trends can impact on the demand for a firm's products and the availability and willingness of individuals to work.
- *Technological factors:* new technologies create new products and new processes. Technology can reduce costs, improve quality and lead to innovation. These developments can benefit consumers as well as the organisations providing the products.
- *Environmental factors:* environmental factors include the weather and climate change. Changes in temperature can impact on many industries including farming, tourism and insurance. With major climate changes occurring due to global warming and with greater environmental awareness this external factor is becoming a significant issue for firms to consider.
- *Legal factors:* these are related to the legal environment in which firms operate. Legal changes can affect a firm's costs (e.g. if new syste.g. prd81(c(at)6(s(i)5(f)3(hi)5(dpr)3(1)7(d)12n)12(df)3(

- Societal pressures – the only basis for survival for companies is the ability to be adapt to the values and expectations of society. Adapting to society's growing demand for fairness, ethics and sustainability presents challenges for businesses.

Grant, Robert M. "

suppliers and related industries. This usually occurs at a regional level as opposed to a national level.

4. Firm strategy, structure and rivalry - conditions for organization of companies, and the nature of domestic rivalry. The structure and management systems of firms in different countries can potentially affect competitiveness. Likewise, if rivalry in the domestic market is very fierce, companies may build up capabilities that can act as competitive advantages on a global scale. Home markets with less rivalry may therefore be counterproductive, and act as a barrier in the generating of global

http://www.e-benchmarking.org/benchmarking.html

109. Discuss the terms Business Process Re-engineering BPR

Michael Hammer and James Champy defined Business process reengineering – as the fundamental rethinking and radical resign of business processes to achieve dramatic improvements in critical contemporary measures of performance, such as cost, quality, service and speed.

Business process Reengineering can be referred to analysis and design of processes within the organization that can facilitate the achievement of substantial efficiency. BPR includes

- Combining several jobs into one
- Allowing workers to make decision
- Performing the steps of a process in a natural order
-

110. What is Strategy/ discuss difference between the Corporate and Business Strategy

As the business environment undergoes dramatic changes, the definition of strategy from being a detailed plan has changed into quest for success. In a turbulent environment strategy must be flexible and easily adjustable. In order to effectively respond to external changes. M porter empathized that Strategy is not about doing things better it is about doing things differently. Strategic choice is revealed in two questions, where to compete and how to compete. The answer to these questions refers to business and corporate strategy.

Corporate strategy- defines the scope of the firm in terms of industries and markets in

actual part of a business, 2005 saw many big companies plunging into the international strategy e.g. GE, ExxonMobile, Citigroup, Microsoft.

For the strategic alliance to be successful it must be capable of generating economic profit, exploit a firm's rare and costly to imitate resources and capabilities. The valuable international strategies must exploit the real economies of scope, which are rare and costly to imitate. In other words it must allow the company to exploit environmental opportunities and neutralize all the threats. International strategy helps the company gain access to potential new customers that in its turn increases the volume of production. So, if successfully implemented international strategy can gain access to new customers and change the domestic demand as well

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

A pers

<u>Support activities:</u>

6. Firm infrastructure: general management, planning, finance, legal, investor relations, culture;
7. Human resource management: recruitment, education, promotion, reward systems;
8. Technology development: research & development, IT, product and process development;
9. Procurement: purchasing raw materials, lease properties, supplier contract negotiations.

By subdividing an organization into its key processes or functions, Porter was able to link classical accounting to strategic capabilities by using value as a core concept, i.e. the ways a firm can best position itself against its competitors given its relative cost structure, how the composition of the value chain allows the firm to compete on price, or how this composition allows the firm to differentiate its products to specific customer segments.

Value chain analysis will help to make outsourcing decision. Margin here is presented as a value delivered, therefore a firm's margin depends on its effectiveness to perform each activity.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 45

116. Explain Vertical Integration

Value chain represents set of activities that must be accomplished in order to design, sell and distribute a product or service. Different companies make different decision about which activities they would like to perform themselves and in which activities they would like to engage other firms. The higher the level of engaged firms the higher the level of vertical integration. Over time firms can become more vertically integrated or less vertically integrated

Barney, J. B. "Gaining and Sustaining Competitive Advantage", 2nd edition, Prentice-Hall, NJ, 2002

Vertical integration – is the process in which several steps in the production and/or distribution of a product or service are controlled by a single company or entity, in order to increase that company's or entity's power in the marketplace.

http://www.investorwords.com/5977/vertical_integration.html

117. Discuss 3 types of vertical integration

- Backward upstream 283.01 Td[( )] TJET0 0 0.W*nBT0 0 0 . reW*n6ical

Example: When company owns a tire company automobile

- Forward vertical integration: when a company owns the subsidiaries that market the product.

Example: Movie studio that also owns a chain of theaters

- Balanced Vertical Integration: when a company that sets up subsidiaries that supply them with inputs and also markets the product

Barney, J. B. "Gaining and Sustaining Competitive Advantage", 2nd edition, Prentice-Hall, NJ, 2002, p. 194

118. Explain different types of Vertical Integration

Different Types of Vertical Integration

1. Long Term Contracts – that encompass series of transactions over a period of time. It works effectively in the absence of need for transaction specific investment by either party.. Long term contracts always include provisions for arbitration of contract or dispute.
2. Vendor Partnership – e.g contract between two companies. One company crafts a partnership program to provide a sales outlet to the trader for a fee, which typically includes rates for featuring, or exhibiting, the vendor's products.
3. Franchising - contractual agreement between the owner of a business and trademark that permits the franchisee to produce and market the franchiser's product or service in a specific area.

Grant, Robert M. "Contemporary Strategy Analysis", 7-th edition, John Willey & Sons Ltd Publication, 2010, pp. 362-363

119. What is Strategic Alliance and Types of Strategic Alliance?

Strategic alliance takes place when two or more independent organizations collaborate in the advancement, manufacture or sale of product or service. It can be equity, non-equity or joint venture.

Non Equity Alliance– parties to the strategic alliance do not take equity position on each others firms e.g supply agreement, distribution agreement

Equity Alliance - parties to the strategic alliance supplement their contracts with equity

developed by Robert Kaplan and David Norton. This method provides a framework for balancing strategic and financial goals and bringing performance measures down to the organization to individual business units and departments. This approach combines

PRINCIPLES OF BUYING BEHAVIOR AND THE IMPORTANCE OF PRICING

Buying behavior

126. Discuss types of buying decision behavior

Complex buying behavior - takes place when a consumer is highly involved in a purchase and perceives differences among brands. This mostly takes place when a product is expensive

Dissonance-reducing buying behavior – takes place pl

BRANDING AND A

- User – brand suggests the kind of consumer who buys or uses the product

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, pp. 404-405

137. Guidelines for selecting brand name

Brand name should be selected carefully with the consideration of the following important aspects:

1. Brand should suggest something - e,g beauty rest
2. Brand should suggest something - benefits or function e,g march First, Agilent Technologies
3. Brand should be easy to pronounce, recognize and remember
4. Brand should be distinctive
5. Brand should not carry poor meaning in other countries and languages

Brand names should be easy to remember, it increases brand awareness. Marketers can also shorten the names e,g Coca cola is also coke. Short names facilitate the recall.

The brand name should also be familiar and meaningful.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey, 2000, p. 413

138. What is Brand Equity/its components?

Brand Equity evaluates the strength, power and value of a brand in the marketplace. Some brands are not known to customers, whereas there are some enjoying a high level of brand awareness among customers, there are also brands with high level of acceptability, with high level of preference and finally brands with a high level of loyalty

Brand equity is highly related to the degree of brand name recognition, perceived brand quality, strong mental and emotional association, patents, trade marks and channel relationship. Brand equity is not reflected on the company's balance sheet.

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey,2000, p. 405

139. Discuss criteria for choosing brand elements

Brand elements are those trademarkable devices emp-210.56 Teo 0 0 rg0 0 0 RG/F5 9.96 Tf451.51 384.91 Td[( )]

Memorable – the element must be easily memorable, easily recalled and realized
Meaningful – the element should be meaningful, credible and suggestive, must suggest

142. How to successfully develop advertising message?

Developing accurate message for the target audience is a tough and very complex task. Focusing on irrelevant features of a product will result not only into the wasted efforts but into a loss of money. Both the appeal and the way appeal is conveyed is critical to successful communication. Initially advertising objectives has to be determined, followed by evaluating the buying criteria of the target audience, as well as identification of the right language, format and style for presenting the message. For the message to be successful first individual must be exposed to it in order to identify the perceptual barriers. Advertisers should connect two important things attention and interpenetration, how correctly the audience will interpret the launched message. Another important aspect is to understand the buyers' motive, which product benefits are important for the target group. So intensive marketing research must be in place aimed at fully describing the key buying criteria of each buying influencer in each of the firms different target markets.

Hutt, M. D. & Speh, T. W. "Business Marketing Management: B2B", Maiami University, Thomson South Western, 2007, pp. 397-399

143. Discuss the importance and contribution of trade shows

One of the non-direct communication methods- trade shows have long been proved as a unique source of being exposed to a larger audience. Trade shows offer opportunity to publicize significant contribution to technology or to demonstrate new and old products. Trade shows can contribute to the following aspects:

- An effective message can be delivered to relatively large and interested audience at one time
- New products can be introduced to mass audience
- Customers can get hands-

PUBLIC RELATIONS

144. What does Public Relations mean and functions of PR department?

Public Relations represent an important marketing communication tool. Public Relations – is applied both inside and outside the organization. PR is sometimes considered as an external marketing tool aimed at reaching the large audience in a positive light, which is very limited thinking. PR also has a great role as an internal marketing communication tool. Public Relations involve multiple programs designed to promote or protect a company's image and individual products. PR departments usually perform five functions such as

- press relations presenting news and information
- product publicity publicizing specific products
- corporate communication promoting understanding of the organization though internal and external communications
-

146. Explain the role of PR in Crisis Management

Public Relations represent an important marketing communication tool. Public Relations – is applied both inside and outside the organization. PR is sometimes considered as an external marketing tool aimed at reaching the large audience in a positive light, which is very limited thinking. PR also has a great role as an internal marketing communication tool. Public relations has extremely vital role to play in 'crisis management' scenarios. In case of unexpected catastrophe, especially if it affects the lives of people by injuring or loss of lives, the presence of the right public relations activities is essential, which will facilitate the putting of a fair and balanced account of events forward to the general public and thus mitigating the adverse effects of the disaster to the organization concerned.

Based on Geoff Lancaster, London School of Commerce. Lecture notes, 2009

147. Define the term -Marketing Public Relations

Marketing managers and public relations specialists not always use the same language. Marketing managers are bottom line oriented, whereas public relations specialists are more oriented on preparing and disseminating information. Many companies are now turning to marketing public relations that facilitate the mitigation of the difference between the two above mentioned points, thus focus is made on supporting corporate or product promotion and image making.

Thus Marketing Public Relations MPR serves as a special constituency- marketing department and goes beyond the simple publicity and plays an important role in the following tasks:

- Assisting the launch of a new product
- Assisting in repositioning the nature product
- Building interest in a product category
- Influencing specific target groups
- Defending products that have encountered pubic problems
- Building the corporate image in a way that reflects favorably on its product.

MPR is also very effective in reaching specific ethnic and other groups. MPR carries more credibility than advertising

Kotler, P. The Millennium Edition, "Marketing Management", Northwestern University, Prentice Hall, New Jersey, 2000, pp. 606-607

148. Identify the impact of technology on a firm

The world economy undergoes dramatic changes. Geographical and cultural distances have shrunk with the advent of global computer and technology development. This enabled many

companies to expand their geographical market coverage, facilitated purchasing and manufacturing processes. Many companies commenced creating global structure in order to move ideas swiftly around the world.

Technological developments have significantly affected the process of doing business. Monitoring new technology is an essential aspect in terms of keeping up with competitors at the background of today's marketing environment. Another greatest impact of technological advancement is increased productivity and innovation, which provides basis for remaining competitive at the global market.

Lamb, Ch., Hair, J. &McDaniel, C.

MANAGEMENT

MANAGEMENT DOMAIN (GENERAL CONCEPTS AND HISTORY)

1. What is management?

A **manager** is someone who coordinates and oversees the work of other people so that organizational goals can be accomplished. A manager's job is not about *personal* achievement – it's about helping *others* do their work.

Management is a process of coordination and overseeing the work activities of others so that their activities are completed efficiently (getting the most output from the least amount of input; doing things right) and effectively (doing those work activities that help the organization reach in goals; doing the right things).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 7-8

See Mind-Map 1

2. Describe how to classify managers in organizations

3. What do managers do in terms of functions?

Planning – defining goals, establishing strategies, and developing plans.
Organizing – arranging and structuring work.
Leading – working with and through people.
Controlling – monitoring, comparing and correcting work performance; evaluating whether things are going as planned.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 8-10
See Mind-Map 1

4. What are the main managers' roles?

Management roles are specific categories of managerial behavior.

- security threats – leads to risk management, work life-personal life balance, restructuration or workplaces, discrimination concepts, globalization concerns, employee assistance;
- organizational and managerial ethics emphasis – leads to redefining values, rebuilding trust, increased accountability;
- competitiveness – leads to customer service issues, innovation issues, globalization issues, efficiency/productivity.

Specifically, customers and innovation are most urgent changes that impact managerial work.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 15-17
See Mind-Map 1

7. What is organization?

Organization is a deliberate arrangement of people to accomplish some specific purpose. Any organization has three indivisible and interconnected elements: People, Purpose, Structure.

Organizations are (1) social entities that (2) are goal-directed, (3) are designed as deliberately structured and coordinated activity systems, and (4) are linked to the external environment.

Organizations are made up of people and their relationships with one another. An organization exists when people interact with one another to perform essential functions that

Quantitative approach uses applications of statistics, optimization models, information m

14. What is the systems approach?

During 1960s, management researchers began to analyze organizations from the systems point of view. *System* is a set of interrelated and interdependent parts arranged in a manner that produces a unified whole.

Systems can be closed and open. Open system interacts with dynamically with the environment. Organizations are treated as open systems – "open" to and interacting with its environment.

The **systems approach** implies that decisions and actions taken in one organizational area will affect others and vice versa. The systems approach recognized that organizations are not self-contained. They follow environmental influences.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 38-39
See Mind-Map 3

15. What is the contingency approach?

Most early theories of management treated their principles as universally applicable. Later research showed that there are many exceptions. Management is not based on the simplistic principles that work in all situations. Vice versa different situations make managers use different methods, techniques and principles. The **contingency approach** (situational approach) suggests that organizations are different, face different situations (contingencies) and require different ways of managing.

The contingency approach is about "if, then". Some popular contingency variables are: organization size, routineness of task technology, environmental uncertainty, individual differences.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 39-40
See Mind-Map 3

16. What are the current trends and issues in management?

Globalization – managers are less constrained by national borders, which leads to the challenges as working with people from different cultures, movement of jobs to countries with low-cost labor, etc.

Ethics – there are more and more ethical dilemmas in making decisions.

Workforce diversity – managing people with different cultural backgrounds, work styles, family needs etc.

Entrepreneurship – an important global activity is the process of starting new businesses, generally in response to opportunities. Innovation is included in this issue, as far as it involves changing, revolutionizing, transforming, introducing new products or services or new ways of doing businesses.

19. Describe culture in organizations by the source and the ways employees learn culture

23. What influence does the environment have on managers?

The specific environment (those external forces that have a direct impact on manager's decisions and actions and are directly relevant to an organization's goals) includes customers, suppliers, competitors, and pressure groups. The general environment (those broad external forces that affect the organization) includes economic, political/legal, socio-cultural, demographic, technological, and global conditions.

Stakeholders are any constituencies in the organization's environment that are affected by the organization's decisions and actions. The most common ones are customers, social and political action groups, competitors, trade and industry associations, governments, media, suppliers, communities, shareholders, unions, and employees.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 73-82
See Mind-Map 6

24. Define possible global perspectives in business

An ethnocentric attitude is the belief that the best work approaches and practices are those of the home country. A polycentric attitude is the view that the managers in the host country know the best work approaches and practices for running their business. And a geocentric attitude is a world-oriented view that focuses on using the best approaches and people from around the globe. Successful global management requires managers to be sensitive to global differences in national customs and practices in order to find which work best and to prevent making costly blunders.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 91-93
See Mind-Map 7

25. What is social responsibility? Contrast with social responsiveness and social obligation

In the four-stage *stakeholder model of social responsibility*, at stage 1 manager feels responsible to only the stockholders. At stage 2, managers expand their responsibility to the employees. At stage 3, managers expand their responsibilities to other stakeholders in the specific environment, primarily customers and suppliers. Finally, at stage 4, managers feel they have a responsibility to society as a whole. Social obligation is when a firm engages in social actions because of its obligation to meet certain economic and legal responsibilities. Social responsiveness is when a firm engages in social actions in response to some popular social need. Social responsibility is a business's intention, beyond its economic and legal obligations, to pursue long-term goals that are good for society.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 116-122
See Mind-Map 8

26. Explain the greening of management and values-based management

Organizations can "**go green**" by using different approaches. The *light green approach* is simply doing what is required legally, or the social obligation approach. Using the *market approach*, organizations respond to the environmental preferences of their customers. Using the *stakeholder approach*, organizations respond to the environmental demands of multiple stakeholders. Both the market and stakeholder approaches can be viewed as social responsiveness. The *activist* or dark green approach involves an organization looking for ways to respect and preserve the earth and its natural resources, which can be viewed as social responsibility.

Values-based management is an approach to managing in which managers are guided by the organization's shared values in their management practices. An organization's values have a big influence on whether employees act ethically.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 122-128
See Mind-Map 8

27. Present the main issues of managerial ethics

Ethics

29. How do managers make decisions?

PLANNING

32. What is planning? Why it is important in management?

Benchmarking is the search for best practices among competitors or noncompetitors that lead to their superior performance.

ORGANIZING

37. What are the essence of organizing and elements of organizational structure?

Organizing is arranging and structuring work to accomplish the organization's goals. Organizing includes managing organizational structure and organizational design. **Organizational structure** – the formal arrangement of jobs within an organization. When managers develop or change the structure, they're engaged in **organizational design**, a process that involves decisions about six key elements: work specialization, departmentalization, chain of command, span of control, centralization and decentralization, and formalization.

Definition of **organization structure** consists of three issues: 1. organization structure designates formal reporting relationships, including the number of levels in the hierarchy and the span of control of managers and supervisors; 2. organization structure identifies the grouping together of individuals into departments and of departments into the total organization; 3. organization structure includes the design of systems to ensure effective communication, coordination, and integration of efforts across departments. These three elements pertain to both vertical and horizontal aspects of organizing. Organization structure is reflected in the *organization chart*. The *organization chart* is the visual representation of a whole set of underlying activities and processes in an organization. It can be useful in understanding how a company works, as it shows the various parts of an organization, how they are interrelated, and how each position and department fits into the whole.

Organization design facilitates the communication among employees and departments that is necessary to accomplish the organization's overall task. Linkage is the extent of communication and coordination among organizational elements; linkages can be vertical and horizontal. *Vertical linkages* are used to coordinate activities between the top and bottom of an organization and are designed primarily for control of the organization (hierarchical referral, rules, plans, and formal management information systems). *Horizontal linkages* refer to the amount of communication and coordination horizontally across organizational departments (information systems, direct contact, task forces, full-time integrator, teams).

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; p. 266
Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 191-199
See Mind-Map 14

38.

videotapes, hotlines, e-mail, computer conferencing, voice mail, teleconferences, and videoconferences. All of these communication channels include oral or written symbols, or both.

Interpersonal communication is impossible without its nonverbal dimension (nonverbal communication is communication transmitted without words). **Body language** refers to gestures, facial expressions, and other body movements that convey meaning. Knowing the meaning behind someone's body moves and learning how to put forth your best body language can help you personally and professionally.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 296-298
See Mind-Map 15

42. What are the possible barriers to effective communication and how they can be overcome?

The barriers to effective communication include filtering,d[(R(ve)24(com)6(m)5(uni)5(cat)7(i)5(on)23(i)5(ncl)6(u

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 303-306
See Mind-Map 16

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

Organization’s human resources can be a significant source of competitive advantage, but achieving competitive success through people requires a fundamental change in the work relationship. It involves working with and through people and seeing them as partners. It also involves high-performance work practices that led to bnB74C004 hi

with up-to-date knowledge and skills; and the final three ensure that the organization retains competent and high-performing employees.
Source: Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007, p. 324

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 322-324
See Mind-Map 17

46. Describe human resource planning

Human resource planning is the process by which managers ensure that they have the right number and kinds of capable people in the right places and at the right times. HR planning consists of two steps: (1) assessing current human resources and (2) meeting future HR needs.

Current Assessment: a) managers begin HR planning by reviewing the organization's current human resource status; b) *job analysis* **-** an assessment that defines jobs and the behaviors necessary to perform them; with information from the job analysis, managers develop or revise job descriptions and job specifications.

Meeting Future Human Resource Needs**:** future human resource needs are determined by the organization's mission, goals and strategies. Demand for employees is a result of demand for the organization's products or services.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 326-328
See Mind-Map 18

47. Define human resource recruitment and decruitment

Recruitment is locating, identifying, and attracting capable applicants. If HR planning shows a surplus of employees, management may want to reduce the organization's workforce through **decruitment.**

Recruitment**:** potential job candidates can be found by using several sources – internet, employee referrals, company website, college recruiting, professional recruiting organizations.

Decruitment

Manag

51. How compensation and benefits can be managed in organizations?

Developing an effective and appropriate **compensation system** is an important part of the HRM process, because it can help attract and retain competent and talented individuals who help the organization accomplish its mission and goals; an organization's compensation system has an impact on its strategic performance. Organizational compensation can include many different types of rewards and benefits such as base wages and salaries, wage and salary add-

54. Explain the two view of the change process. Is change episodic or ongoing?

Change can be perceived in two views: 1) metaphorically the organization as a large ship crossing a calm sea, and change comes in the form of an occasional storm, a brief distraction in an otherwise calm and predictable trip – the calm waters metaphor, change is seen as an occasional disruption in the normal flow of events; 2) metaphorically the organization is seen as a small raft navigating a raging river with uninterrupted white-water rapids, aboard the raft are half-a-dozen people who have never worked together, who are totally unfamiliar with the river, who are unsure of their eventual destination, and who, as if things weren't bad enough, are traveling at night – the white-water rapids metaphor, change is an expected and natural state, and managing change is a continual process.

Managers can face both constant and chaotic change. Some industries are considered to be more like in white-waters as software companies, some more like in the calm waters as banking. However, days of stability and predictability seem to be long gone. Managers must be ready to efficiently and effectively manage the changes facing their organization or their work area.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 357-360
See Mind-Map 20

55. How organizational change is managed?

Organizational change – is any alteration of people, structure, or technology. Organizational changes often need someone to act as a catalyst and assume the responsibility for managing the change process – *change agent*. Usually changes are initiated and coordinated by managers. Change agent can be a nonmanager.

Change can be of different types (and must be managed in accordance): Structure – work specialization, departmentalization, span of control, centralization, formalization, chain of command, job or structural redesign; Technology – work processes, methods, equipment; People – attitudes, expectations, perceptions, behavior.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 360-366
See Mind-Map 20

56.

Innovation refers to the implementation of creative ideas within organizations. It takes different forms depending on three factors: impact on existing business (sustaining innovation if impact is minor, and disruptive innovation if impact is major), the degree of uncertainty involved (incremental innovation if uncertainty is low, and radical innovation if uncertainty is high), and its sources (manufacturer innovation if ideas come from within, and end-user innovation if ideas come from customers).

Management*, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 372-376*
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 561-574
See Mind-Map 20

LEADING

57.

influences individuals and groups. To thrive in organizations, managers and employees need to understand multiple levels simultaneously.

Introduction to the Theory and Design of Organizations, Richard L. Daft; South-Western: Thomson, 2007; pp. 33-34
See Mind-Map 21

59. Identify four different forms of organizational justice and the organizational impact of each

Organizational justice refers to people's perceptions of fairness in organizations. People respond to how they perceive things, which may or may not be based on objective truths. The forms of organizational justice are distributive justice, procedural justice, interpersonal justice, and informational justice. Distributive justice refers to the perceived fairness of rewards (e.g., pay) received. People who feel they have received fair amounts of reward feel satisfied with their jobs. Procedural justice refers to people's perceptions of the fairness of the procedures used to determine the outcomes they receive. When high levels of procedural justice are perceived, people are inclined to follow organizational rules and policies. Interpersonal justice refers to the fairness of interpersonal treatment by others. High levels of interpersonal justice are related to high levels of satisfaction with one's supervisor. Finally, informational justice refers to people's perceptions of the fairness of the information used as the basis for making a decision. People tend to be high3(hsi)8(on365dytlreW*n912ef*q0.pSy19 0 rg0 09f33(be).se)3(d)-22(a(hi)5(n5(gh3(hsi)5

relatively stable pattern of behavior, thoughts, and emotions shown by individuals. It, along with abilities (the capacity to perform various tasks) and various situational factors, determines behavior in organizations.

Personality can be accessed through different approaches. One of the most popular in organizations is MBTI (Myers-Briggs Type Indicator). There is another tool – Big Five Model of personality (extroversion, agreeableness, conscientiousness, neuroticism, openness to experience). Additionally, there are five other personality traits that have proved to be the most powerful in explaining individual behavior in organizations: locus of control (the way people believe that they control their own destiny (internal locus of control) or believe that their lives are controlled by outside forces (external locus of control), Machiavellianism (an individual who is high in Machiavellianism is pragmatic, maintains emotional distance, and believes that ends can justify means), self-esteem (the degree to which they like or dislike themselves), self-monitoring (an individual's ability to adjust his or her behavior to external, situational factors), and risk-taking (willingness to take chances, differences in the propensity to assume or to avoid risk).

The Big Five dimensions of personality – so named because they seem to be very basic aspects of personality – appear to play a role in the successful performance of many jobs. These are conscientiousness (a tendency to show self-discipline, to strive for competence and achievement), extroversion-introversion (a tendency to seek stimulation and to enjoy the company of other people), agreeableness (a tendency to be compassionate toward others), neuroticism (a tendency to experience unpleasant emotions easily), and openness to experience (a tendency to enjoy new experiences and new ideas). Two of these dimensions, conscientiousness and neuroticism (emotional stability), have been found to be good predictors of success in many different jobs. This is especially true under conditions where job autonomy is high.

emotions in oneself (the ability to regulate one's own emotions); use of emotions to facilitate performance – relationship management (the ability to use emotions by directing them toward constructive activities and improved performance (e.g., by encouraging oneself to do better)).

Social skills main types: social perception (accuracy in perceiving others, including accurate perceptions of their traits, motives, and intentions); impression management (proficiency in the use of a wide range of techniques for inducing positive reactions in others); persuasion and social influence (skill at using various techniques for changing others' attitudes or behavior in desired directions); social adaptability (the ability to adapt to a range of social situations and to interact effectively with people from many different backgrounds); emotional awareness/control (proficiency with respect to a cluster of skills relating to the emotional side of life).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 154-161

65. Distinguish between emotions and moods. Explain how emotions and mood influence behavior in organizations

Whereas **emotions** are overt reactions that express people's feelings about a specific event, **moods** are more general. Specifically, moods are unfocused, relatively mild feelings that exist as background to our daily experiences. Emotions have the following characteristics: emotions always have an object; the spread of emotions is contagious; expression of emotions is universal; culture determines how and when people express emotions.

Emotions and mood affect behavior in organizations in various ways. Generally, happier people are more successful on their jobs; they perform at higher levels, and they make higher incomes. Furthermore, happier people tend to make better decisions, remember positive events,

including occupational demands, conflicts between the work and non-work aspects of one's life (i.e., role conflict), not knowing what one is expected to do on the job (i.e., role ambiguity), overload and underload, having responsibility for other people, and experiencing sexual harassment (unwanted contact or communication of a sexual nature, usually against women).

Experiencing high levels of organizational stress has negative effects on task performance. It also adversely affects people's physical and mental health in a variety of ways. Stress also is a major cause of such serious problems as desk rage (lashing out at others in response to stressful encounters on the job) and burnout (a syndrome of emotional, physical, and mental exhaustion coupled with feelings of low self-esteem or low self-efficacy, resulting from prolonged exposure to intense stress, and the strain reactions following from them).

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 181-195

67. How does perception affect behavior?

Perception is a process by which individuals give meaning to their environment by organizing and interpreting their sensory impressions. People interpret what they see and call it reality, and behave according to perceptions. Our perceptions of people differ from our perception of inanimate objects because we make inferences about the behaviors of people that we don't make about objects.

Managers need to recognize that their employees react to perceptions, not to reality. Employees organize and interpret what they see, so there is always the potential for perceptual distortion. Managers should pay close attention to how employees perceive both their jobs and management actions, and remember, the valuable employee who quits because of an inaccurate

69. Distinguish between prejudice and discrimination, and identify various victims of prejudice in organizations

Prejudice refers to negative attitudes toward members of specific groups, and *discrimination* refers to treating people differently because of these prejudices. Today's workforce is characterized by high levels of diversity, with many groups finding themselves victims of prejudicial attitudes and discriminatory behaviors (based on many different factors, including age, sexual orientation, physical condition, racial or ethnic group membership, gender, and people from different religions than our own). Although people are becoming more tolerant of individuals from diverse groups, prejudicial attitudes persist.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 206-215

70. What is stereotyping? Explain the dangers of using stereotypes

Stereotypes – beliefs that members of specific groups tend to share similar traits and are prone to behave identically. We rely on stereotypes because people tend to do as little cognitive work as possible when it comes to thinking about others; we tend to rely on mental shortcuts.

The following dangers exist in organizations, rel3(t)56eo50000912 0 o11(an 792 reW*ot)6(yc RGi)6(zat)(912 0 0

information processing model specifies that people adopt attitudes and behaviors in keeping with the cues provided by others with whom they come into contact.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 221-234

72. What can be the consequences of job dissatisfaction and the possible ways to promote job satisfaction?

When people are dissatisfied with their jobs, they tend to withdraw. That is, they are frequently absent

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

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

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

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

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

78. What are the characteristics of effective team?

Nowadays organizations without teams are exclusions. Teams typically outperform individuals when the tasks being done require multiple skills, judgment, and experience. Managers have found that teams are more flexible and responsive to changing events than are traditional departments or other permanent work groups. **Work teams** are groups whose members work intensely on a specific, common goal using their positive synergy, individual and mutual accountability, and complementary skills.

There exist some insights into the characteristics associated with effective teams: clear goals, relevant skills, mutual trust, unified commitment, good communication, negotiating skills, appropriate leadership, internal and external support. To build successful teams, it is needed: to provide training in team skills, compensate team performance, provide managerial support, promote employee support, promote cooperation, select team members based on their skills or potential skills.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 438-442
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 307-325
See Mind-Map 23

79. What is interpersonal behavior? Define the range of its major types

unchanging in nature, and have a narrow, well-defined scope. Another kind is the *relational contract*. It applies to relationships that are longer-term in scope and go beyond basic economic issues such as pay for performance. A third type is the *balanced contract*; this involves elements of both transactional and relational contracts.

Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 426-432

81. Define organizational citizenship behavior and its major forms

Organizational citizenship behavior (OCB) – an informal form of behavior in which people go beyond what is formally expected of them to contribute to the well-being of their organization and those in it (actions which exceed the formal requirements of one's job). The main forms OCB can take are: altruism, conscientiousness, civic virtue, sportsmanship, courtesy. Organizational citizenship behavior can be directed both at an *individual* (**OCB-I**) and at the *organization* itself (**OCB-O**). Examples of OCB-I: assisting a coworker with a personal problem, bringing in food to share with others. Examples of OCB-O: offering ideas to improve the functioning of the organization, expressing loyalty toward the organization.

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Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 432-434

82. Explain how individual 5.98 3.026di1gormsnic4(e 4( )i)-5(/ g)4(go)-3(a 3.02s is-3( )aff6(en4

B208avior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall,

83. Distinguish between various forms of individual power in organizations

Power refers to the capacity to influence others. One major type of power, *position power,* resides within one's formal organizational position. It includes (1) reward power (the individual power base derived from an individual’s capacity to administer valued rewards to others) and (2) coercive power (the individual power base derived from the capacity to administer punishment to others), the capacity to control valued rewards and punishments, respectively,(3) legitimate power, the recognized authority that an individual has by virtue of his or her organizational position, and (4) information power, power that stems from having special data and knowledge. A second major type of power, *personal power,* resides within an individual's own unique qualities or characteristics. It includes (1) rational persuasion, using logical arguments and factual evidence to convince others that an idea is acceptable, (2) expert power, the power an individual has because he or she is recognized as having some superior knowledge, skill, or expertise, (3) referent power, influence based on the fact that an individual is admired by others, and (4) charisma, having an engaging and magnetic personality.

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

84. What is leadership and who are leaders?

Leader is someone who can influence others and who has managerial authority. **Leadership** – the process whereby one individual influences other group members toward the attainment of defined group or organizational goals. More specifically, it's the process of influencing a group to achieve goals. Because leading is one of the four management functions, ideally, all managers should be leaders. Leaders from managerial perspective are positional leaders mostly. Informal leaders may be able to influence others.

Leadership involves *noncoercive influence*, the influence is *goal-directed*; leadership requires *followers*. Although leaders do indeed influence subordinates in various ways, leaders are also influenced by their subordinates.

Management*, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; p. 488*
Behavior in Organizations, 9ed., Jerald Greenberg, Robert A. Baron; Person/Prentice Hall, 2008; pp. 500-502
See Mind-Map 25

85. What are the contemporary views on leadership?

There can be determined three contemporary approaches to leadership including transformational-transactional leadership, charismatic-visionary leadership, and team leadership.

CONTROLLING

87. What is control and why it is important?

Control is the process of monitoring, comparing, and correcting work performance. An

produce them), the planning and controlling of the activities of the operation, and the improvement of the operation over time.

Indirect responsibilities include working closely with other functional areas of the business.

Broad responsibilities include understanding the impact on the operation of globalization, environmental responsibility, social responsibility, new technologies and knowledge management.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 27-32

See Mind-Map 27

93. What are the performance objectives of operations and what are the

94. What is process design and its main issues?

Design is the activity which shapes the physical form and purpose of both products and services and the processes that produce them. This design activity is more likely to be successful if the complementary activities of product or service design and process design are coordinated. Process and product/service design are interrelated – their overlapping has implications for the organization of the design activity: products and services should be designed in such a way that they can be created effectively; processes should be designed so they can create all products and services which the operation is likely to introduce. The overall

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

Supply network perspective refers to setting an operation in the cont

98. What is TQM?

TQM – **Total Quality Management** – is a holistic approach to the management of quality that emphasizes the role of all parts of an organization and all people within an organization to influence and improve quality; heavily influenced by various quality 'gurus' (as W.E. Deming, J.M. Juran, K. Ishikawa and others).

TQM can be seen as being an extension of the traditional approach to quality – inspection based quality control being replaced by the concept of quality assurance with in turn has been suppressed by TQM. Some core ideas of TQM are:

- TQM puts customers at the forefront of quality decision making.
- TQM takes an organization-wide perspective.
- TQM places emphasis on the role and responsibilities of every member of staff within an organization to influence quality.

Operations Management, 5ed., Nigel Slack, Stuart Chambers, Robert Johnston; Prentice Hall, 2007; pp. 651-661

See Mind-Map 27

99. What is value chain management?

Organizations must provide the value to attract and keep customers. *Value* is defined as the performance characteristics, features and attributes, and any other aspects of goods and services for which customers are willing to give up resources (usually money). The **value chain** is the entire series of organizational work activities that add value at each step from raw materials to finished product; the value chain can encompass the suppliers to the customer. Value chain management is the process of managing the sequence of activities and information along the entire product chain, is externally oriented and focuses on both incoming materials and outgoing products and services; is effectiveness oriented and aims to create the highest value for customers. The goal of value chain management is to create a value chain strategy that meets and exceeds customers' needs and desires and allows for full and seamless integration among all members of the chain.

Management, 9ed., Stephen P. Robins, Mary Coulter; Pearson/Prentice Hall, 2007; pp. 568-574

See Mind-Map 27

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

Knowledge Management

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

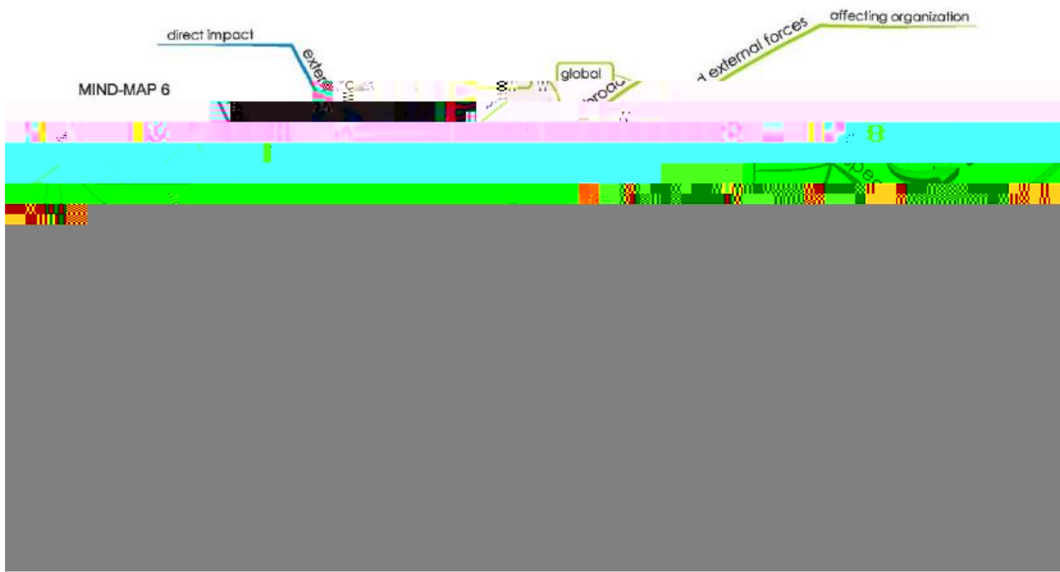
several resources can be used to achieve this, which includes money, men and machines. Of these resources, the most important of them all is the people (Kehinde, 2012).

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

APPENDIX: MANAGEMENT MIND-MAPS

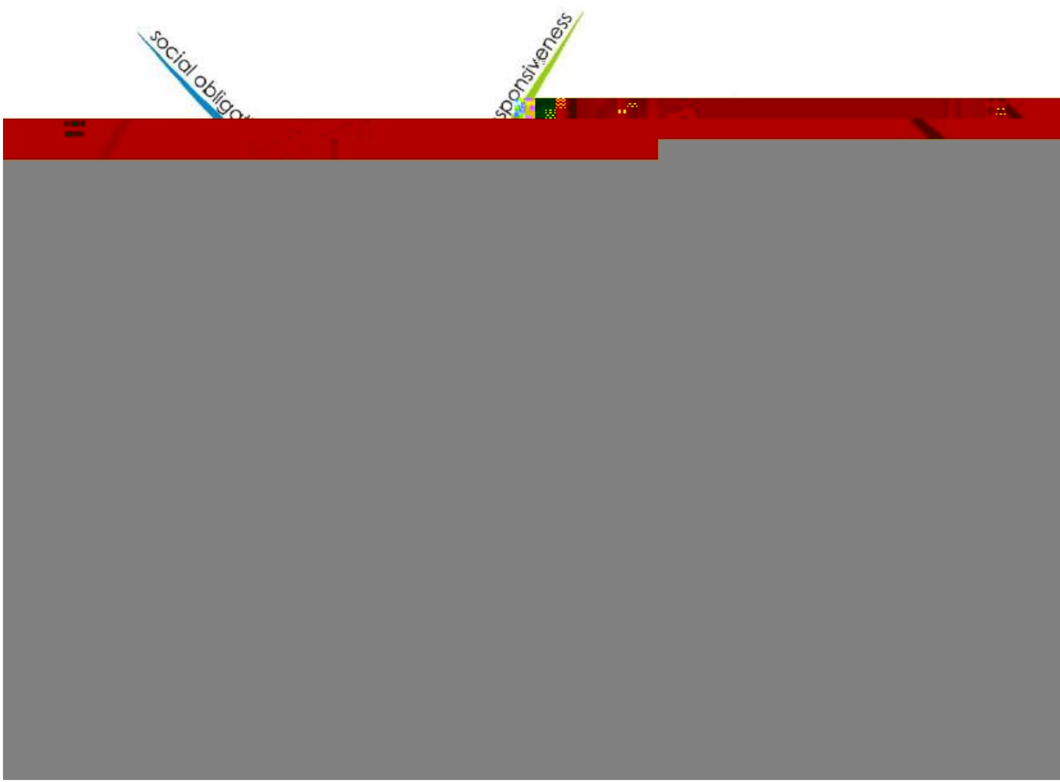
machines, factories

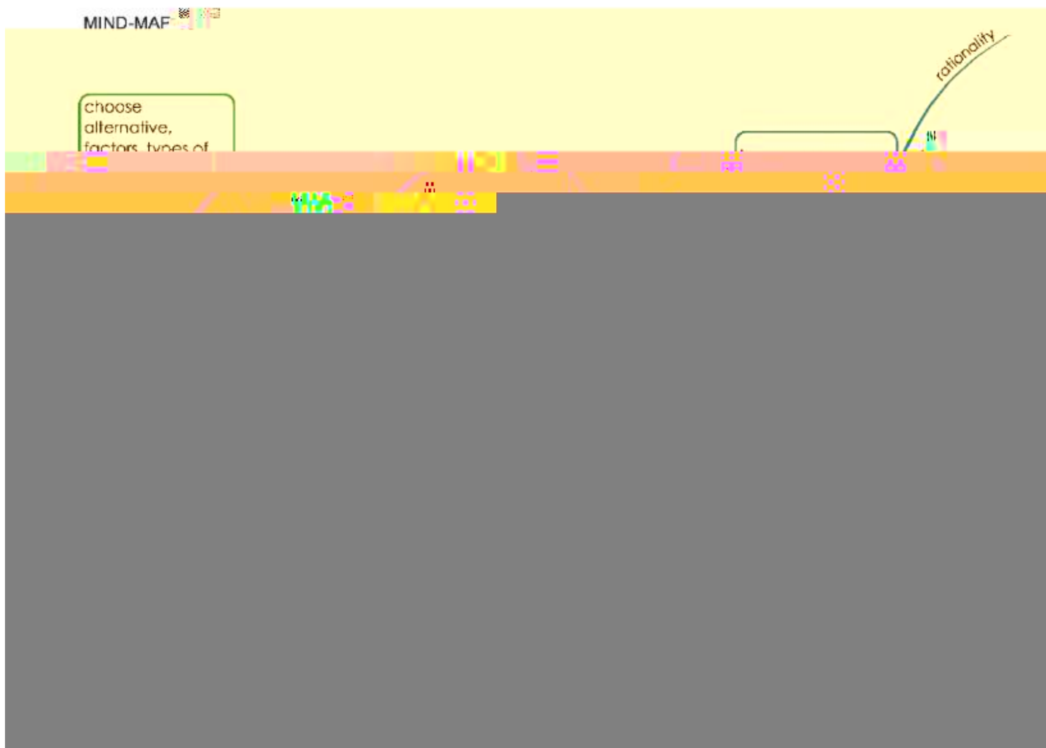
MIND-MAP 5
trust, challenging,

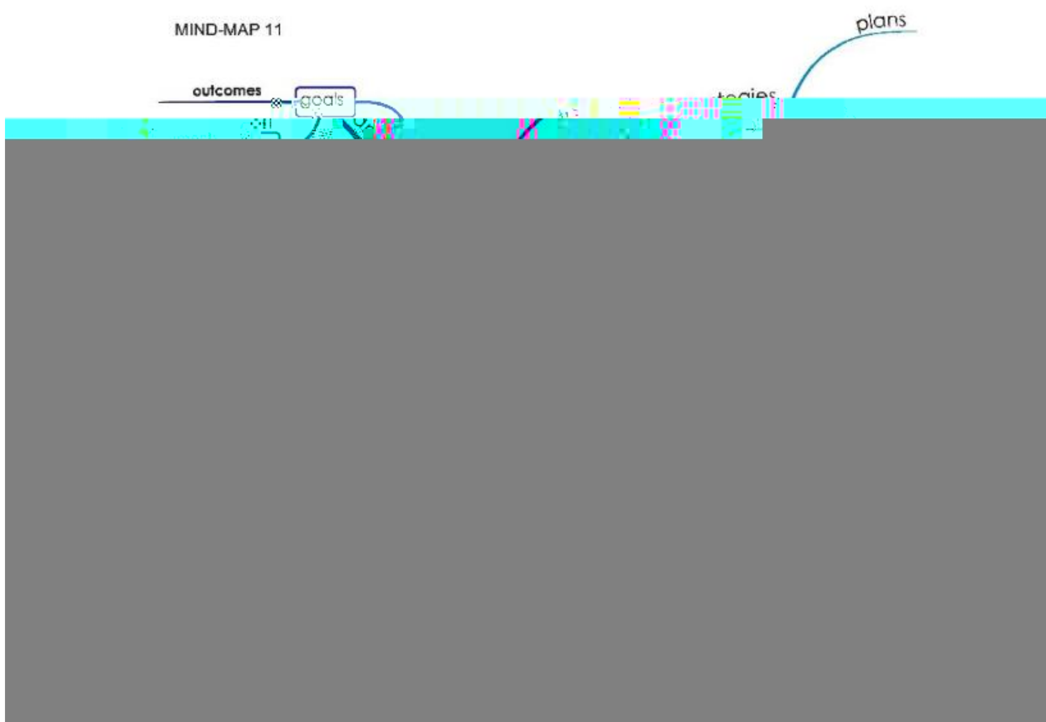


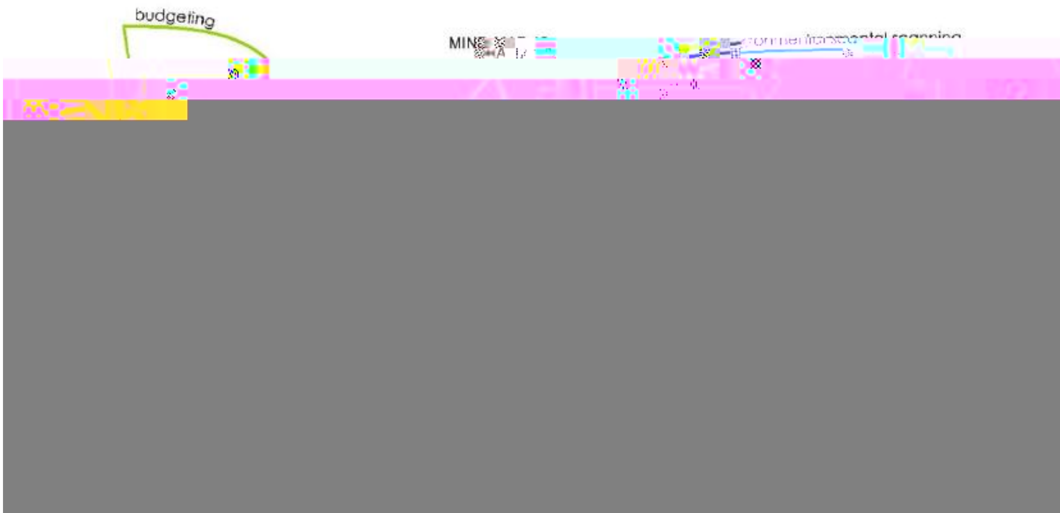
MIND-MAP 6
direct impact
global
affecting organization

MIND-MAP 7
prevent blunders
home country perspective

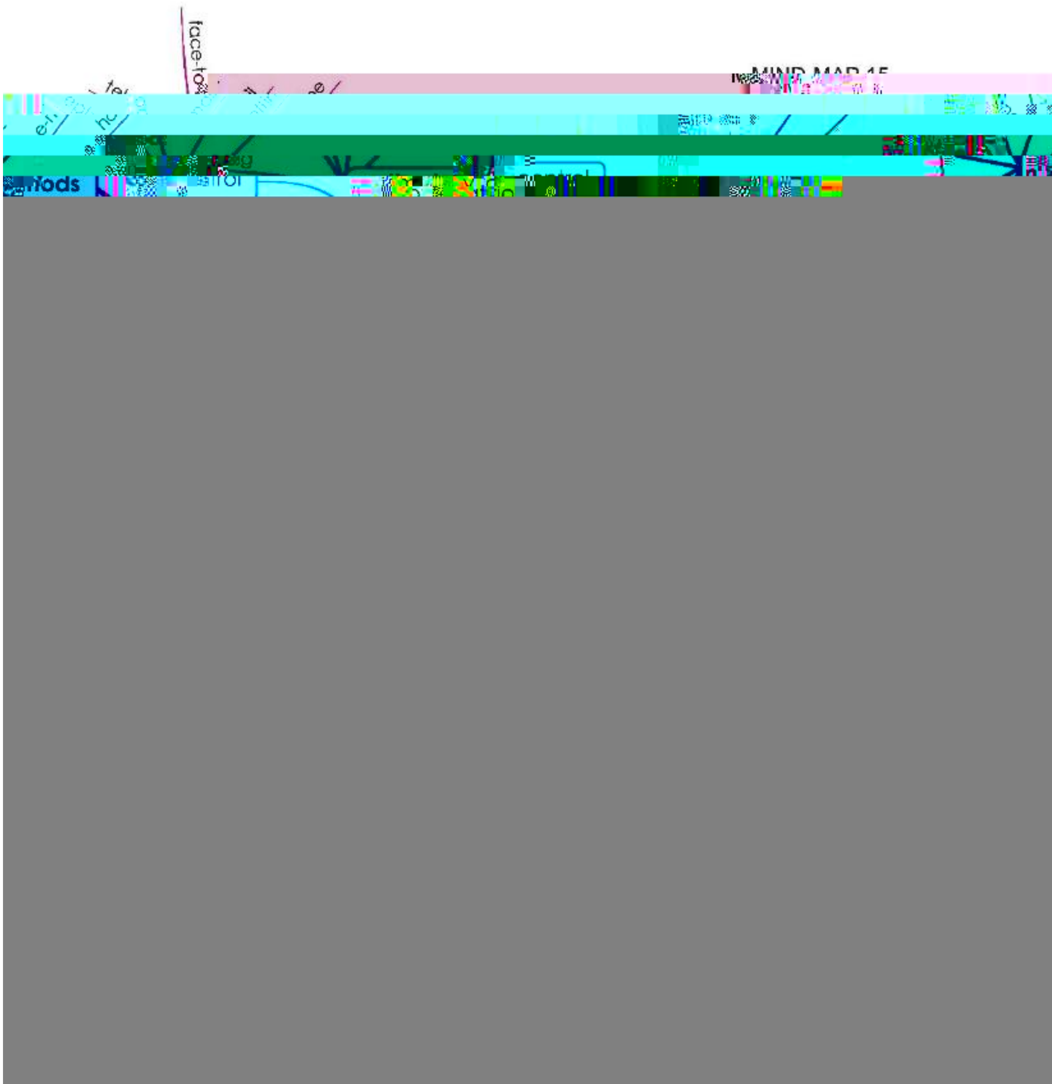



choose
alternative,
rationality

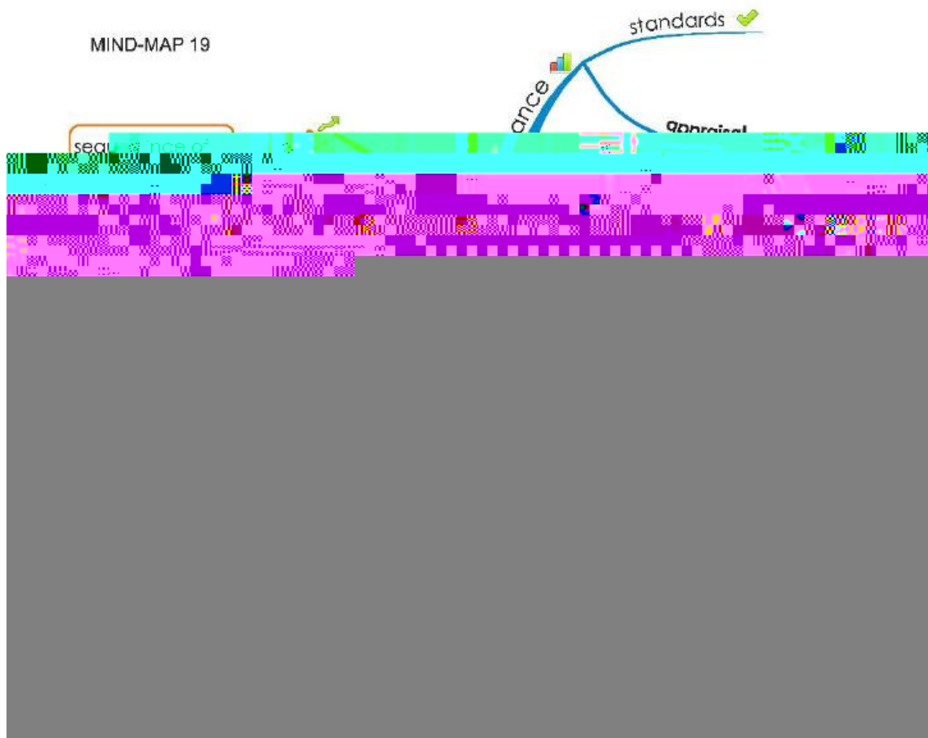

MIND-MAP 11
plans
outcomes
goals


budgeting

arranging

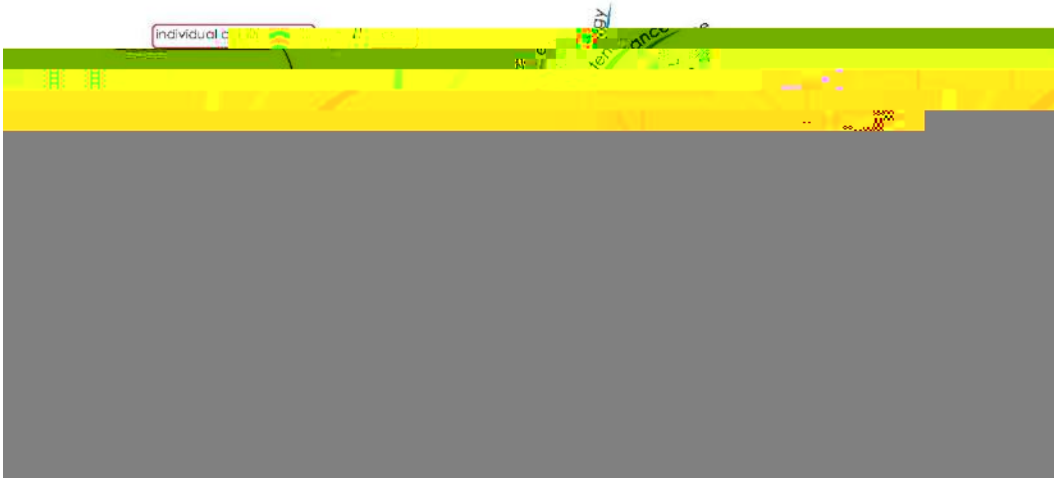


formal

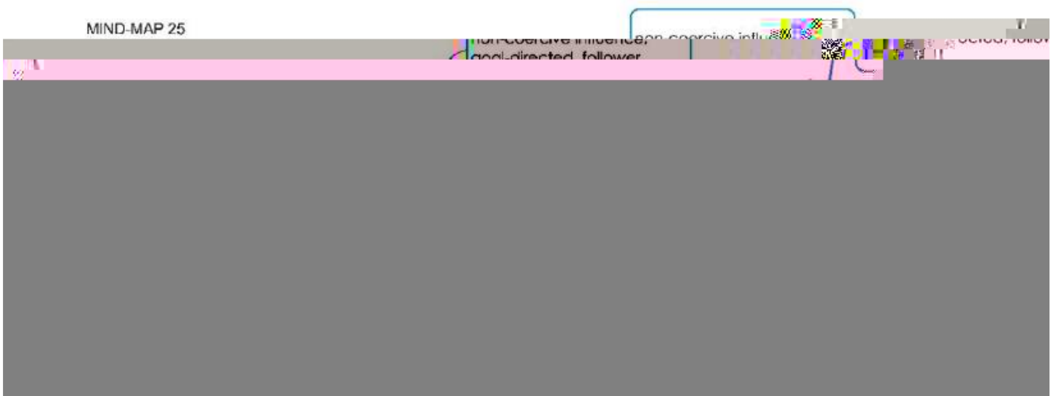

MIND-MAP 19
standards

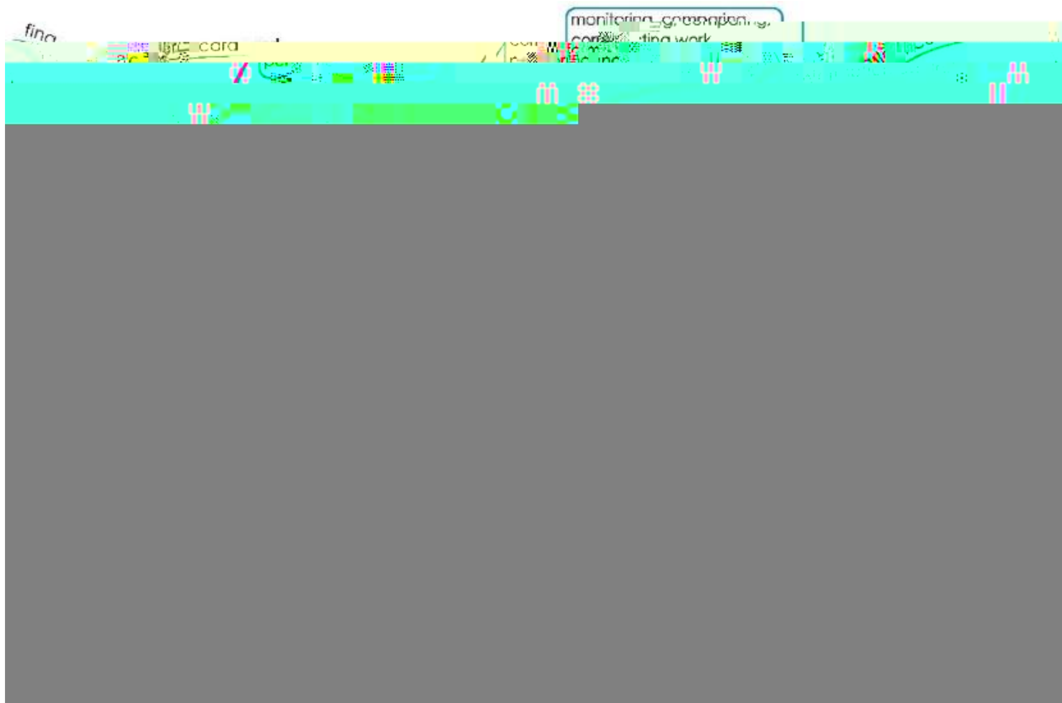
MIND-MAP 23

MIND-MAP 24



MIND-MAP 25





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