

## **business management 1b**

only study guide for MNB1601

department of business management  
university of south africa, pretoria

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# INTRODUCTION

## MODULE AIM

The purpose of this module is to develop learners' understanding of the individual functional areas of business management which ultimately form a synergistic whole that directs the business towards its goals. These functional areas are human resources, marketing, finance, operations and purchasing.

## MODULE OUTCOMES

When you have worked through this module you should be able to:

- explain how human resource requirements can be met and how effective human resources can be developed
- explain how human resources can be motivated and managed
- describe the marketing process
- explain the marketing instruments of product, price, distribution and marketing communication
- apply financial management concepts and principles relating to financial analysis, investment decisions and financing decisions in order to achieve continued financial health in a business
- manage the operations of a business by using sound operational activities, techniques and methods to optimise the transformation of inputs into outputs
- plan, organise and control the purchasing and control function in such a manner that it helps achieve the objectives of the business

## STUDYING THE PRESCRIBED BOOK

The prescribed book for Business Management I, which is used in both modules MNB1501 and MNB1601, is *Introduction to Business Management*, 8th edition, by Du Toit, Erasmus & Strydom, 2010.

## GETTING AN OVERVIEW

You have already studied the module MNB1501. In that module you dealt with the following topics:

- Topic 1: Introduction to Business Management  
Topic 2: The management process

The study material for MNB1601 has been divided into the following topics:

- Topic 1: Operations management  
Topic 2: The human resource function  
Topic 3: The marketing function  
Topic 4: Financial management  
Topic 5: The purchasing and supply function

## DIVISION OF THE TUTORIAL MATTER FOR MODULE MNB1601

For our study purposes we have divided the study material into the following topics:

### TOPIC 1: Operations management



- The operations management function
- Operations management: activities, techniques and methods

### TOPIC 2: The human resource function



- Meeting human resource requirements and developing effectiveness in HR
- Motivating employees

### TOPIC 3: The marketing function



- The marketing process
- The marketing instruments

### TOPIC 4: Financial management



- The financial function and financial management
- Asset management: the investment decision
- Financing decisions

### TOPIC 5: The purchasing and supply function



- Purchasing and supply management
- Sourcing activities

## THE ASSIGNMENTS

The best way to work through the prescribed book is to study one topic at a time. That is why the assignment questions have been based on the different topics of the tutorial matter.

## GETTING A FEEL FOR THE LAYOUT OF THE PRESCRIBED BOOK

At this stage you are still not ready to start reading the actual text. You first need to get a feel for how the tutorial matter has been set out.

### Learning outcomes and layout

At the start of each chapter you are given the learning outcomes and layout. These outcomes and layouts tell you what the author had in mind when the chapter was written – and they can sometimes serve as a useful summary of the topics dealt with in the chapter.

Just looking at the outcomes and the layout at the start of each chapter and listing the topics set the stage for understanding what the chapter is all about.

### Figures and tables

As you page through the book you will also see figures and tables. For example, in section 12.4 of the prescribed book you will see table 12.1, while in section 12.5 you will see figure 12.2. These figures and tables are intended to illustrate a point covered in the text. For example, just before table 12.1 you will see reference made to table 12.1, while in a paragraph above figure 12.2 reference is made to figure 12.2. Thus you do not have to take note of any figures or tables until they are actually referred to in the text.

Then, before reading any further, you should turn to the figure or table (it will sometimes be on the next or the previous page) to see what you can learn from the information presented. You must understand the point that these figures and tables are intended to illustrate, but you do not have to memorise their contents for examination purposes.

### Illustrations

You will also see information given in blocks. These illustrations are usually not referred to in the text itself. They are intended to give you additional insight into the text that surrounds the block, and to reinforce a point the author has made in the text. Again, make sure that you understand the point the author is trying to reinforce with these illustrations, but be assured that you do not have to memorise the contents for examination purposes.

## THE STUDY PROCESS

When you have listed the main topics as set out in the outcomes and layout, you should read the entire chapter just to get a feel of what it is all about. Don't worry too much at this stage if you don't understand every detail. The important thing here is to make a few notes of the key issues as you read. Then draw a diagram or simple mind map to visualise the key issues.

You are now ready to start studying. Tackle one study unit at a time. If there is something that you do not understand, read it again, and try to figure out what the author is saying. **DO NOT SKIP ANY TUTORIAL MATTER THAT YOU DO NOT UNDERSTAND.** Ask someone else to help you understand a sentence or paragraph, and if you really cannot figure it out, contact one of your lecturers at Unisa. They are there to help you.

One of the best ways to make sure that you understand the material is to make a summary in your own words – one study unit at a time.

A good summary length is about 5% of the original text, so section 1.2 in the prescribed book should be summarised in approximately two written pages. The reason for summarising your tutorial matter stems from an adage (or saying): "A thought expressed is a thought impressed." This means that the more you write down (in your own words) what the message of a particular study unit is, the more it will be impressed or imprinted on your own mind.

NB: The purpose of studying is to understand the concepts – not to memorise them.









## HOW TO USE THE STUDY GUIDE

The primary purpose of this study guide is to provide you with guidelines to help you to understand some of the most important theoretical perspectives, general principles and contextual factors that underlie the nature and dynamics of business management. All of this is, however, done from a management perspective. You must therefore use the study guide as a source of additional information and to help you work through the material contained in the prescribed book. You will find that certain terms are repeatedly used to structure this study guide and your thinking:

- A topic represents an important component of the module and tutorial matter. Each topic has one or more learning outcomes. These outcomes indicate the general standard or level of competence you should achieve in respect of each topic.
- A study unit is an identifiable part of a topic. Each topic therefore consists of one or more study units.

Very important for the purposes of your studies are the learning outcomes. For each topic, specific outcomes are set, **WHICH YOU AS A STUDENT MUST BE ABLE TO ACHIEVE.** These learning outcomes are linked to the assignments as well as the examination and are therefore the means by which you and your lecturers can evaluate the extent to which you have in fact mastered a specific topic (ie your knowledge and understanding of it).

Certain icons are used throughout the study guide:

Icon	Description
	<p><b>Learning outcomes.</b> The learning outcomes indicate what aspects of the particular topic or study units you have to understand and of which you should be able to demonstrate your understanding.</p>
	<p><b>Study.</b> This icon indicates which relevant sections of the prescribed book or the study guide you need to study and internalise.</p>
	<p><b>Key concepts.</b> The key concepts indicate which terms or keywords are important for a particular study unit.</p>
	<p><b>Read.</b> This icon will direct you to read certain sections of the prescribed book for background information.</p>
	<p><b>Activity.</b> This icon refers to activities that you must do to develop a deeper understanding of the learning material.</p>
	<p><b>Mind map.</b> Mind maps are provided to help you to see the relationship between various parts of the learning material.</p>
	<p><b>Assessment.</b> When you see this icon you will be required to test your knowledge, understanding and application of the material you have just studied.</p>
	<p><b>Feedback.</b> This icon indicates that you will receive feedback on your answers to the self-assessment activities.</p>

## IMPORTANT

You should always read the study guide first and then study the relevant sections in the prescribed book as indicated in the study guide (along with the learning material in the study guide).



This study guide therefore has certain specific functions:

- It provides you with material that you have to study.
- It indicates which parts of the prescribed tutorial matter you have to study.
- It contains certain activities that will help you master the field of study.

## THE STEPS IN THE STUDY PROCESS

- (1) **Get an overview of the book as a whole.** You should have completed this step already.
- (2) **Get an overview of the parts.** Draw a mind map of the parts.
- (3) **Read the first chapter of that part.** Draw a mind map of the topics in the chapter.
- (4) **Study the first section of the chapter.** Write a summary in your own words.
- (5) **Read the corresponding study unit in the study guide.** Amend your own summary, if necessary.
- (6) **Read the next section of the chapter.** Repeat steps 4 to 6 until you have completed the chapter.
- (7) **Tackle the next chapter in that part.** Repeat steps 3 to 7 until you have completed the part.

## COMPLETING THE ASSIGNMENTS

### Multiple-choice questions

The assignments as well as the examination comprise only multiple-choice questions. For every question there are usually four options numbered from 1 to 4, of which you must select only one. For example:

- (1) Which one of the following statements is correct?
  - (a) Capitalism ensures a more even distribution of wealth.
  - (b) Socialism discourages private initiative.
  - (c) Communism ensures a better utilisation of resources.
  - (d) South Africa's economic system tends towards socialism.

You cannot select more than one option. In other words, your answer will be option 1 or 2 or 3 or 4.

Sometimes the question asks you to select the wrong statement. You should be extra careful when answering such questions and not get confused and mark a statement that is correct (and therefore the wrong answer). Please look at the assignments in Tutorial Letter 101. You will find the occasional question asking you to indicate which of the options is wrong.

In some questions, however, there will be several statements that could be correct. In such cases the statements will always be indicated by letters (a, b, c and d), and the answer will still be option 1, 2, 3 or 4, but these answers may refer to more than one statement. For example:

- (2) Which of the following statements are correct?
- (a) A business owned and managed by one person may be a private company.
  - (b) A partnership is usually limited to 20 partners.
  - (c) The owner of a sole proprietorship does not pay tax on his or her business's profits.
  - (d) A public company may not offer its shares for sale on an open market.
- (1) a b c d
  - (2) a b d
  - (3) b c
  - (4) c d

This question asks you to indicate which of the statements are correct. If you therefore think that statements b and c are correct, you will mark only option 3 as the correct answer.

In all the above examples the stem of the question asks you to identify the correct statement(s). Sometimes the alternatives are a continuation of the stem. For example:

- (3) The economic principle ...
- (a) is an endeavour to achieve the maximum with the minimum.
  - (b) does not apply to government organisations because they do not strive for a profit.
  - (c) is mainly an indication of how low the operating costs were.
  - (d) is always measured in terms of the business's profitability.

In an example such as the above you have to read the stem plus option 1, then you have to read the stem again plus option 2, the stem plus option 3, and so on.

There is one other type of question that some of you may find somewhat confusing. For example:

- (4) Match the management level in the first column with the corresponding organisational objective in the second column.
- (a) top management            i the mission of the organisation
  - (b) middle management      ii functional objectives
  - (c) lower management        iii operational objectives
- (1) a (i)    b (ii)    c (iii)
  - (2) a (i)    b (iii)    c (ii)
  - (3) a (ii)    b (i)     c (iii)
  - (4) a (iii)    b (ii)    c (i)

In this question you have to match the items in one column with the items in a second column. Let's say that you think that top management (a) is involved in the formulation of the mission of the organisation (i); then you already know that your answer could be either option 1 or 2. By comparing the other options in column one with those in column two, you should be able to choose between options 1 and 2.

## Answering a multiple-choice question

Make a photocopy or record your answers on a separate page.

You will find the multiple-choice questions in the assignment extremely useful when you prepare for the examination. However, if you mark your answers (or the correct answers) on the actual page in Tutorial Letter 101, you will not be able to use these questions for revision. We strongly recommend that you either make a photocopy of the assignments and use that for revision, or else write down your answers on a separate sheet of paper to avoid making any marks on Tutorial Letter 101 itself. You will then be able to work through these questions again in preparation for the examination, without seeing the marks that indicate the correct answers.

Decide on each option independently.

When answering a multiple-choice question, much time is often wasted (especially in the examination) by reading all four options before deciding which one is correct. The secret is to read and decide on each option separately. For example, look at question 1 above. The stem asks you to identify which statement is correct. Take a ruler and cover the other three statements so that you only see statement 1. Read it, and then, without reading any other statement, decide whether the statement is correct, wrong or that you don't know. Put a tick next to it if you think it is correct; put a cross next to it if you think it is wrong; and put a "?" if you are not sure. Then move the ruler down so that you can read statement 2. Again decide and mark the category in which it falls.

When you have done that with every one of the four statements, you may find that you have marked one statement correct and three statements wrong. The former is then your answer. If you find that you have marked two correct, then compare the two statements and choose the one that seems to be the most correct, or the most comprehensive.

Write down your reasoning.

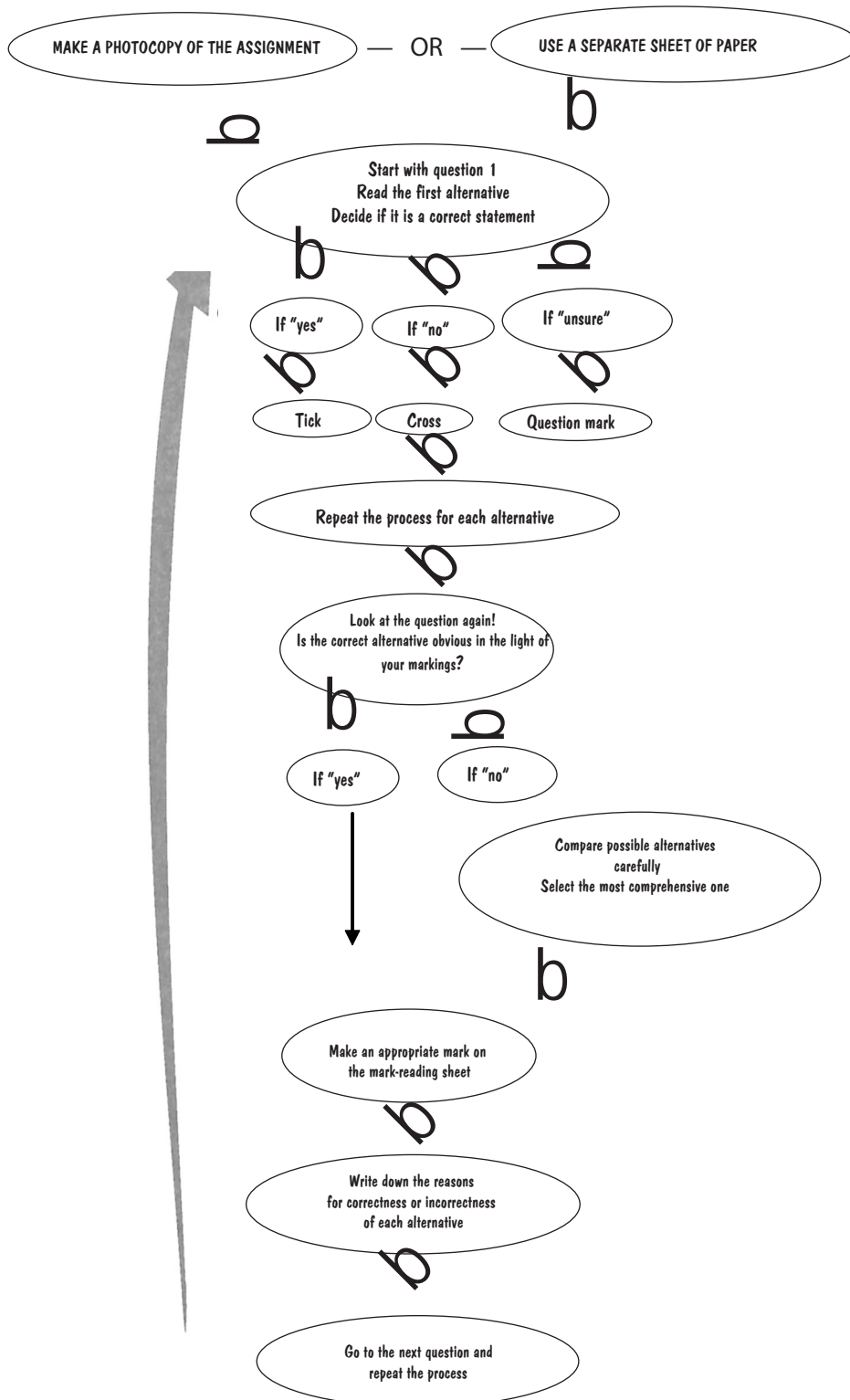
When you have selected your answer to a particular question, it is essential that you write down your reasons for doing so. For example, if you chose option 2 as the correct answer to question 2 above, implying that statements a, b and d were correct, you should write on a separate sheet of paper why you think statements a, b and d were correct. Write down the actual reference in the prescribed book on which you base your reasoning. However, you must even go a step further. You must also write down why option c is wrong. Again make specific reference to the prescribed book to back up your reasoning.

This is probably the most important learning step that you can take. We want our students to understand the tutorial matter and to be able to explain the concepts and apply the principles. We are not interested in whether a student has memorised the tutorial matter and can repeat it in an examination. That is why it is so important for you to be able to give a reason for your answer.

It takes a few weeks from the time that you answer an assignment to the time that you get back the correct answers and explanations. By that time you will have forgotten why you chose a certain option for a particular question, unless you wrote down your reasons.

The real learning takes place when you compare your reasoning with that of the lecturers. So don't take the easy way out by just answering the multiple-choice questions.

The flow diagram below will help you to picture the process.



# TOPIC 1

## Operations management

### AIM

The aim is to explain what the nature of operations management in a business entails and to demonstrate how the operations activities of design, planning and control, and improvement are performed for better effectiveness, increased efficiency and overall productivity of the operations processes.



### Learning outcomes

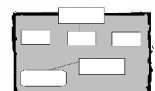
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When you have worked through topic 1 you should be able to:

- explain the nature of operations management by highlighting the importance and providing a definition of the operations function, distinguishing between the various components of an operations management model, and describing a classification system for the different operations processes for manufacturers and service providers
  - demonstrate how the operations activities of design, planning and control, and improvement are performed within the operations function by illustrating the application of various operations techniques and methods
- 

### OVERVIEW OF THE TOPIC

Topic 1 comprises the following study units:



TOPIC 1	
Study unit 1	Study unit 2
The operations management function	Operations management: activities, techniques and methods

# Study unit 1

## The operations management function

### Contents

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Key concepts

Learning outcomes

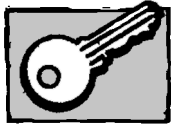
Getting an overview

- 1.1 The nature and definition of operations management
- 1.2 An operations management model
- 1.3 The classification of operations process types for manufacturers and service providers

Summary

Self-assessment questions

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### Key concepts

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operations management	operations activities
operations function	operations management function
operations design	operations planning and control
operations improvement	operations processes
effectiveness	efficiency
overall productivity	operations techniques and methods
operations management model	operations management strategies/objectives
inputs	transformation process
outputs	goods (products) and services
transformation model	operations classification system
manufacturers	service providers
project system	job system
repetitive/continuous systems	multiple-unit project system
job-lot system	mass service
service shop	professional service

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### Learning outcomes

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When you have worked through study unit 1 you should be able to:

- explain the nature of operations management by highlighting its importance and providing a definition
  - depict an operations management model by distinguishing between its various components
  - illustrate a classification system for the different operations processes by describing such a system for manufacturers and service providers
-

## Getting an overview



Read section 10.1 in the prescribed book.

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You will note that the discussion in the introduction to the prescribed book focuses on the idea that “more prosperous” countries generally produce more products and services to satisfy not only their own national needs, but also, when in excess, to export internationally and in so doing increase their “wealth” even further. Thus (agreed, very simplistically argued!) having an increased number of successful businesses producing more and better products and services will directly translate into increased prosperity for all the citizens of a particular country. Surely a worthwhile objective!

As the one main function in a business primarily responsible for managing all the activities whereby such products and services are manufactured/rendered, the operations function is critical for achieving such fine ideals.

This first study unit of topic 1 examines the nature of operations management and highlights certain definitions. It also summarises the proposed operations management model by distinguishing between its various components and, lastly, it reviews a classification system for the different operations processes for manufacturers and service providers.

### 1.1 THE NATURE AND DEFINITION OF OPERATIONS MANAGEMENT



Study section 10.1.1 and 10.1.2 in the prescribed book.

---

To summarise: operations management is said to be important for all businesses because of what it can do to improve a business operation.

One of the main contributions that the operations management function can make to the business is that of increased productivity. Productivity (among other things) improves when fewer inputs are used to produce the same outputs, or more outputs are produced with the same inputs. So obviously the more efficient the transformation or conversion process, the higher the productivity.

The second major contribution of the operations management function is to ensure that customers/clients are satisfied with the product and/or service for which they pay or, as in the case of the most successful businesses, exceptional! Functions like finance, human resources and purchasing, important as they are, do not directly satisfy the needs of the customer/client. Only operations management can do this, because it manages the business functions that design, plan and control, and it improves the operations processes which physically manufacture the products or are actually involved in rendering the services.

The third major contribution of the operations management function is closely linked to the second one mentioned above: if the product or service quality is poor, the business will get a bad reputation among not only its direct customers/clients but also the general public; consequently, it may lose a great deal of business.

## 1.2 AN OPERATIONS MANAGEMENT MODEL



Study section 10.2 in the prescribed book.

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To summarise: the operations management model is a diagrammatic representation of the main distinguishable components which are necessary in a process of manufacturing and/or service providing. It is made up of a basic input-transformation-output model which is driven by the operations management strategies and objectives which must satisfy customer/client needs and requirements through the means acquired by the operations activities of design, planning and control, and improvement.

It is important to distinguish between the inputs that are transformed by the very nature of the business itself (ie raw materials, customers/clients, information) and the resources it uses to bring about that transformation (ie labour, equipment, facilities, technology). So we make the distinction and refer to “input transformed resources” and “input transforming resources”. When it comes to manufacturing, obviously raw materials are transformed into usable products, like leather sheets, rubber and cotton thread, which are transformed into shoes in a shoe factory. But when it comes to providing a service it is not always easy to “see” what is “transformed”, for example in the case of an air carrier. Here both passengers and cargo are not physically changed in appearance but they do undergo transformation in as much as they are moved or relocated! Table 10.2 in your prescribed book has a number of examples of what is actually transformed or changed in different types of businesses.

Table 10.1 sets out some important differences in the characteristics of products and services. A product, for example, is definitely very tangible – it can physically be seen and touched, whereas a service is viewed as intangible because it can only be “experienced” and not physically be characterised. A product can furthermore be “stored” or kept in inventory, while a service cannot. For example, should an increase in the demand for a service occur (ie transport by mini taxi), it is not possible to make use of yesterday’s unused capacity to supplement the current available capacity which may only consist of one mini taxi. If the capacity of the taxi service was not used yesterday it cannot be kept in “store” and used later.

Differences between products and services may have some major implications for how capacity is managed. For example, a certain factory may produce a fixed, constant number of products each month. But in months when sales are low, the excess products can simply be stored or kept in inventory – consumption is delayed or put on hold for the time being. In months when actual sales exceed production, the extra products needed may be taken out of inventory and sold. The factory therefore does not have to make



adjustments to its physical manufacturing capacity when there are seasonal fluctuations in demand. However, this is not so easy when it comes to rendering a service. Banks, for example, find that far more clients come to the bank towards the end of the month, when their salaries are paid, than in the middle of the month. The bank must therefore ensure that additional capacity is put in place (ie more personnel are brought in as tellers) to deal with the increased demand for banking services towards the end of the month. Questions which arise immediately are: Do they hire more permanent personnel during the peak times? And what do they do with these personnel at times when they are not needed? In the case of a banking service, a bank thus needs to adjust its service capacity when there are monthly variations in demand.

Of course most businesses do not solely (and exclusively) manufacture products or render services. Rather, they usually offer some combination of both products and services. Take the motor vehicle manufacturer who physically produces the vehicle itself but also offers a service in terms of maintenance, roadside assistance in case of breakdown, etc. Similarly, a traditional service provider like the post office may also have products like envelopes, stamps, pens, etc for sale.



### Activity 1.1

---

Identify two businesses that both manufacture a product and provide a service. Also indicate what product(s) they manufacture and what service(s) they provide.



*A furniture factory may focus on the production of furniture, but there will also be a service component like delivering products, modifying products to customer needs, and so on. Similarly, even service providers produce some kind of tangible product. A bank, for example, provides a banking service but also issues physical cheque books, bank statements, deposit slips and so on.*

## 1.3 THE CLASSIFICATION OF OPERATIONS PROCESS TYPES FOR MANUFACTURERS AND SERVICE PROVIDERS



Study section 10.3 in the prescribed book.

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To summarise: a classification system is proposed for both manufacturers and service providers based on two dimensions of volume (number or quantity of products produced or clients serviced) and variety (range of products or options to choose from) of products/services. On both dimensions, values of high and low and high-low combinations will represent different types of operations processes.

When it comes to manufacturers, it is important to be able to distinguish between the inherent characteristics of the operations processes for a project, a job and a repetitive/continuous system as well as the two hybrids which are formed individually between the first two systems and the last system mentioned: multiple-unit project (combination of project and repetitive systems) and job-lot (combination of a job and repetitive systems).

A project system is relatively easy to understand. It encompasses something that is normally only done once. For example, to build a house designed by an architect is a project because it is built only once, and no other house is likely to be exactly the same. A project is therefore a unique type of production – and usually it embodies a major effort either in terms of size, or length of time needed to complete.

Further to the project system mentioned above, where several houses of similar design are built, we have the first type of hybrid system previously mentioned, namely between a project and a repetitive system. This is referred to as a multiple-unit project system.

A job system refers to a single task on a small scale or in small volume which has a definite individual uniqueness to it. A printing shop uses this type of system. Each printing job, say for a business card, is unique in the sense that it has its own wording, font style, paper type, colours, and so on.

Further to the job system mentioned above, as soon as the range of a similar type of products increases – like a magazine printer – the job system starts to resemble that of a repetitive system. The second type of hybrid system is then applicable, namely that of a job-lot system.

A repetitive operations system is one in which the same product (or range of very similar type of products) is produced many times over. Most factories are examples of this: for example, where the same model vehicle is manufactured by means of a process that is repeated over and over again and could go on for many years until a new model is introduced. Also similar to this type of operation, a continuous operations system is one in which exactly the same product is produced continually “forever”. For example, a power utility company produces the same “product” (electricity) on such a basis.

When it comes to service providers, it is also important to be able to distinguish between the characteristics of the operations processes for a professional service, a mass service and service shop.

A professional service is characterised by low volume – each individual client requires service according to his or her own needs but with more variety of service on offer as a result.

A mass service represents operations for services which are similar to mass product producers – the service is rather standardised with less variety, but high volume.

A service shop falls in between the characteristics of the professional service and mass service (thus with both moderate variety and volume).



## Activity 1.2

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Use the practical examples of the various types of businesses listed in table 10.2 and classify their dominant operations processes according to proposed classification for manufacturers or service providers.



<b>Type of business</b>	<b>Dominant operations process</b>
<i>Rail transport</i>	<i>Mass service</i>
<i>Banks</i>	<i>Service shop</i>
<i>Hairdressing salon</i>	<i>Professional service</i>
<i>Gold mine</i>	<i>Continuous manufacturer</i>
<i>Furniture manufacturer</i>	<i>Job-lot manufacturer</i>
<i>Printing works</i>	<i>Job-lot manufacturer</i>
<i>Construction firm</i>	<i>Project system</i>
<i>Missile manufacturer</i>	<i>Job-lot manufacturer</i>

## SUMMARY

Now you should have a basic insight into the operations management function. In the next study unit you will study the activities, techniques and methods of operations management.



## SELF-ASSESSMENT QUESTIONS

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- (1) *For which of the following reasons is operations management important to the business?*
  - (a) *It can contribute to an increase in the productivity of the business.*
  - (b) *It can help the business satisfy the needs of its customers/clients more effectively.*
  - (c) *It can assist in both the design and marketing of products/services in order to improve the financial return on investment.*
  - (d) *It can be a decisive factor for the general reputation of the business.*
  - (1) *a b*
  - (2) *a b c*
  - (3) *a b d*
  - (4) *a b c d*
  
- (2) *Which of the following are positive results obtained from the application of the operations management guidelines?*
  - (a) *higher quality*
  - (b) *lower costs*
  - (c) *increased lead times*

- (d) *greater adaptability*
- (e) *better service*

- (1) *a b c*
- (2) *a b d e*
- (3) *a c d e*
- (4) *b c d e*
- (5) *a b c d e*

- (3) *Which one of the following statements is wrong concerning the classification of operations processes in manufacturing businesses?*
- (a) *Project systems represent operations processes which are highly individual.*
  - (b) *Job systems normally represent operations processes conducted on a small scale.*
  - (c) *Continuous or repetitive systems represent operations systems in which the output volume is low but reflects more variety.*
  - (d) *Job-lot systems represent a combination of a repetitive and a job system.*



### **Question 1**

*The correct answer is option 3 (a b d).*

*Operations management is important because it can contribute to an increase in the productivity of the business (alternative a), it can help the business satisfy the needs of its customers/clients more effectively (alternative b), and it can also be a decisive factor for the general reputation of the business (alternative d). Alternative c is, however, incorrect because while it can assist with the design of products/services, it is not directly involved in their marketing and further is not primarily concerned or held responsible for improving the financial return on investment.*

*If your answer was wrong, please refer to section 10.1.1 in the prescribed book.*

### **Question 2**

*The correct answer is option 2 (a b d e).*

*Positive results obtained from the application of the operations management guidelines are higher quality (alternative a), lower costs (alternative b), greater adaptability (alternative d), and better service (alternative e). Alternative c is, however, incorrect because the operations guideline would rather endeavour to shorten lead times (quicker response) than increase the lead times (longer waiting periods).*

*If your answer was wrong, please refer to section 10.2.1 and figure 10.2 in the prescribed book.*

### **Question 3**

*The correct answer is option 3.*

*Options 1, 2 and 4 regarding the classification of operations processes in manufacturing businesses are all correct. However, option 3 is incorrect because continuous or repetitive systems (as in a water purification plant or brick manufacturer) have more volume and less variety.*

*If your answer was wrong, please refer to section 10.3.1 in the prescribed book.*

# Study unit 2

## Operations management: activities, techniques and methods

### Contents

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Key concepts

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Getting an overview

2.1 Operations design

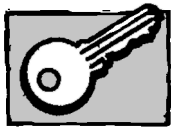
2.2 Planning and control of the operations process

2.3 Operations improvement

Summary

Self-assessment questions

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### Key concepts

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operations design  
operations improvement  
design of processes  
idea/concept generation  
preliminary design  
prototype and final design  
bill of materials  
demand side  
layout and flow  
fixed position layout  
product layout  
process technology  
method study  
loading  
scheduling  
level capacity plan  
demand management  
cumulative representation  
quality planning and control  
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planning and control of the operations process  
design of products/services  
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screening process  
design evaluation and improvement  
basic product structure  
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process layout  
cellular layout  
job design and work organisation  
work measurement  
sequencing  
capacity planning and control  
chase-demand plan  
moving average  
inventory and purchasing planning and control  
quality characteristics  
*kaizan*  
business process re-engineering (BPR)  
failure prevention and recovery  
total quality management (TQM)

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## Learning outcomes

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When you have worked through study unit 2 you should be able to:

- explain the nature of design in operations by highlighting the various activities involved in the design of products, services and operations processes, including the application of selected operations management techniques and methods
  - explain the nature of planning and control in operations by highlighting the various activities involved in capacity, inventory and purchasing, and quality planning and control, including the application of selected operations management techniques and methods
  - explain the nature of improvement in operations by highlighting various activities involved in failure prevention and recovery and total quality management, including the application of selected operations management techniques and methods
- 

## Getting an overview

Having gained a basic understanding of what the transformation model entails, it is now possible to examine in more detail the operations activities of design, planning and control, as well as of improvement. Also, certain operations techniques and methods that can be used to perform such activities “better” are briefly illustrated.

## 2.1 OPERATIONS DESIGN



Study section 10.4 in the prescribed book.

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To summarise: operations design consists of two core components: the design of the product and/or service itself and the design of the operations process by which the product will be physically manufactured or a service rendered. A five-step procedure is followed in the design of a product/service, starting from the generation of ideas/concepts, through screening processes by which some “less promising” ideas are eliminated, to a preliminary design, to further design evaluation and improvement, and eventually to a prototype of the product or simulation of the service and final design. In the case of the design of the operations process, four interrelated areas need to be considered: the operations network, the layout and flow of the manufacturing/provisioning facility, the use of appropriate process technology, and the design of jobs and organisation of the work.

The operations manager of a manufacturer will be involved in at least three steps. First is the physical design of the product itself – for example, its shape, size, features and packaging. Second, the possible ancillary services that go with it, like guarantees and level of after-sales service, are considered. Third, with possibly deeper involvement, will be the design of the operations process that is to physically manufacture the product.

The operations manager of a service provider, however, cannot “physically” design the service itself, but rather will specify what the service will entail and move on to the de-

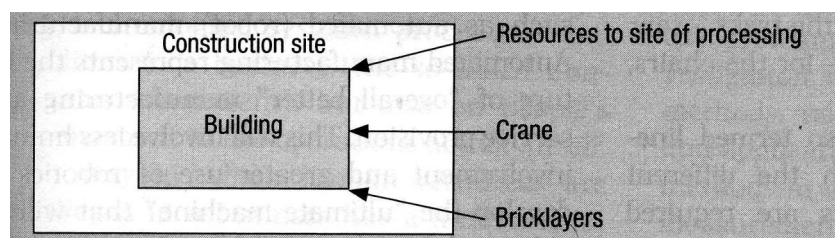
sign of the tangible products which will accompany the service, and the design of the operations process by which the service will be rendered. For example, the operations manager of a commercial bank will be involved in decisions about where branches of the bank should be located. How large (number of tellers) or how comprehensive should the services offered (new accounts, credit card issues, foreign exchange, etc) in each be? That two similar types of businesses may offer different levels of service is in fact the result of different operational designs.

Section 10.4.2.3 in your prescribed book sets out the steps in the design of a product or service. Note that while it is easier to “picture” how these steps could be followed in the design of a product because it encompasses a tangible “something” at the end, the design of a service is more difficult because you cannot physically see the service and can only experience it.

Not only does the product and/or service have to be designed, but the process whereby they are to be manufactured/provided must also be designed. The first area of concern is to decide how much of the operations network the business wishes to “control” or own. For example, a cement manufacturer may decide to purchase the mine where its raw materials are sourced. Also, it may decide to own a share in the building warehouse where the cement is sold to the public. In this way, the cement manufacturer can exercise better coordination over the supply side (raw material resources) and demand side (wholesaler) of its operations network.

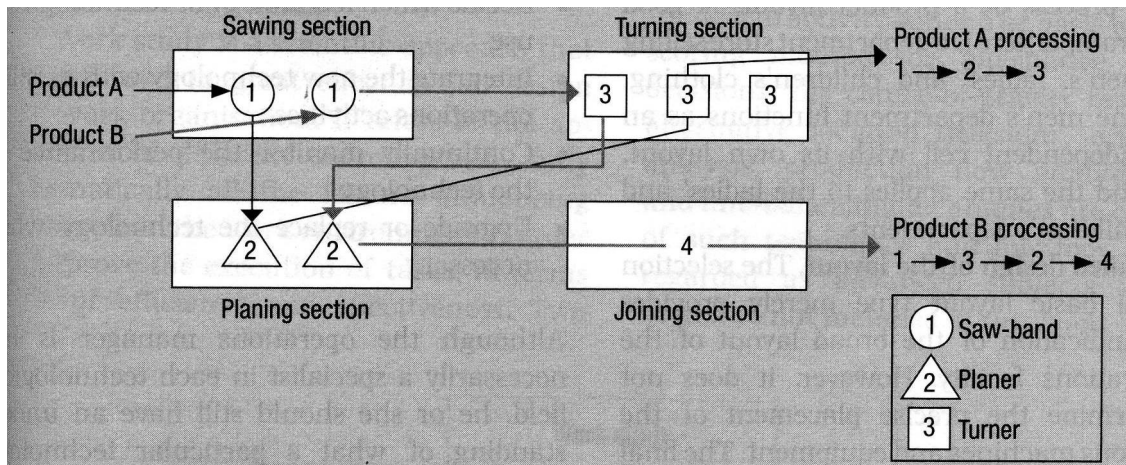
The second area of concern in the design of the operation relates to the layout and flow of the manufacturing or service provisioning facility. It thus has to decide on the physical arrangement of machines, equipment and operators or personnel in the operations facility. Also, how will the process of manufacture or service rendering take place? What comes first, second and last? Section 10.4.3.2 in your prescribed book refers to four types of layout: fixed position, process, product and cellular.

A **fixed position layout** is found where the product or service is completed at the position where it is to function (house, bridge, dam and highway) or where it is directly required (borehole, plumbing repair, telephone installation). Resources of manufacture or service provision are brought to the receiver of the conversion or the processing.

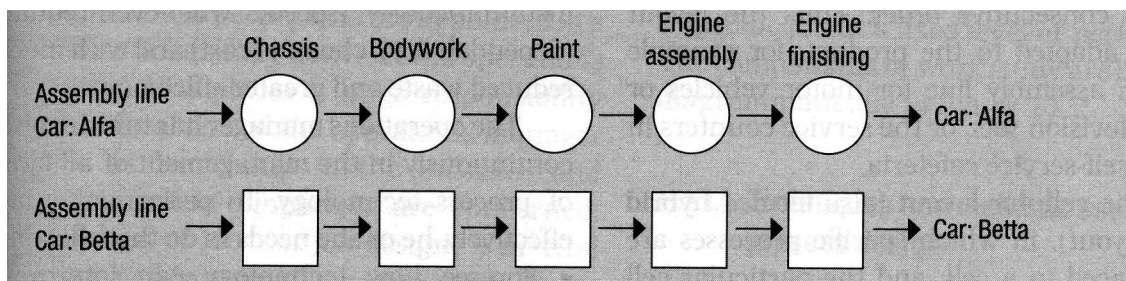


A **process layout** is found where a number of similar processes are grouped together in departments or sections, though not all the processes are necessarily used in the manufacture/rendering of each and every product/service. A hospital, for example, has all kinds of departments – the orthopaedic department, cardiology department, paediatric department, to mention but a few. Patients are taken to the department where they will receive the specific treatment they require. A process layout may also be used

in a service provider like a departmental store. Customers do not necessarily purchase articles from each and every department – so they visit only those that offer the specific items they need.

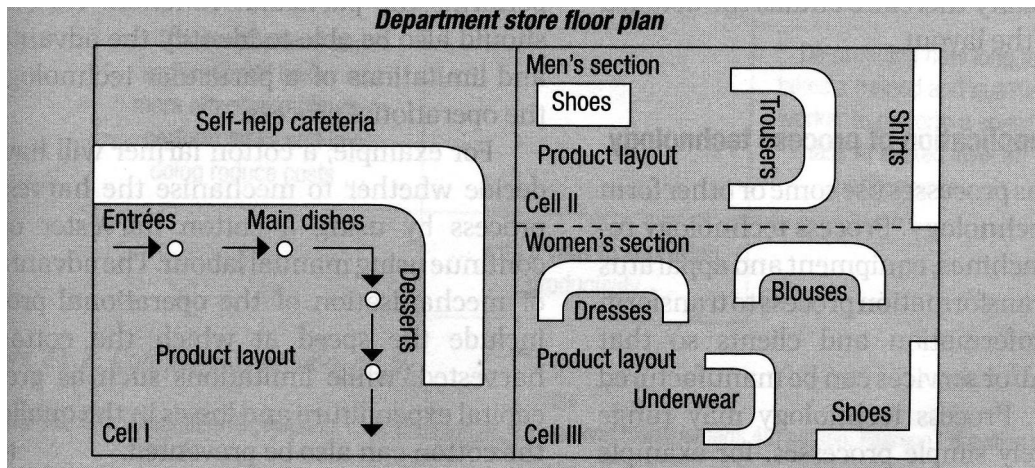


A **product layout** is found where all the processes that need to be executed for a specific product to be manufactured are placed together consecutively in a “line arrangement”, with one after the other – thereby progressing through all the various production stages, finally ending up in one product. In the manufacture of shirts, for example, a piece of cloth is measured, then cut into patterns, then stitched together, then the collar and the cuffs are attached, and finally each item is ironed. In a self-help cafeteria, the customers go through the same basic steps: they enter the “line” at the same place, they collect a tray, they select food and/or a drink, they pick up the required condiments (salt, pepper, tomato sauce, etc) and finally they pay the cashier before sitting down to eat. This is an example of a product layout for a service provider.



A **cellular layout** comprises a combination of a process and a product layout. For example, a furniture factory may use an initial process layout, where the raw materials are cut, planed, turned and varnished. The raw materials may then be moved to the various departments (cells), like the chair assembly department, the desk assembly department and the wardrobe assembly department, where the products are “put together” in a product layout arrangement.





The third area of concern in the design of the operation relates to the use or application of process technology. The operations manager needs to keep up to date with the latest processing technologies for materials, information and customers/clients. A prudent operations manager will constantly be searching for and investigating new technologies that may benefit the operation. The main focus will be on finding or adapting technologies to help the operation follow the operations management guidelines, to gain the positive results of higher quality, lower costs, shorter lead times, greater adaptability, less variability and overall better service. Using the latest processing technologies may also help a business get a competitive advantage over competitors.

The fourth area of concern in the design of the operation relates to job design and work organisation. One technique that can be used to facilitate the design of the process is work study. It comprises two facets: method study and work measurement. Method study seeks to find more efficient ways of carrying out a particular task. Work measurement determines how long each task should take – given normal working conditions. In combination they may be used to improve productivity but also to ensure that the total workload is evenly distributed among enough workers.



### Activity 2.1

Think of your favourite clothing store (eg Jet, Pep, Edgars, Foschini, Woolworths), or if you cannot think of one then just visit the most convenient store next time you are in town. Identify the cellular layouts of the men's, ladies' and children's departments. Sketch the cellular layout of the ladies' department. Label all the different parts of your sketch.



*You noticed that the store is divided into cells. Did you notice any other cells in the overall layout, for example cosmetics which, in turn, may have smaller cells of men's after-shave and ladies' perfumes?*

*The ladies' department is subdivided further into smaller cells of, say, underwear, dresses, skirts and blouses. Did you find any other cells in the ladies' department? Look at the diagrammatic illustration of a cellular layout in section 2.1 of this study unit.*

## 2.2 PLANNING AND CONTROL OF THE OPERATIONS PROCESS



Study section 10.5 in the prescribed book.

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To summarise: planning and control of the operations process endeavour to reconcile the operation's supply of products and services on the one hand with customer/client demand for these on the other hand. Specific areas of concern deal with capacity, inventory and purchasing, and quality.

Operations planning and control refer to activities which put "the whole operations process into action". The task of the operations manager in planning and control of the operations process involves trying to "match" or reconcile the supply of products and services with demand in three areas: volume, timing and quality. In other words, the operations manager needs to decide how much to produce or how many service points to provide, when to produce these products or render these services, and what exactly needs to be produced or rendered to satisfy customer/client requirements.

The first specific area of concern is the activity dealing with the planning and control of the operations process in terms of volume. Capacity in an operations context refers to the availability of a manufacturing and/or service provisioning capability. It is one-dimensional not only in terms of size or volume (ie 220 motor vehicles) but must also have a time dimension added (ie per day, per week, etc, thus manufacture of 220 vehicles per 2 shifts per day each of 9 hours' duration). Capacity planning and control in operations has three elements: determining the total demand (from which the planned demand that the operation will attempt to satisfy will be derived as well as the required operations capacity to meet it), identifying alternative plans to meet the planned demand and/or variations in it (level, chase-demand or demand management plans), and choosing an appropriate detailed capacity planning and control approach for both fixed (facilities, machines, etc) and adjustable (operators, equipment, etc) operations capacity.



### Activity 2.2

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Distinguish between the alternative capacity plans in order to accommodate possible variations in demand.



- *Level capacity plan. The operation is committed to manufacturing a constant volume of products (ie 220 vehicles per day). When demand is less than what is being produced, the surplus products are stored or put into inventory or sold elsewhere in other markets. When demand is more than what is being produced, these surplus stocks can then be used to meet demand. Such a plan will, of course, only apply to a product manufacturer, because a service itself cannot be "stored".*
- *Chase-demand plan. Here the production volume is continually adjusted in accordance with the variation in actual demand. In the case of a manufacturer, such a strategy would be rather unproductive, as it would mean that during periods in which demand is less than normal volume produced, some machinery would be standing idle and some employees would have to be retrenched, and then hired again when demand picks up. Very few employees would want to work under such conditions of service. However, adjusting capacity to demand is somewhat easier in the service industry. For example, banks expect*

*considerably more clients at the beginning and end of the month than during the middle of the month. To meet this increase in demand at the end of each month, the bank may hire some employees on a part-time basis, say for two weeks per month. This kind of employment is particularly attractive for some housewives who would like to earn an extra income, but also spend time at home with their children.*

- *Demand management plan. In the case of this strategy an attempt is made to influence or “manage” the demand. Airlines, for example, will offer much lower fares to certain overseas destinations in the “off-season” period. Hotels at holiday resorts may do the same. Their off-season rates are usually much lower than their holiday season rates. By doing this they hope to attract guests during the off-season period in order to fill up their capacity.*

The second specific area of concern is the activity dealing with the planning and control of the operations process in terms of timing. Inventory and purchasing planning and control are dealt with comprehensively in the next topic of this study guide. Suffice to note here that manufacturing operations need to carefully “manage” their inventories for raw materials, components, and so on, in order to ensure a “smooth” flow of production. Furthermore, with “just-in-time” (JIT) or “lean” production philosophies becoming ever more popular, the idea is to only manufacture for actual demand and avoid costly inventory build-up of finished products. The purchasing activity whereby materials are bought in to the operation has also become a highly specialised field of expertise, spanning national and even international supply chains.

The third specific area of concern is the activity dealing with the planning and control of the operations process in terms of quality. Today, quality is seen as a critical factor in most businesses – it is probably one of the more important areas (at least from the customer/client point of view) where a business can set itself apart from its competitors and literally “add value at no extra cost”! Quality planning and control encompass six steps, ranging from defining the quality characteristic(s) of the product/service, measuring its current status, setting a standard of acceptability, comparing the achieved quality against the standard set, identifying deviations or causes of non-conformance, and finally continuously improving actual quality, standards and conformance.

## 2.3 OPERATIONS IMPROVEMENT



Study section 10.6 in the prescribed book.

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To summarise: operations improvement is the third main activity undertaken by the operations manager. It follows the design, planning and control of the operations process by which products are manufactured and/or services rendered. Three main areas are covered: measuring current performance, preventing failure but recovering where necessary, and implementing total quality management.

It is probably an age-old truth that it is not possible to improve if you do not know how you are currently performing! For example, an athlete cannot improve his or her time for running the 100 metres flat if his or her current performance cannot be measured accurately. So too, an operation cannot hope to improve its performance if it does not

know how it is currently doing. It is thus not only important to compare itself against its past performance but also to compare itself against competitors' performance and in so doing set new standards or theoretical maximums to pursue in the future.

Four different kinds of performance standards are discussed in your prescribed book. The first two, historical and target performance standards, have an internal focus (the business compares with itself) while the last two, competitors' and absolute performance standards, have a more external focus (the business's performance is compared with similar businesses for theoretical maximums in the industry).



### Activity 2.3

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Describe the two approaches to improvement and justify in which circumstances the one may be more appropriate to follow than the other.



*The first approach to business or process improvement is referred to as breakthrough improvement or BTI and focuses on major, even sometimes "radical", "starting from scratch", "clean slate", types of improvement projects. BPR or business process re-engineering is a well-known example of this type of approach. The second approach, referred to as continuous improvement or CTI, or the Japanese word kaizan, focuses on smaller, more modest, maybe less "ambitious" improvement programmes. They often run over longer periods of time (a year or more) and, unlike BTI projects (which are shorter and frequently introduce "quick-fix" solutions), attempt to put the business on a solid footing with suggestions for improvement coming from the employees themselves – which encourages commitment to change.*

As pointed out in the prescribed book, regardless of how well an operations process was initially designed, or how effectively and efficiently it is "activated" to produce products or render services, the reality of the dynamic business environment is that change, whether anticipated or not, will necessitate adjustment to prevent failures – or to allow for recovery to get the business back into "operation" as soon as possible, if they have already occurred. Generally, many businesses focus on correcting failures/problems when they occur, but not necessarily on taking prudent steps to prevent failures from occurring in the first place or in the future. For example, when a strike occurred at one of the large platinum mines, the industrial relations department immediately swung into action to resolve the issue. Management and the IR people were rather pleased with themselves when the conflict was quickly resolved and workers returned to work. However, they were annoyed when asked four weeks later what steps they had taken to prevent such a strike from recurring in the future. They had primarily focused on correction, and not really considered prevention.

The TQM philosophy is but one of the "latest" approaches in the evolution of "quality management thought". However, because it involves more than one technique, method or idea, it has survived as a comprehensive managerial philosophy for a number of years and, while opponents of the approach cite some known business failures, there is clear evidence of considerably more successes. It is an inherently sound approach, based on getting everyone in the business involved in and committed to quality, monitoring both the costs and benefits of better quality, working smart and declaring "war on waste", putting life into the quality management system to guide and help the business to improve rather than burden it with bureaucracy and inflexibility, as well as promoting

and nurturing creativity to continuously strive for improvement in the face of repetitive routine and autocracy.

## SUMMARY

If you have carefully worked through the last two study units of the topic dealing with operations management, understood our explanations and appreciated the practical applications pointed out, you should now have a basic insight into, firstly, what the operation management function in a business entails and, secondly, what the operations management activities of design, planning and control and improvement involve, as well as how certain operations techniques and methods may be used to help an operations manager perform “better”.



### SELF-ASSESSMENT QUESTIONS

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- (1) Which of the following statements about the basic layout types used in the design of operations processes are correct?
  - (a) The fixed position layout is used when the product cannot be shifted on account of its size, shape or location.
  - (b) The process layout is used when the different operations are arranged in consecutive order.
  - (c) The product layout is used when similar operations are grouped together into sections.
  - (d) The cellular layout is used when various operations processes are placed in a cell and the particular cell is then arranged according to either a process or a product layout.
  - (1) a d
  - (2) b c
  - (3) a b d
  - (4) a c d
  - (5) a b c d
- (2) Which of the following statements on the design of products and services are wrong?
  - (a) The design of a product or service is said to “begin and end” with the customer/client.
  - (b) The implicit advantages in the package relating to products and services are the psychological advantages.
  - (c) Peripheral services supplement the core service.
  - (d) The financial function is also involved in the screening process of designing products and services.
  - (e) The preliminary design specifies the components to be included in the product or service package.
  - (1) b d
  - (2) d e
  - (3) a b c d
  - (4) a c e
  - (5) none
- (3) Which one of the following statements related to operations improvement is wrong?
  - (a) All areas in a business are equally important when it comes to improvement.

- (b) *Priorities for improvement depend in part on the performance and activities of competitors.*
- (c) *Business process re-engineering (BPR) is an example of breakthrough improvement.*
- (d) *In continuous improvement, more regular but smaller incremental initiatives are undertaken in the operations process.*



### **Question 1**

*The correct answer is option 1 (a d).*

*Regarding the basic layout types which may be adopted in the design of the operations processes, alternatives a (fixed position layout) and d (cellular layout) are correct. Alternative b is, however, incorrect because in a product layout (not process layout) the different operations are arranged in consecutive order, for example a vehicle assembly line. Furthermore, alternative c is also incorrect because in a process layout (not product layout) similar operations are grouped together in sections, for example a furniture manufacturer who may place all the wood-cutting machines in one section, and have a planing section, painting section, assembly section, and so on.*

*If your answer was wrong, please refer to section 10.4.3.2 in the prescribed book.*



### **Question 2**

*The correct answer is option 5.*

*All the statements regarding the design of products and services are correct. Review all of section 10.4.2. The correct answer is therefore option 5.*

### **Question 3**

*The correct answer is option 1.*

*Options 2, 3 and 4 regarding operations improvement are correct. However, option 1 is incorrect because NOT all areas in the business are equally important when it comes to improvement. After measuring the business's performance and comparing it against some form of performance standard, and deciding on the particular approach to improvement, you may see there is a greater urgency to improve some areas in the business because they are more important than others. For instance, you may see a scheduling problem in the delivery of raw materials that is delaying all other operations, resulting in large-scale loss of orders, while there may also be a "smaller" problem in quality assurance. The priority would thus be to first deal with or improve the raw material delivery according to schedule, and then move on to the quality assurance issue.*

*If your answer was wrong, please refer to section 10.6.1 in the prescribed book.*

# TOPIC 2

## The human resource function

### AIM

The aim is to explain the nature and importance of the human resource function, with emphasis on meeting human resource requirements and developing effectiveness in HR.



### Learning outcomes

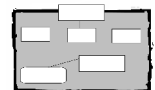
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When you have worked through topic 2 you should be able to:

- explain how the HR department assists the line managers to achieve the organisation's goals by ensuring that the organisation has employees with the necessary qualifications, knowledge and experience when they are needed
  - demonstrate how human resource management contributes to employee motivation
- 

### OVERVIEW OF THE TOPIC

Topic 2 comprises the following study units:



TOPIC 2	
<b>Study unit 3</b>	<b>Study unit 4</b>
Meeting human resource requirements and developing effectiveness in HR	Motivating employees

# Study unit 3

## Meeting human resource requirements and developing effectiveness in HR

### Contents

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Key concepts

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Getting an overview

- 3.1 The relationship between line management and the HR department
- 3.2 Human resource planning
- 3.3 Finding qualified workers
- 3.4 Developing qualified workers
- 3.5 Keeping qualified workers

Summary

Self-assessment questions

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### Key concepts

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job analysis	job description
job specification	human resource forecasting
recruitment	labour market
preliminary screening	psychological testing
diagnostic interview	references
induction	training
development	human resource development
informal development	formal development
analysing development needs	performance appraisal
feedback	direct compensation
indirect compensation	rewards

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### Learning outcomes

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When you have worked through study unit 3 you should be able to:

- describe the human resource planning process by discussing each step and explaining its purpose
- explain the process of finding qualified workers by describing the recruitment and selection processes
- explain how a systematic approach to human resource development contributes to organisational success by explaining the different approaches to training and emphasising the contribution of analysis of development needs



- explain how compensation contributes to the retention of staff by discussing the different kinds of compensation that employers can offer and briefly describing how the size of compensation is determined
- 

## Getting an overview



Read section 11.1 in the prescribed book.

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You will see in this module that the main objective of a business is to maximise profitability in the long term. This goal can be achieved in various ways, for example by producing and/or selling a product or service that is unique or satisfies a specific need for customers. What is central to these business activities is that people are involved in them. Even the most automated, state-of-the-art businesses employ people; yet one of the most difficult management tasks is to find and keep people who are able and willing to work towards the achievement of organisational goals. This is the responsibility of the human resource function.

### 3.1 THE RELATIONSHIP BETWEEN LINE MANAGEMENT AND THE HR DEPARTMENT



Study section 11.2 in the prescribed book.

---

The human resource function has changed dramatically over the past decade. In the past, human resource managers were only responsible for administrative activities such as keeping leave records up to date and managing the payroll. Today, this is only one of the activities of a human resource manager. The HR manager must be a strategic partner in the business, aligning HR strategies with organisational goals and strategies.

This implies that managers should treat their human resources differently, assisting them to reach their work goals, utilising their skills efficiently, maintaining and developing quality of work life and managing change to the advantage of all the stakeholders. It is important to remember that every manager is responsible for the efficient management of human resources and that the human resource function serves as advisor and guide.

## 3.2 HUMAN RESOURCE PLANNING



Study section 11.3 in the prescribed book.

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Human resource planning is the point of departure of other HR activities. No human resource activity in an organisation can be conducted successfully if human resource planning has not been done.

What is human resource planning? We do human resource planning when we determine how many employees will be needed and what their skills, knowledge, qualifications and experience must be to ensure the achievement of organisational goals. This means that the point of departure for a human resource plan should be the organisation's strategy and goals.

The steps in the HR planning process are:

- Step 1: Identify what the employees are doing currently (job analysis and job descriptions).
- Step 2: Identify what skills, knowledge, experience and qualifications employees need to be effective in their jobs (job specifications).
- Step 3: Identify how many employees will be needed in the future (human resource forecasting and planning).

These are the main steps in the human resource planning process, but these steps can also be divided into smaller steps or activities. For example, in step 1, when we identify the work being done in the organisation, the activity that we will be involved in is called job analysis. We do a job analysis to find out what the job entails – what the tasks are, what the working conditions are, to whom the position reports, and which decisions are made in this job. Various methods can be used to collect this information (the methods are discussed in the prescribed book) and the information is used to compile a job description and a job specification.

A job description provides information about the tasks performed in a specific job, while a job specification provides information about the knowledge, skills, abilities, education and experience required to perform the job successfully. The job specification gives us the information we need for step 2 of the human resource planning process.

The last step in this process is to do human resource forecasting. This is done to balance human resource supply with human resource demand. The demand for human resources (how many people we will need at a given time) is influenced by the business objectives, while the supply is influenced by HR programmes that provide the human resources – for example, promotions, training and development, and recruitment and selection. This information is used to compile a human resource plan. This will indicate how the organisation's human resource requirements can be provided for. For example, if the HR planning process indicates that a shortage may be experienced in a year's time, the plan will indicate that the organisation must engage in an extensive recruitment and

selection campaign. If the HR plan indicates that employees will have to be retrained because of the updating of equipment, then training and development programmes must be developed. In this way HR planning indicates what the future focus of HR activities in the organisation should be.



### Activity 3.1

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Cecilia works for a processing plant that produces avocado and peanut oil. The process is largely automated, but the plant equipment will be updated in the next year. Describe the HR planning steps that Cecilia must take and identify the HR implications of this plan.



*Cecilia must follow the steps in the HR planning process. This means that she must do job analyses and compile job descriptions and specifications of the current staff. Then she must determine how many employees will be needed after the plant machinery has been updated. The last thing she will have to do is to determine which employees will have to be retrained because of the updated machinery that they will be working on. She may also have to find out whether the company will have to redeploy some employees, whose skills may not be needed any more.*

## 3.3 FINDING QUALIFIED WORKERS



Study section 11.4 in the prescribed book.

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The HR plan can indicate that the organisation has to employ new staff. What does this mean in practice? It means that the organisation has to look for possible employees and then choose those who will be able to do the job best. This is the recruitment and selection process.

Be careful not to confuse recruitment and selection. Recruitment is what an organisation does to alert people that there are vacancies available. The purpose of recruitment is to create as large as possible a pool of candidates for a vacancy, so that the organisation can choose the best of them for a vacant position. The technique most commonly used to do this is advertising. Selection is what is done after the advertisement, when people who are interested in the position have applied for it and the organisation then goes through a process to determine which of the interested people will be best to fill the position. In other words, selection follows on recruitment.

Organisations can recruit from within (in other words, recruit from the existing employees) or from outside the organisation. Both these approaches have advantages and disadvantages. Different techniques are used to recruit possible employees – for example advertising, using consultants or using existing employees.



### Activity 3.2

Indicate which recruitment techniques are used in the following examples.

Description	Recruitment technique
John works as a software developer for a small independent company. Microsoft contacts him and invites him to send his CV through to their HR department.	
Talk Radio 702 broadcasts that there are vacancies available for interns.	
Adele reads an advertisement in the <i>Sunday Times</i> for a Human Resource Officer and decides to apply.	
Martin owns a fast-food restaurant. One of his cooks has resigned and he asks his other employees if they know of anyone who is available to do the work.	
An engineering firm approaches The Personnel Concept (a placement agency) to fill the position of senior engineer	



*Recruitment techniques are discussed in the prescribed book. Organisations can use techniques such as advertising, or using recruitment agencies, existing employees, the personal approach, or radio, TV and the Internet. The technique used will be determined by the position that must be filled. In the activity John was recruited by using the personal approach, 702 used the radio, Adele applied for an advertised post, Martin used a referral from existing employees and the engineering firm used a recruitment agency.*

Selection starts after the pool of candidates has been created. The selection process can contain various steps, depending on the kind of position being filled. Figure 11.2 in the prescribed book depicts nine steps in the selection process, but an organisation can decide which of these steps to include. Note the effect of the Labour Relations Act and the Employment Equity Act on the selection process of organisations.



### Activity 3.3

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In each of the following examples, indicate which steps will be included in the selection process and indicate the purpose of each step.

- (1) Mary has applied for a vacancy as a waitress in a well-known restaurant. This will be a part-time position.
- (2) The CEO of a manufacturing company resigns and the position must be filled.
- (3) A financial institution wants to employ a human resource officer.



*When the position that must be filled is on a lower level in the company, or when the position is only temporary or part-time, the company will want to ensure that the selection process is as short as possible, because selection is expensive. They may include the following steps.*

*First is preliminary screening – to compare applications with the job specification and in this way screen out applications from people who obviously do not have the required experience, qualifications and knowledge. This preliminary screening can be done using the application form or CV and information can be clarified by doing a short telephonic interview.*

*This position does not require or justify the use of psychological tests, but a more intensive interview (diagnostic interview) can be used to obtain more information or make selection easier when there are a number of candidates who fit the job requirements. If reference checks are to be used, it is better to do the reference checking before this second interview, to clarify any information that may be revealed during the reference check. Reference checks are used to confirm the information that job applicants have provided on the application form or in the CV and in the preliminary interview.*

*The conclusion of the selection process for the first example will be a job offer and placement, followed by an induction programme.*

*The higher the position is in the organisation's hierarchy, the more steps may be included in the selection process. In the case of the second example, apart from the steps already discussed, the organisation may include extensive psychological tests (ensure that tests are not culturally biased) and work simulation tests. Another set of interviews may also be included.*

*In the third example, the intensive psychological testing may be excluded, as well as one set of interviews.*

## 3.4 DEVELOPING QUALIFIED WORKERS



Study section 11.5 in the prescribed book.

---

The human resource plan (discussed in section 3.2) may indicate that employees must be trained and developed, to make sure they can achieve the organisation's goals. Sometimes organisations appoint employees at entry level and then undertake to develop them for future positions. Investing in employee development enables the organisation to reap the benefits of employees who are willing and able to do their jobs efficiently and effectively.

The prescribed book differentiates between training and development and then defines the concept of human resource development. Make sure that you do not confuse these

concepts and remember that learning is at the core of all human resource development activities. Human resource development activities can take place either within or outside the work situation and can be either formal or informal.



### Activity 3.4

Identify the development methods used in the following examples.

Description	Method
John is a bank clerk. He works as a cashier but in the past year he has also worked in the foreign currency department, the bonds department and the savings department. He is on a training programme to develop bank managers.	
Mary is a cashier in a department store. She has just started working and is assisted by Rachel, who has been working as a cashier at this store for three years.	
Paul has been appointed as an engineer and is attending an orientation course.	
Christel has been promoted to a supervisory position and has to attend a conflict management course.	
Alexander works as a clerk in the Civil Service and is studying part-time for a degree in Public Administration.	



	<b>Informal development</b>	<b>Formal development</b>
	<i>The employee does not follow an official training programme.</i>	<i>The employee follows an official training programme and receives a formal qualification.</i>
<i>INSIDE THE WORK SITUATION</i>	<i>Employees are put to work immediately and expected to learn the work in due course, for example coaching and job rotation (John and Mary).</i>	<i>Learnerships. Employees are trained in the work environment but must also pass certain compulsory modules and at the end receive a formal qualification, for example electricians.</i>
<i>OUTSIDE THE WORK SITUATION</i>	<i>Training courses offered inside the company, for example induction courses and courses in computer literacy (Paul and Christel)</i>	<i>Students acquire a formal education at the end of a study period, for example a BCom degree (Alexander)</i>

Organisations evaluate the performance of their employees because they wish to establish whether employees comply with job requirements and also want to find out which employees perform exceptionally well. Employee performance is measured against job criteria and the appraisal process should be objective to ensure success. The appraisal process is also an opportunity for supervisors to give feedback to employees about job performance. Performance information is used to make human resource management decisions, such as who should be promoted and who should be given a salary increase or performance bonus. It can (and should) also be used to determine whether employees need training and development, either because their job performance is below standard or to equip them with the skills and knowledge they will need to perform well in higher level positions.



### Activity 3.5

Think about your own job, or the job of a close relative or friend. Try to answer the following questions:

- (1) Describe the performance appraisal process that is used in your place of work.
- (2) Is this an ongoing process or a once-a-year event?
- (3) How does the performance appraisal process contribute to your own job performance?



*Performance appraisal systems can measure employee performance against quantitative objectives, for example determining how many units were produced by each employee in a specific period of time. This is often the most objective form of performance appraisal. Other systems measure personal characteristics such as loyalty, enthusiasm and dedication to work. This is a more subjective method of evaluation and does not really measure work performance as such. A 360° system uses information from more than one source – for example, information from the supervisor, colleagues and customers is used to measure job performance.*

A performance appraisal process should be utilised throughout the year, because then it provides opportunities for the supervisor to give feedback to the employee on his or her job performance throughout the year. If performance does not comply with job requirements, the employee and supervisor can compile a development plan to take care of the problem and in this way employees can be developed to their full potential and can become fully productive members of the organisation.

### 3.5 KEEPING QUALIFIED WORKERS



Study section 11.6 in the prescribed book.

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Effective human resource management, based on HR planning, will be difficult if an organisation cannot hold on to good employees because the salaries and benefits it offers do not compare with those of competitors. We need money to survive and provide necessities as well as the good things in life and this can be a headache for an organisation. How can it establish salaries that will encourage prospective employees to apply for vacancies and motivate current employees to stay with the company, but still contain HR costs?

Compensation is all the financial returns and tangible services and benefits employees receive as part of their employment relationship. The kind and level of compensation is determined by the compensation policy. This indicates the company policy on the following matters:

- a level of pay that may be higher or lower than, or equal to, competitors' pay
- the kind of benefits employees will receive
- how annual increases will be approached
- how exceptional performance will be rewarded



#### Activity 3.6

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What happens in the company where you work?

- (1) Explain how salary increases are determined.
- (2) Explain how exceptional performance is rewarded.



*In some companies, yearly increases are linked to performance appraisal results, while in others they are linked to measures such as inflation. The compensation policy should also be clear about issues such as rewards for exceptional performance. Sometimes this is linked to salary increases – in other words, employees who perform well get higher increases than employees who do not perform well. In other companies, employees receive a once-off bonus as a reward for good performance.*



We have seen that compensation consists of three main elements:

- a basic salary (also called direct compensation)
- benefits (also called indirect compensation)
- rewards

What are the differences between these?

<p>DIRECT COMPENSATION</p>	<p>This is a monthly salary or daily, weekly or bi-monthly wage. It is the money that the employee receives at the end of a wage/salary period. The determination of this compensation is based on the worth of the job to the organisation and not on individual or team performance. In other words, everyone who is employed as a cashier in a bank will receive more or less the same salary, with differences being based on years of experience and qualification and not on job performance.</p>
<p>INDIRECT COMPENSATION</p>	<p>This compensation is not monetary. Instead of giving employees more money and expecting them to supply their own benefits such as a pension fund and medical aid fund, the organisation saves money for a pension fund and medical aid on behalf of the employee. So the employee does not receive money in hand or in the bank, but receives the benefit of the money in the form of a pension when he or she reaches retirement age, or as financial assistance from a medical aid scheme when he or she falls ill. Some benefits are required by law (such as vacation leave and sick leave), while others are provided by the organisation but not required by law (such as pension funds and medical aid schemes).</p> <p>In some organisations the benefits employees receive are linked to the hierarchical level of their job. For example, in a bank, only employees at certain levels may receive a housing subsidy or car allowance. Benefits are also not linked to individual or team performance.</p>
<p>REWARDS (INCENTIVES)</p>	<p>This compensation is linked to individual or team performance. It can take the form of a once-off performance bonus, a better-than-average salary increase or sometimes a paid holiday or other special reward. The aim of rewards or incentives is to motivate employees to perform above average. Incentives are not a right – if an employee performs well one year and gets a bonus, he or she may not claim a bonus the following year if his or her performance is not above average.</p>



### Activity 3.7

Try to identify the direct compensation, indirect compensation and incentives on the following salary advice (pay slip).

Name:	Salary period:	Salary range:
Rank:	Date:	Salary notch:
Basic salary: R8 500,00	PAYE: R2 080,00	Profit sharing bonus: R2 000,00
Medical aid: R1 500,00	UIF: R115,00	Gross salary: R8 305,00
Pension plan: R850,00		
Housing subsidy: R600,00		
Leave credit: 10 days' vacation 12 days' sick leave		



*As stated earlier, direct compensation is the monthly, daily, weekly or bi-monthly salary or wage the employee receives. In this instance, the basic salary is the direct compensation. The pension plan, medical aid, housing subsidy, UIF (unemployment insurance fund contribution – required by law) and vacation leave (required by law) are the indirect compensation or benefits the employee receives. The profit-sharing bonus is an incentive, usually paid out at the end of an organisation's financial year. Remember that the combination of salaries/wages, benefits and incentives that employees receive will differ from organisation to organisation and is determined by the organisation's compensation policy.*

How do organisations determine the salary or wage that each employee should receive? The way to determine salaries is to make comparisons – external comparisons and internal comparisons. The purpose of an external comparison is to determine the salary levels of comparable positions in other organisations. This comparison is made by doing a salary survey. The next step is to do an internal comparison by means of a job evaluation. A job evaluation is a determination of the worth of a job (value of a job to the organisation). The job description is essential in a job evaluation exercise, because it provides information that can be used to classify or grade a job according to certain criteria. Different job evaluation methods use different criteria.



### Activity 3.8

There are many terms in human resource management that sound similar but have varying purposes and are used for different applications. To make sure you do not confuse these terms, do the following exercise.

Give a brief description of each of the following terms and explain what it is used for.

Description	Used for
Job analysis	
Job description	
Job specification	
Performance appraisal	
Job evaluation	



*Job analysis is one of the basic activities of a human resource manager. Through a job analysis, an organisation can determine the activities involved in each job and the information can be used to compile a job description and job specification. A job description is a description of the tasks, duties and responsibilities of a job, and can include information about reporting lines and working conditions as well as decisions that must be made in a specific job. A job specification is a description of the qualifications, knowledge and experience the job incumbent needs in order to perform the job successfully. Job descriptions are used in performance appraisals, to compare employee performance against job standards. They are also used in job evaluations. Job specifications are used in recruitment and selection, to determine whether candidates possess the qualities necessary to be successful in a job. Performance appraisals are used to evaluate the quality of an employee's job performance. In other words, compared with the job standards, did the employee perform equivalent to the standard, above the standard or below the standard? Job evaluation determines the worth of a job, establishes where a job fits into an organisation's hierarchy and determines the salary that should be attached to that job.*

## SUMMARY

This study unit should have given you a basic insight into how organisations plan for, find, develop and keep their human resources. It should also be clear that human resource managers make it possible for line managers to manage their staff effectively, by providing the necessary policies and procedures, delivering efficient HR services, advising and

counselling employees and managers and listening to employees' concerns and presenting their needs to managers.



## SELF-ASSESSMENT QUESTIONS

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- (1) *Doing a job analysis, compiling job descriptions and job specifications and identifying the number of employees who will be needed in the future are steps in the process.*
  - (a) *job evaluation*
  - (b) *human resource planning*
  - (c) *performance appraisal*
  - (d) *recruitment*
  - (e) *selection*
- (2) *In this human resource management activity, observation, interviews and questionnaires can be used to collect information about job behaviours and activities.*
  - (a) *job description and job specification*
  - (b) *forecasting labour supply and demand*
  - (c) *job evaluation*
  - (d) *job analysis*
  - (e) *diagnostic interviewing*
- (3) *This document consists of a job summary, a description of each main task and a description of the kind of decisions that the incumbent must take.*
  - (a) *job description*
  - (b) *job specification*
  - (c) *short list*
  - (d) *job behaviours*
  - (e) *labour market analysis*
- (4) *The purpose of recruitment is to*
  - (a) *fill vacant positions with existing staff members.*
  - (b) *appoint people from outside only at the lowest level.*
  - (c) *ensure that a sufficient number of applicants apply for the vacancy.*
  - (d) *make an active effort to obtain the right person for the job.*
  - (e) *create the opportunity to bring new ideas, schools of thought and approaches to the business.*
- (5) *The correct order of the steps in the selection process is as follows:*
  - (a) *reference checking; preliminary screening; short-listing; psychological testing; diagnostic interviewing; job offer; placement and induction*
  - (b) *preliminary screening; reference checking; short-listing; diagnostic interviewing; psychological testing; job offer; placement and induction*
  - (c) *preliminary screening; short-listing; reference checking; psychological testing; diagnostic interviewing; job offer; placement and induction*
  - (d) *reference checking; short-listing; preliminary screening; diagnostic interviewing; psychological testing; job offer; placement and induction*
  - (e) *preliminary screening; psychological testing; diagnostic interviewing; short-listing; reference checking; job offer; placement and induction*
- (6) *It is important to ensure that informal development inside the work situation does not take place at random. The HR manager can ensure this by*

- (a) *encouraging employees to attempt extramural studies, arranging for employees to attend training programmes and keeping careful record of employees' development progress.*
  - (b) *analysing development needs, encouraging employees to attempt extramural studies and arranging for employees to attend training programmes.*
  - (c) *arranging for employees to attend training programmes, analysing development needs and making plans with the immediate supervisor concerned to utilise the new skills in the work situation.*
  - (d) *keeping careful record of employees' development progress, encouraging managers to establish this kind of development and discussing employees' progress and prospects with them.*
  - (e) *keeping careful record of employees' development progress, encouraging managers to establish this kind of development and encouraging employees to attempt extramural studies.*
- (7) *A performance appraisal is done to*
- (a) *identify the characteristics of a job, assess the impression the employee has made on the manager and determine whether employees should be promoted.*
  - (b) *provide employees with feedback on how well they are doing, provide a basis for financial rewards and determine whether employees should be promoted.*
  - (c) *assess the impression the employee has made on the manager, provide employees with feedback on how well they are doing and provide the basis for financial decisions.*
  - (d) *provide employees with feedback on how well they are doing, identify the characteristics of a job and assess the impression the employee has made on the manager.*
- (8) *The size of the compensation for a specific position is determined by*
- (a) *doing an external comparison of salaries, using a salary survey, and then doing an internal comparison of salaries, using a job evaluation based on the job description.*
  - (b) *doing an external comparison of salaries, using a salary survey, and then doing an internal comparison of salaries, using a job specification.*
  - (c) *doing an external comparison of salaries, using a job description, and then doing an internal comparison of salaries, using a job specification.*
  - (d) *doing an external comparison of salaries, using a salary survey, and then doing an internal comparison of salaries, using a job analysis.*
  - (e) *doing an external comparison of salaries, using a job analysis, and then doing an internal comparison of salaries, using a salary survey.*



### **Question 1**

*The correct answer is option 2.*

*Refer to section 11.3 in the prescribed book.*

*Job analysis, compiling job descriptions and specifications, and determining the number of employees who will be needed in future are the three steps in the human resource planning process. The human resource needs are based on the organisation's goals and strategy.*

### **Question 2**

*The correct answer is option 4.*

*Refer to section 11.3.1 in the prescribed book.*

*Observation, interviews and questionnaires can be used to collect information about job behaviours and activities for job analysis. Job analysis is the process of describing and recording information about job behaviours and activities.*

### **Question 3**

*The correct answer is option 1.*

*Refer to section 11.3.2 in the prescribed book.*

*A job description consists of a job summary, a description of each main task and a description of the kind of decisions that the incumbent must take. The format of a job description can differ from business to business, but the information is usually presented in a format that is easily readable.*

### **Question 4**

*The correct answer is option 3.*

*Refer to section 11.4.1 in the prescribed book.*

*The purpose of recruitment is to ensure that a sufficient number of applicants apply for a vacancy in a business. Applications can be received from existing employees and from outside the business.*

### **Question 5**

*The correct answer is option 5.*

*Refer to section 11.4.2 in the prescribed book.*

*The steps in the selection process are as follows: preliminary screening to separate undesirable candidates from potential applicants. Preliminary screening is usually based on the application form. The next step is to do an intensive assessment which consists of psychological testing and diagnostic interviewing. Psychological testing can provide valuable information on an applicant, while the diagnostic interview is used to obtain information that was not highlighted in the tests or on the application form. After these interviews there is usually enough information available about the applicants to compile a short list. After the short list is compiled, the candidates' references are checked to confirm the information that they provided. When the most suitable applicant has been chosen, a job offer is made, and the person can then accept or decline the offer. If the offer is accepted, the candidate is placed in the position and goes through an induction or orientation programme.*

### **Question 6**

*The correct answer is option 4.*

*Refer to section 11.5.2 in the prescribed book.*

*Informal development inside the workplace is not a formal development programme. The employee is put to work immediately and expected to learn in due course. The HR manager can ensure that informal development inside the workplace is planned and structured (does not take place at random) by keeping a careful record of each employee's progress, encouraging managers to establish this type of development and discussing the progress and prospects of individual staff members with them.*

**Question 7**

*The correct answer is option 2.*

*Refer to section 11.5.4 in the prescribed book.*

*A performance appraisal is done to provide employees with feedback on how well they are doing, provide a basis for financial rewards and determine whether employees should be promoted. It gives an indication of whether the employee complied with the requirements of the job and performed well or not.*

**Question 8**

*The correct answer is option 1.*

*Refer to section 11.6.3 in the prescribed book.*

*The size of the compensation for a specific position is determined by doing a salary survey (comparing salaries paid by this company with salaries at the same level paid by other companies in similar businesses – an external comparison of salaries). The second step is to do an internal comparison, using a job evaluation based on the job description. The value of the jobs in a company is compared in terms of the demand that they make on the employees.*

# Study unit 4

## Motivating employees

### Contents

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Key concepts

Learning outcomes

Getting an overview

- 4.1 Employee motivation
- 4.2 Employee motivational strategies
- 4.3 The legal environment

Summary

Self-assessment questions

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### Key concepts

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internal motivation	motivation
needs	external motivation
process approaches	content approaches
job rotation	job design
job enrichment	job enlargement
training and education	intrapreneurial incentives
empowerment and participation	incentives
labour legislation	

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### Learning outcomes

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When you have worked through study unit 4 you should be able to:

- explain the concept of motivation by referring to internal and external motivation and the needs satisfaction process
  - differentiate between the different content and process approaches to motivation by briefly describing each
  - make suggestions about the motivational strategies that managers can apply in the work situation and how the human resource manager can assist them
-



## Getting an overview

These days it is generally accepted that people make an important contribution to the organisation's success. This means that the organisation's philosophy and culture should emphasise this belief. In this study unit, we will explore what the concept of motivation entails, the different theories of motivation that have been developed and the motivational strategies that managers can utilise to improve employee morale and productivity.

### 4.1 EMPLOYEE MOTIVATION



Study section 11.7.2 in the prescribed book.

Motivation is the internal drive that encourages people to achieve certain goals. It has two dimensions – internal and external.

Internal motivation is the satisfaction one experiences when a task is completed successfully or a duty is performed well.	External motivation is the motivation that one feels in anticipation of a reward.
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Does this mean that all employees will be motivated if they can experience job satisfaction, or that they will only be motivated if they think they will get some kind of reward? No, motivation is a complex process determined by individual needs.

Think of what happens when you feel hungry. Hunger is a need and it will probably result in some kind of behaviour to satisfy that need. If you are at home, you may go and cut a sandwich or look in the fridge or grocery cupboard for something to eat. If you are in town, you may decide to buy something to eat. When you have acted, you may achieve the fulfilment of the need – after you have eaten the sandwich you will not be hungry anymore and will be rewarded by the satisfaction of a full stomach. If you are on a diet you may feel guilty about eating a sandwich because it isn't part of your eating plan! If you are still hungry, the need will be unsatisfied and you may look for something else to eat.



#### Activity 4.1

Think about your own motives. Why are you studying, what do you want to buy when you get your next salary or allowance, and what do you want to achieve in life? Also think about what was important to you four years ago. Are the same outcomes still important? Discuss this with a friend, and try to find out what is important to the friend. Are the things you want similar? Do you know what is important to your friend? Write down what you think is important to her and then compare that with what she says.

Write your findings down.

Compare what you have written down about your own motives with the characteristics of motives that appear below. Can you see that the characteristics discussed below also apply to your own motives?



The difference between people is that their needs are not all similar at a given time (we do not usually get hungry at the same time as a colleague or friend, and we may not want to eat the same snack). In other words, motives (or needs) differ. Managers must keep this in mind when they want to motivate staff. Motives also change – when I am not hungry any more, having a sandwich will not be important to me. If I meet a friend and the friend is hungry, having something to eat will be important to her! Motives vary in importance. If I know that I can make a sandwich at any time of the day, because there is food in the grocery cupboard, then satisfying my hunger may be less important than my need to be thin – so maybe I will not have the sandwich and will rather keep to my dietary requirements.

On a more complex level, motives may be unconscious – someone who grew up very poor may want to assure that they always have money in the bank and not know why this is important to them. I have heard of victims of the Holocaust, who survived Hitler’s concentration and death camps, who always carry a piece of bread with them when they leave their houses, because the hunger they experienced in the camps was so severe that they want to ensure that they always have something to eat. Also, managers do not always know what their subordinates’ motives are – instead they infer the motives from people’s behaviour.

Motivation theories are divided into two groups – content theories or approaches, and process theories or approaches. The content theories emphasise the things in us that guide behaviour, while the process theories focus on why people choose certain behavioural options and how they evaluate their satisfaction following goal achievement.



#### Activity 4.2

Give a short description of each of the motivational theories discussed in the prescribed book.

#### Content theories

<b>MASLOW’S HIERARCHY OF NEEDS</b>
The crux of the theory:
The theory assumes that <ul style="list-style-type: none"> <li>•</li> <li>•</li> </ul>
Unsatisfied needs <ul style="list-style-type: none"> <li>•</li> <li>•</li> </ul>
Management can help employees by <ul style="list-style-type: none"> <li>•</li> <li>•</li> </ul>

Needs

- 
- 
- 
- 

### **ALDERFER'S ERG THEORY**

A refinement of Maslow's five-level hierarchy

Three core needs:

- existence
- 
- 

No rigid hierarchy of needs; two or three needs categories can influence behaviour simultaneously.

If attempts to satisfy growth needs are frustrated .....

### **HERZBERG'S TWO-FACTOR THEORY**

Maintenance factors

Motivational factors

Can be linked to Maslow's theory.

Job satisfaction lies in the task itself, but:

- 
- 
- 

### **McCLELLAND'S THEORY**

Three needs:

- 
- 
-

Managers must determine the dominant need of subordinates and offer opportunities to satisfy those needs.

**Process theories**

**EXPECTANCY THEORY**

Motivation depends on two things

- 
- 

Assumptions:

- The individual and the environment controls behaviour.
- People make decisions about their behaviour.
- People's needs and goals differ.
- The tendency to act in a certain way depends on the strength of the expectation that action will lead to a given outcome and how much the person desires the outcome.

Three key concepts:

Valence  
(Desirability of outcome)

Instrumentality  
(Strength of belief)

Expectancy  
(Effort = Outcome)

Managerial implications:

- 
- 
- 

**EQUITY THEORY**

Employees compare their efforts and rewards with those of other employees in similar situations.

People are motivated by

- 
- 
-

<p>Equity exists when: my input-output ratio = your input-output ratio</p>	<p>Inequity exists when: my input-output ratio is unequal to yours</p>
<p>Employees can restore equity by:</p> <ul style="list-style-type: none"> <li>•</li> <li>•</li> <li>•</li> <li>•</li> <li>•</li> </ul>	

<p><b>GOAL SETTING</b></p>
<p>Assumption:</p> <ul style="list-style-type: none"> <li>•</li> <li>•</li> </ul>
<p>Goals must be:</p> <ul style="list-style-type: none"> <li>• specific</li> <li>• achievable</li> </ul>
<p>Employees must:</p> <ul style="list-style-type: none"> <li>•</li> <li>•</li> </ul>



*Maslow's hierarchy of needs groups needs into five main areas and states that some needs must be satisfied before others can become important. This is the crux of the theory. Maslow's theory assumes that lower-level needs must be satisfied before we can progress to higher-level needs and that satisfied needs can no longer motivate. Alderfer identifies three core needs: existence, relatedness and growth. Herzberg is of the opinion that for the motivation to be possible, maintenance factors must be present even though maintenance factors do not act as motivators. Motivational factors (growth factors) concentrate on the content of the job and these are the factors that motivate employees. Maintenance factors are issues such as organisational policy, equipment, interpersonal relationships, salary, status and working conditions. Motivational factors are successful completion of tasks, recognition of achievement, the meaningfulness of the job and the feedback. McClelland indicates that three main areas of needs exist (namely for achievement, power and affiliation), and that managers must determine the dominant need of their subordinates and offer opportunities for employees to meet their individual needs.*

*The expectancy theory is complex, but briefly states that our motivation is influenced by how much we want something, and how likely we think we are to get what we want. This means that managers should set attainable standards, link rewards such as incentive bonuses to performance standards and try to link personal goals to organisational goals. The equity theory states that employees compare how much effort they put into their work and the compensation they get with how other employees fare. Equity should exist and when employees perceive that it does not exist they will use certain means to restore equity. Goal-setting theory states that employees will perform better if they strive towards a specific goal and receive feedback on their performance.*

What does this mean in practice? Managers must be actively involved in employees' motivation. But how can this be achieved?

## 4.2 EMPLOYEE MOTIVATIONAL STRATEGIES



Study section 11.7.3 in the prescribed book.

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Activity 4.3

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Identify which of the motivational strategies discussed in the prescribed book are influenced by the human resource manager.



*Human resource managers directly influence job design, training and education, incentives and compensation, and career management in organisations. You must also remember that the human resource manager supports the line manager, so indirectly the human resource manager can influence things like empowerment, participation and creating a culture of change.*

## 4.3 THE LEGAL ENVIRONMENT

Maintaining human resources within an organisation includes being aware of and abiding by the Acts that regulate various dimensions of the employment relationship.

There are a number of Acts that directly impact on the management of labour relations in organisations. However, there are also numerous other Acts that impact on business activity. Although you are not expected to know these Acts in detail, you need to be aware of them. It is, however, essential for you to have a **basic understanding** of the labour laws, because you will not be able to effectively manage human resources within any South African organisation without this understanding.



Read section 11.8 in the prescribed book.

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## Activity 4.4

Use the information obtained from sections 11.8.4 to 11.8.13 in the prescribed book to complete the following table.

<b>Act</b>	<b>Purpose</b>	<b>Aspects of HR management and LR regulated by this act</b>
Labour Relations Act		
Basic Conditions of Employment Act		
Skills Development Act		
Skills Development Levies Act		
South African Qualifications Authority Act		
Employment Equity Act		
Occupational Health and Safety Act		
Compensation for Occupational Injuries and Diseases Act		
Unemployment Insurance Acts		



*Once you have completed the above table it should serve as a brief summary of the various pieces of labour legislation. Refer to this table when you are confronted with human resource management and labour relations issues in the workplace. If you know which aspects of labour relations and human resource management are regulated by legislation, you can obtain advice from legal experts when you need to deal with these matters.*

*The Government Gazettes containing Acts can be obtained at a nominal fee from the Government Printer in Pretoria. The Acts are also available on a number of websites such as that of the South African government ([www.gov.za](http://www.gov.za)) or Acts Online ([www.acts.co.za](http://www.acts.co.za)).*

## SUMMARY

By now you should have a clear understanding of the process of motivation, the different motivational theories and how human resource managers can influence the morale of employees. Remember that people differ and that needs and motives are therefore individualistic. Managers should try various approaches to motivation and not believe that one approach will be successful for all employees and in all situations.



## SELF-ASSESSMENT QUESTIONS

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- (1) *A salesman works hard to achieve a sales target. This is an example of:*
  - (a) *Maslow's hierarchy of needs*
  - (b) *a process approach to motivation*
  - (c) *motivation that originates from the satisfaction of doing a job*
  - (d) *the equity theory*
  - (e) *motivation in anticipation of a reward*
- (2) *The correct sequence of needs in Maslow's hierarchy of needs is:*
  - (a) *safety needs; physiological needs; esteem needs; affiliation needs; self-actualisation needs*
  - (b) *physiological needs; safety needs; affiliation needs; esteem needs; self-actualisation needs*
  - (c) *safety needs; physiological needs; affiliation needs; self-actualisation needs; esteem needs*
  - (d) *physiological needs; affiliation needs; safety needs; self-actualisation needs; esteem needs*
  - (e) *physiological needs; affiliation needs; safety needs; esteem needs; self-actualisation needs*
- (3) *Mary is a lecturer at a big university. She is frustrated because her computer is outdated and this results in a waste of time because the computer support services staff have to come and assist her often. She has become so frustrated that she has started looking for another job. This is an example of Herzberg's two-factor theory, which states the following:*
  - (a) *The absence of motivational factors could have a negative effect on employee morale.*
  - (b) *The presence of motivational factors will always have a positive effect on employee morale.*
  - (c) *Employees will be motivated by motivational factors, irrespective of whether the maintenance factors are present.*
  - (d) *The absence of maintenance factors could have a negative effect on employee morale.*
  - (e) *Employees will be motivated by maintenance factors, irrespective of whether the motivational factors are present.*
- (4) *According to Vroom, motivation depends on:*
  - (a) *how much I want something and how likely I think I am to get what I want*
  - (b) *the attractiveness of a specific outcome, my needs, goals and desires and my tendency to act in a certain way*
  - (c) *the attractiveness of a specific outcome and how personal goals are linked to organisational goals*
  - (d) *how much I want something and how personal goals are linked to organisational goals*
  - (e) *how personal goals are linked to organisational goals and how rewards are linked to performance standards*
- (5) *In the equity theory, when input-outcome ratios are unequal, inequity exists and employees will perceive the situation as unfair. They will try to restore equity by:*
  - (a) *resigning*
  - (b) *changing their attitudes*
  - (c) *changing their inputs or outputs*



- (d) *changing the people they compare themselves with*
  - (e) *all of the above*
- (6) *Robert works in a bank. There have been retrenchments and Robert has been assigned more duties at the same level (his job has been expanded). This is an example of:*
- (a) *job enlargement*
  - (b) *job design*
  - (c) *job enrichment*
  - (d) *job reward*
  - (e) *job rotation*



### **Question 1**

*The correct answer is option 5.*

*Refer to section 11.7.2.2 in the prescribed book.*

*When a salesman works hard to achieve a sales target, he is motivated because he expects to receive a reward for his behaviour. Motivation is the internal drive that encourages people to achieve a particular goal and it can be internal or external. Internal motivation originates from the satisfaction that a person experiences when a task is completed or a duty is performed. In the case of external motivation, a person is motivated in anticipation of receiving a reward of some kind.*

### **Question 2**

*The correct answer is option 2.*

*Refer to section 11.7.2.2.*

*The correct sequence of needs in Maslow's hierarchy of needs is physiological needs, safety needs, affiliation needs, esteem needs and self-actualisation needs. The theory assumes that a person attempts to satisfy the most basic needs before progressing to satisfying higher-level needs. A need also ceases to motivate once it has been satisfied.*

### **Question 3**

*The correct answer is option 4.*

*Refer to section 11.7.2.2.*

*According to Herzberg's theory of motivation, things such as office equipment provide maintenance factors for motivation. The office equipment in itself cannot motivate, but the absence of proper equipment prevents Mary from being motivated. Maintenance factors have to be present before motivational factors can motivate employees.*

### **Question 4**

*The correct answer is option 1.*

*Refer to section 11.7.2.4.*

*According to Vroom, motivation depends on how much I want something and how likely I think I am to get what I want. The three key concepts in his theory are valence (the attractive-*

*ness of a specific outcome for an individual), instrumentality and expectancy – the strength of the person’s belief that a certain performance will lead to a desired outcome.*

**Question 5**

*The correct answer is option 5.*

*Refer to section 11.7.2.4 of the prescribed book.*

*Inequity occurs when employees perceive that input-output ratios are unequal (in other words they think they are not paid enough for the effort they put into their work). They will try to restore equity by resigning, changing their attitudes, changing their inputs or outputs or changing the people they compare themselves with.*

**Question 6**

*The correct answer is option 1.*

*Refer to section 11.7.3 of the prescribed book.*

*When an employee is assigned more duties at the same level in the organisation, his or her job is expanded and this is known as job enlargement. When a job is enlarged, more tasks are added but the employee does not receive more decision-making or planning responsibility.*

# TOPIC 3

## The marketing function

### AIM

The aim is to explain the importance of the marketing function to the business, with emphasis on the marketing process and marketing instruments.



#### Learning outcomes

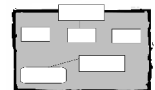
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When you have worked through topic 3 you should be able to:

- demonstrate an understanding of the marketing process by highlighting its components
  - formulate the decisions involved when designing the marketing instruments, by summarising the inherent elements of product, price, distribution and marketing communication decisions
- 

### OVERVIEW OF THE TOPIC

Topic 3 comprises the following study units:



TOPIC 3	
<b>Study unit 5</b>	<b>Study unit 6</b>
The marketing process	The marketing instruments

# Study unit 5

## The marketing process

### Contents

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Key concepts

Learning outcomes

Getting an overview

- 5.1 The nature of marketing and the marketing process
- 5.2 Evolution of marketing thought
- 5.3 Consumer behaviour
- 5.4 Marketing research
- 5.5 Market segmentation, target marketing and positioning

Summary

Self-assessment questions

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### Key concepts

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product	marketing concept
distribution	consumer orientation
marketing communication	social responsibility
price	profit orientation
individual factors	organisational integration
group factors	market aggregation
phases in decision making	target market selection
survey method	single segment approach
sales forecasting	multisegment approach

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### Learning outcomes

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When you have worked through study unit 5 you should be able to:

- analyse the definition of marketing by referring to the keywords
  - demonstrate an understanding of the market offering by highlighting its four variables
  - describe the evolution of marketing thought by highlighting the origin and different approaches
  - analyse the behaviour patterns of consumers by identifying the determinants of consumer behaviour and the consumer decision-making process
  - demonstrate an understanding of marketing research by emphasising how it can be used in scanning the environment
  - demonstrate an understanding of how the consumer market can be segmented by emphasising the components of market segmentation and target market selection
-

## GETTING AN OVERVIEW



Read section 12.1 in the prescribed book.

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The main objective of a business is to maximise profitability in the long term. It is generally recognised that marketing is central to this objective because of its role in defining customer needs and wants and directing the resources of the business to meet these needs. The rapid change in the marketing environment over the past decade has heightened an awareness of the importance of marketing because businesses have had to face increasing competition, economic fluctuations, political changes and the need to become more ecologically conscious. Successful marketers are those who can best satisfy consumer needs in the context of the dynamic environment where threats must be countered and all opportunities grasped in order to survive. One such business is Edgars, who are continually doing research to determine the clothing needs of the different market segments which they target. They then adapt their marketing strategy according to these needs by designing clothes for the different segments, charging prices which these segments are prepared to pay, selling these clothes in stores which are easily accessible to their customers and advertising these clothes in media that are purchased by these customers, such as *FAIRLADY* magazine and the *Edgars Magazine*. This study unit introduces you to the nature and components of marketing, the evolution of marketing thought, the determinants of consumer behaviour, the marketing research process, market segmentation and target market selection.

### 5.1 THE NATURE OF MARKETING AND THE MARKETING PROCESS



Study the definition of marketing in section 12.4 and the relevant keywords in table 12.1 as well as the components of the marketing process in section 12.5.

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Marketing is everywhere. It is something we experience every day of our lives. You switch on the television and there is an advertisement for Omo washing powder on the screen, you stroll down a supermarket aisle and you are handed a coupon for All Gold tomato sauce, while at the end of the next aisle you try a sample of a new brand of fat-free potato chips. At home, you answer a phone call asking you to participate in a survey about radio listening habits and then complete an order form to subscribe to *Garden and Home* magazine.

All these situations involve marketing. Many people mistakenly think of marketing only as selling and advertising, and no wonder, because every day we are bombarded with the above types of messages. Someone is always trying to sell us something. Therefore many students are surprised to hear that selling is only the tip of the iceberg. It is but one of several marketing functions. This does not mean that advertising and selling are

unimportant, but rather that they are part of a larger “marketing mix” – a set of tools that work together to affect the marketing place. Today’s businesses face increasingly stiff competition, and the rewards will go to those who can best read customer wants and deliver the greatest value to their customers. The essence of marketing is the development of exchanges in which businesses and customers voluntarily engage in transactions that are designed to benefit both of them. For example, customers receive benefits from purchasing Crosse & Blackwell’s mayonnaise and Ricoffy, and Nestlé, the company that sells these products, receives benefits by getting money for it.

In order for Nestlé to receive these benefits, it has to be involved in various activities which form part of the marketing process. For instance, Nestlé has to divide the market into segments with more or less similar needs (market segmentation) and it then has to choose those target markets that it wishes to sell its products to (ie the retail market and the catering market). It then has to do market research into the specific needs and wants of these markets in order to develop market offerings that will satisfy their needs. The market offering consists of four variables: the product, the price, the distribution of the products and the promotion messages to sell these products. For instance, when designing its products, Nestlé caters for the retail market with its 100 g, 250 g, 500 g and 750 g tins of Ricoffy, while it satisfies the catering market with its 1,5 kg tin and 25 kg bag of Ricoffy. It sets different prices for the different sizes of Ricoffy. While customers in the retail market can buy the products from stores such as Shoprite and Spar countrywide, Nestlé makes use of agents to deliver its products directly to hotels, hostels, universities and guesthouses in the catering market. Nestlé uses sales representatives and brochures to promote its products in the catering market, while the traditional promotional methods are used to sell its products to the ordinary customer, namely advertising in newspapers and magazines regarding discounts on Ricoffy, attaching coupons and samples of Ricoffy to magazines and offering competitions in which customers can win a motorcar, for example.

By combining these four variables, Nestlé creates a market offering that will satisfy the needs of its many customers.



### Activity 5.1

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Explain the four variables of the market offering which Toyota offers to its customers.



**Product:** *Toyota has many different vehicles that cater to the needs of the different market segments. For instance, the Tazz is aimed at the lower income groups, while the Corolla and Camry are directed at the middle income groups. The Lexus, on the other hand, is aimed at the higher income segments of the market.*

**Price:** *Toyota has set different prices for the different vehicles.<sup>1</sup> The selling price of the Yaris, for instance, starts at R126 900, while that of the Corolla and Verso respectively start at R173 800 and R248 200. The selling price of the Lexus starts at R363 000.*

**Place:** *Toyota’s vehicles are available at dealers countrywide (eg McCarthy Toyota), which makes it possible for customers to buy these vehicles in places that are convenient to them.*

**Promotion:** *Toyota makes use of various methods to persuade the markets to purchase its products, for example advertisements in Car and You magazines, as well as over the radio and on television, the input of knowledgeable salespeople in their dealerships, and competitions in which consumers can win a motorcar.*

## 5.2 EVOLUTION OF MARKETING THOUGHT



Study sections 12.2 and 12.3 in the prescribed book.

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This section describes the changes in marketing thought over the last 100 years or so. It is important to understand what each “school of thought” involves, because many businesses are still “stuck in the past” and unwilling to adapt successfully to the new approaches needed to compete in a changing environment.

The phases in the development of marketing thought are as follows.

### 5.2.1 Operation-oriented management

In the production era the belief was that products would sell themselves, so the major concern of businesses was production, and not marketing, and the needs of consumers were largely ignored. Henry Ford’s marketing of the Model T epitomises this era. He concentrated on making more cars to fill the demand; he said consumers could buy any colour of the model T Ford they liked – as long as it was black!

### 5.2.2 Sales-oriented management

In this era the focus was on selling as much as possible by whatever means. Whether the consumer really needed the product, or whether it really met his or her needs was not important. This sometimes led to unethical sales practices, false claims, false promises, and so on, in order to persuade the consumer to buy. There are still companies today that are basically sales-oriented. Many mail-order businesses advertise products that are not readily available or are not worth the quoted price. Someone once ordered a beautiful pair of gold earrings from a mail-order catalogue. When they arrived, the earrings were so small that she could hardly see them.

### 5.2.3 Marketing-oriented management

In this phase the focus was still on selling, but in a more integrated way. It was a far broader concept than just selling. Consumers developed more sophisticated needs and were financially in a better position to satisfy their needs. There was also a wide variety of competing products from which they could choose. This led management to realise the importance of the marketing function. The packaging, distribution, quality, advertising, and so forth, all had to be integrated to create a certain “image” of the product. The focus was placed mainly on the effectiveness and efficiency of the marketing tasks, and marketing management came to realise that marketing tasks should be performed according to an ethical code or management philosophy. The essence of this **marketing concept** lies in the four principles discussed below.

The first principle of the marketing concept is **profit orientation**. The marketing concept views customer orientation as a means to achieve profit. By providing market offerings

that satisfy customer needs, the business will achieve its own objectives too. These objectives can be expressed in many ways, for example achieving a rate of return of 25% on investment, or achieving a specified increase in profitable volume of sales, or by increasing market share from 10% to 12%. Overall, the objective can be seen as an attempt to survive and grow.

The second principle is that of **consumer orientation**. This means that the customer's needs become a top priority, and that the products and the services offered by the business are based on customer needs. This is often lacking in South African companies. In a worldwide survey, South Africa was rated 23rd out of 24 countries for service orientation. Here's a typical example. The client of a travel bureau was dissatisfied with the service he was receiving from the bureau. Despite the fact that he travelled frequently, his requests for information were often ignored, there were errors in his account, mistakes were made with his bookings, and so forth. He wrote to the bureau to inform them that their service was not up to scratch, and cancelled his account with them. Nobody from the travel agency even bothered to contact him, possibly to persuade him not to cancel his account, or to find out why he was dissatisfied, with a view to rectifying the situation. This business simply ignored the principle of consumer orientation.

Customer-oriented businesses do not consider the marketing task complete once a sale has been made. Such enterprises provide after-sales service. They check up on how satisfied customers are with the product/service and what can be done to enhance that satisfaction.

The third principle is that of **social responsibility**. This covers a fairly wide field and is becoming increasingly important in the modern business world. Social responsibility primarily implies that a business should make a contribution to the community with whom it does business. Companies donate funds for community projects such as schools, conservation programmes, welfare activities, and so on. For example, by sponsoring the Addo Elephant Park, Total and Ford succeeded in establishing their brands in the market as brands that care for the environment. Social responsibility also entails sponsorship of sporting competitions, thus enabling both players and spectators to enjoy their sport. And of course it is an opportunity for the business to advertise its products, giving it some return on its contribution. By sponsoring the 2004 South African Olympic bid, Pick n Pay showed their commitment to sport and the development of sport in South Africa.

But social responsibility goes further than merely contributing financially to the community. It also requires a business to be law abiding. This can range from absolute openness and honesty in its business operations (eg not taking or offering any bribes) to taking care not to harm the environment (eg by polluting the atmosphere with smoke, or dumping waste material in rivers). When a business adheres to the principle of social responsibility it will try not to offend the morals, values and religious beliefs of the community. A liquor company that encourages teenagers to buy its products would, for example, arouse a good deal of indignation from parents in the community – and they might boycott the products of such a business.

Read the extract below and decide whether you think Engen demonstrates the principle of social responsibility.<sup>2</sup>



Engen, a subsidiary of Malaysian group Petronas, would be charged with violating South Africa's anti-pollution laws, a government official said yesterday.

Investigations by members of the South Durban Community Environmental Alliance found that sulphur dioxide emissions from Engen's refinery in Durban exceeded the maximum permissible levels of the World Health Organization (WHO) 64 times in over a month.

The refinery's operating permit stipulates it may not breach the WHO's guidelines more than 35 times in one year.

The fourth principle is that of **organisational integration**. This implies that every function, department and individual need to be marketing oriented – that is, they must continually be aware of how their actions will affect the image of the business. A telephonist, for example, may not have anything to do with the selling of the business's products, but she is often the first contact a potential customer has with the company. Thus, how she answers the telephone (and how promptly) leaves a lasting impression on the caller about the efficiency of the business as a whole. If a potential client has to wait long before the phone is answered and even longer to be put through to the right person, there is a good chance that she will hang up, and call a competitor.

Organisational integration is particularly important when it comes to cooperation between departments. Imagine the chaos if Daimler Chrysler's marketing department promises a customer that she will receive the ordered vehicles by a certain date, and the production department does not bother to manufacture those vehicles on time. Internal conflict, poor service, and even loss of sales, may be the result.

#### 5.2.4 Consumer-oriented management

The focus of this approach shifted away from marketing, and went one step back – to the consumer. It started with product design. What were the needs of the consumer? How should the product, quality, distribution, and so on, be designed to meet the needs of the consumer? Mecer, for instance, first determine the needs of their different target markets and then design their computers accordingly. This approach includes the marketing orientation, but broadens it considerably.

#### 5.2.5 Strategic approach to marketing

The focus here is an extension of the consumer-oriented approach, but places even more emphasis on the long-term relationships with the consumer, supplier and even competitor. It extends into the field of public relations where a positive relationship with the community itself is fostered. Note that relationship marketing is not a separate approach; it is part of the strategic approach to marketing.

## 5.2.6 Relationship marketing

In order to survive in a changing environment, it is important to maintain long-term relationships with individuals, businesses and other institutions. An insurance salesperson or an estate agent who maintains contact with a client after a transaction has taken place increases his or her chances of doing business with the client again at a later stage.



### Activity 5.2

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Do you think Pick n Pay, the largest retail grocery chain in South Africa, applies the marketing concept? Give reasons for your answer.



*Pick n Pay definitely applies the marketing concept because it applies all four principles of this concept.<sup>3</sup> For instance, it follows the consumer orientation principle. Raymond Ackerman is portrayed as the homemaker's friend and his motto is "the customer is queen". Pick n Pay's quick reaction to matters that affect the consumer also shows its consumer orientation. Its reaction to increases in the bread price is but one example of this consumer orientation that has positioned it as a fighter for the interests of the consumer. Regular surveys are also conducted to determine customers' satisfaction with the service and products offered.*

*It also adheres to the profit orientation. The fact that the company has managed to increase its turnover in the past three years from R18,8 billion to R29,3 billion and has succeeded in acquiring approximately 30% of the formal sector grocery market proves that it retains a winning formula. The principle of organisational integration is also followed since all the different departments work together to achieve objectives and to satisfy customer needs. For instance, Pick n Pay's marketing section will not advertise a discount on Skip washing powder if the purchasing department has not purchased an adequate quantity of Skip.*

*Pick n Pay also shows its responsibility towards society by sponsoring various educational and charitable events. It is very visible in athletics, sponsoring the Comrades Marathon as well as cycling, for example the Pick n Pay Cycle Challenge and the Argus Pick n Pay Cycle Tour.*

## 5.3 CONSUMER BEHAVIOUR



Study section 12.7 in the prescribed book.

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We have emphasised over and over again that a business should satisfy the needs of consumers. So marketers have to know what their customers need and want. They also have to know how their customers make their decisions about buying and using products.

Elizabeth, the mother of two, enters Buyrite, a supermarket, to do her weekly grocery shopping. She has prepared a grocery list at home and walks down the aisles, selecting the needed products from the shelves. When she gets to the aisle in which the cold drinks are kept, she selects Coke for her husband and son, Liqui-Fruit for herself and remembers that her daughter prefers Energade. She then walks to the cereals and selects Rice Krispies for her daughter, Weetbix for her son, and mealie-meal porridge for her husband and herself. She then continues and walks down the toothpaste aisle, and remembers that a friend recommended a new toothpaste and decides to buy it. Elizabeth then remembers an advertisement for a new deodorant called Fresh, and adds it to her trolley.

From the example above, it is clear that Elizabeth is continually influenced by her own needs and preferences, as well as those of her family and friends and the advertisements she has seen. When she does her shopping, she is a consumer who is satisfying certain needs. Marketers need information about Elizabeth and all other consumers. They need to know Elizabeth's needs and preferences and why she has those needs and preferences. When this information is known, marketers can try to satisfy these needs with their particular products.

### **5.3.1 Determinants of consumer behaviour**

From the above it is clear that marketers need to investigate the factors that will influence consumer behaviour. Two sets of factors influence consumer behaviour: individual factors and group factors. To help you remember these factors, we shall summarise each one briefly:

#### *5.3.1.1 Individual factors*

- **Motivation.** The consumer has specific needs that will motivate his or her purchasing behaviour. For instance, in order to be pretty and to be loved by her boyfriend, the young girl buys Estée Lauder cosmetics.
- **Attitudes.** Attitudes may be positive, neutral or negative, depending on the consumer's experience of the product. For instance, the teetotaler has a negative attitude to liquor. He does not even read advertisements for brandy and never considers buying it.
- **Perceptions.** Our perceptions are formed by the ways in which we observe stimuli in the environment by looking, listening, smelling, touching and tasting, and then interpreting the stimuli by attributing meaning to our observations. The young man sees an advertisement for Camel cigarettes. His interpretation is that smoking demonstrates masculinity and he buys a packet of Camel.
- **Learning ability.** This refers to our ability to grasp and remember the marketing message. The housewife learns through experience that Cobra floor polish will put a shine on her floors. She remembers to purchase Cobra on her next shopping trip.
- **Personality.** This refers to the inherent characteristics (eg moods) of the consumer that will affect the way he or she behaves with respect to the buying process. A self-confident person buying a new suit is less likely to seek out and rely on the advice of friends and salespeople than a person who lacks self-confidence.

- Lifestyle. The consumer's lifestyle is the typical way of life (eg habits) with regard to social behaviour, leisure activities, and so on, that will influence the consumer's response to the product offering. Your lifestyle may be to buy books, travel overseas frequently, live in a gracious home, play golf and read the *Financial Mail* and other business publications.

#### 5.3.1.2 Group factors

- Family. Family members have a major influence on the consumer's behaviour. Children under 12, for instance, are most influential in purchases of breakfast cereal, snack foods, sweets, soft drinks, games and toys, clothing, music and toothpaste.<sup>4</sup>
- Reference groups. These are groups that positively or negatively influence our attitudes or behaviour. For example, teenagers typically use their friends as a reference group for deciding which clothes are attractive.
- Opinion leaders. This is a reference person to whom others will look when forming opinions and taking consumer decisions. An advertisement which shows a well-known actress who uses Lux soap will influence those consumers who admire the actress to buy Lux soap.
- Cultural group. The norms and values of the consumer's culture determine his or her priorities in respect of different activities and products. South Africa has many different cultural and subcultural groups. Marketers should be careful not to use symbols in advertisements that can be interpreted incorrectly or differently, and not to portray unacceptable behaviour patterns. Some black and white cultural groups, for example, interpret advertisements differently. For example, flowers have special significance in the white culture, but in many black cultures, gifts in the form of flowers are frowned upon. The well-known Five Roses advertisement which said "And the fifth rose is for you" was thus not successful when used in media aimed at black consumers.<sup>5</sup>

### 5.3.2 Consumer decision making

The consumer decision-making process consists of five phases through which the consumer progresses systematically. The first phase is the **awareness of an unsatisfied need**. The process by which consumers buy products and services begins with a recognised need. Suppose you have a computer, but you begin to realise that it is not adequate for your university work. It is too slow and it does not have a CD-ROM drive, which you need to view your interactive business management study guide. You decide to use some of your savings to buy a new computer with a CD-ROM drive. You then progress to the second phase of the decision-making process: **gathering information on how best to solve the problem**. Now that you are aware that you need a computer with a CD-ROM drive, you gather information to help you make the buying decision. You may turn to information you already have, recalling your prior experiences or those of friends making similar decisions. In this case you have not made a similar purchasing decision; so you may search for more information from external sources such as family members, advertisements and salespeople. After you have gathered all the relevant information you move to the third phase, which involves **the evaluation of all possible solutions**. You now have to sort all the information collected into such categories as price, service and warranty. Additional categories, such as RAM speed, the availability of alternative CD-ROM drives and competing brands, may be added as you talk to other people and

compare models. After you have evaluated all your information, you now have to **decide on a course of action**. You have to stop searching for and evaluating information and turn to the choice of a buying alternative. You need to reach a satisfactory compromise regarding product features and other factors. For example, you may be willing to pay a higher price to get a built-in CD-ROM drive or you may choose a computer with a CD-ROM writer (one that can write data to CDs). You may also choose the store where you have an account, or you may choose the store where your best friend is a salesperson. Once you have made all your decisions, you purchase your new computer. The last phase in the consumer decision-making process is **post-purchase evaluation**. During this stage you will evaluate your decision and use this evaluation for future decision making. If you are unhappy with your new computer, you will not buy the same make or model again.



### Activity 5.3

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Describe the phases of consumer decision making through which you will progress when purchasing a new car.



The phases are:

- *Phase 1: Awareness of an unsatisfied need or problem. Your old car might break down for the fifth time in one month. This indicates the need for a new car to you.*
- *Phase 2: Gathering information on how best to solve the problem. You collect information regarding motor vehicles that you can afford, for example the Toyota Tazz and Ford Focus. In order to collect this information you consult friends, motorcar dealers such as McCarthy Toyota, magazines such as Car and advertisements which appear in newspapers and magazines and on television.*
- *Phase 3: Evaluation of all possible solutions. You compare and evaluate the information regarding the different makes and models, for example price, colour, engine size, air bags, central locking and other features of the car.*
- *Phase 4: Deciding on a course of action. You decide whether to buy or not. If you decide to buy, you also decide on the make and model to buy and the dealer to buy it from. You might decide to buy the Toyota Tazz from Motorcity because they have offered you the best price.*
- *Phase 5: Post-purchase evaluation. You might doubt whether you have made the correct decision. Your experience with your Toyota Tazz will influence your future decisions regarding the purchase of Toyota motor vehicles.*

## 5.4 MARKET RESEARCH



Study section 12.6 in the prescribed book.

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It is simply not possible to keep up with all the changes taking place in the market. This means that marketers have to rely on help from marketing research. For example, a business may want to know something about its competitors or to gain an unbiased understanding of its own customers. Such information needs may require an independent investigation through marketing research. See below for examples of how research can produce results.<sup>6</sup>

### Examples of how research can produce results

- A local award-winning marketing tool, the brand value index, is enabling manufacturers to have their products assessed by a sample of people, and from the results, predict market share. The index was used to determine the value and ideal positioning of the Jetta brand when a new model was introduced a few years ago. A new model Jetta was flown in from Germany prior to the South African launch. People were invited to a "car clinic" to view the car, which was stripped of identifying marks. No test drives were permitted but the subjects were able to sit in the vehicle and view it from all sides, and then, by questionnaire, to rate the car.

The index provided feedback from customers as well as non-customers. To increase market share effectively, it was essential to understand and address the shortcomings of the brand from the perspective of people who were not buying it. The feedback also revealed where in the purchasing process the brand was eliminated.

The results indicated that most people (85%) buy cars for emotional reasons like appeal and image. Only 15% make a purely rational decision when buying a car: that it will get them from A to B reliably and economically.

The pre-launch market share forecast for the Jetta was very accurate, with a 0,1% point difference between actual and predicted market penetration.

- NutraSweet's patent on the artificial sweetener, Aspartame, was due to expire. The company faced disaster as chemical and sugar companies planned to enter the market. NutraSweet analysed competitors' prices, customer relations, expansion plans and advertising campaigns. The company used this information to cut costs, improve service and preserve most of their market. They managed to maintain an 80% market share.

It is important to understand that sound marketing decisions will always be based on reliable information about the market, the environment, as well as the business and its resources. Often that information can be obtained from existing sources such as technical journals, newspaper reports, sales figures, financial reports and the like.

Sometimes, however, the required information can only be obtained by means of a survey – either internally (ie to gather information about the business itself) or externally (ie to gather information about the market). Section 12.6.2 of the prescribed book describes the steps involved in conducting a scientifically based survey.



#### Activity 5.4

Write out the steps with keywords and make sure that you understand what is involved in each step.

The interpretation of the data gathered in a market survey will lead to a sales forecast. This forecast is essential to determine whether the marketing of the product is likely to

be profitable or not. However, a sales forecast alone is not enough. The business also has to make a profit forecast over a longer period of time to determine whether it is worth going ahead with the production and marketing of a particular product.

## 5.5 MARKET SEGMENTATION, TARGET MARKETING AND POSITIONING



Study sections 12.8 and 12.9 in the prescribed book.

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Market segmentation is part of the three-phase STP process. STP is the abbreviation for segmentation, targeting and positioning. Market segmentation deals with an aggregated process that clusters people with similar needs into a market segment. Targeting deals with the process whereby a marketing mix is tailored to fit some specific target customers, while positioning deals with the way customers perceive proposed or present products or services in the market.<sup>7</sup>

Market segmentation is the process in which the total heterogeneous market is divided into smaller, relatively homogeneous groups of consumers with relatively uniform characteristics and needs.

Why is market segmentation important? Simply because it is very rare that one product can satisfy the needs of everyone in the consumer market. We are all different – we have different needs, different tastes, different interests, and so on. That is what the word “heterogeneous” means. The purpose of market segmentation is to identify consumers within the total consumer market that have similar needs, tastes, interests and so on – in other words, to identify a homogeneous group. Even in such a group, the consumers will not all be the same – that is why we refer to a relatively homogeneous group.

Note the three possible approaches to market segmentation:

- Market aggregation. This is the total market approach where all consumers are considered to be relatively homogeneous. (This is in fact not market segmentation.) As mentioned above, there are not many products that will satisfy the needs of everyone in the consumer market. Marketers of basic commodities like salt and sugar usually have this total market approach – but such products are definitely in the minority.
- Single segment. In this approach the marketer identifies one single group and directs the product offering only to that particular segment. Some game lodges in South Africa direct their product exclusively to the overseas tourist, to the point where their rates are quoted in US dollars. Obviously local tourists can also stay at these lodges, but the marketing message is not really aimed at them.

Another example of a company that uses the single segment approach is Fisher-Price. Although they market over 400 products, they focus on toys for children of six years and under. The *Daily Sun* also directs its newspaper at only one target market, namely

urban adults throughout South Africa who are English-literate, reasonably educated and fiercely patriotic.

- **Multisegment.** In this approach the same product is aimed at different market segments. The marketing of a small car may be directed at young people (ie one market segment) and may therefore be advertised as “sporty” and “trendy”. It may also be directed at housewives (ie another market segment) as “the ideal economical second car”. The same product is therefore directed at more than one market segment with a different marketing message to each segment. Rooibos tea, for example, is also marketed in this way. It is directed at black consumers of all income levels in the age group 16–34 years as well as at white consumers of all income levels in the same age group, with a different promotion strategy being directed at the two target markets.

There is no single way to segment the market. Marketers must use different segmentation variables to describe the market structure. When developing a segmentation strategy, the important step is to select the correct basis on which to segment the market, namely demographic, geographic, psychographic and behavioural criteria.

**Demographic** criteria are used to divide the market into groups based on variables such as age, gender, income, education and race. For example, products such as clothing, perfumes and toiletries are marketed differently to men and women.

**Geographic** criteria are used to divide the market according to geographical locations such as provinces, cities and towns. The example below illustrates how King Pie has divided the market into different segments using both geographic and demographic criteria.<sup>8</sup>

#### **King Pie’s use of geographic and demographic criteria**

King Pie has realised that although the South African market is united in its love of pies, there are geographical, ethnic and economic considerations that have prompted it to fine-tune its range of products and cater to targeted groups in some areas. For example, the consumer market in KwaZulu-Natal demands a “hotter” pie and sales of curried pies are high. Some Western Cape franchises have converted to the halaal requirements to service their market sector. The Western Cape market prefers mutton to beef, and adjustments to that effect have been made. The pricing of pies has also come under the spotlight, with “poorer” areas requesting a cheaper pie, while the more discerning pie customer wants a bigger and more substantial pie and is quite willing to pay more for it.

While demographic and geographic segmentation are relatively simple to understand, they do not directly consider the needs and wants that lead people to make purchases. In an attempt to more specifically identify the consumers who would be interested in particular products, marketers have developed **psychographic** segmentation that assists them to understand the lifestyle, personality and social class characteristics of the target market.



### How Frito-Lay uses psychographic criteria

Frito-Lay, the snack marketer, conducted research that identified two broad categories of snackers, which it called Compromisers and Indulgers. The Compromisers are typically female and are relatively likely to exercise, read health and fitness magazines, be concerned about nutrition, and read product labels. Frito-Lay appeals to this group with its Baked Lay's potato chip, a reduced-fat snack. Frito-Lay's traditional potato chips are targeted at the other psychographic category, the Indulgers, who are mostly male, in their late teens and early twenties, snack heavily, feel unconcerned about what they eat, and hesitate to sacrifice taste for a reduction in fat.

Marketers also segment consumer markets in terms of various purchase behaviours such as product usage rate, brand loyalty status, price sensitivity and product benefits sought. These variables are known as **behavioural** criteria. See below for an example of this type of segmentation.

### Campbell Soup's use of behavioural criteria

To target its marketing efforts, Campbell Soup Company conducted research into the usage rate and loyalty status of its customers. The company used this information to divide them into four groups, namely "most profitable" (most loyal, frequent and consistent customers), "profitable" (these customers ranked second in each category), "borderline" (customers who ranked lower than the profitable consumers) and "avoid" (consumers who are least likely to buy, and who select the product on the basis of price).

Campbell's researchers concluded that the "most profitable" group was over three times as profitable as the "borderline" group, making it the focus of the company's marketing efforts.

Once the market has been divided into smaller homogeneous segments according to the segmentation criteria, the marketer has to identify a segment that looks promising as a **target market**. The objectives and resources of the business have to be carefully considered before a target market can be selected.

**Positioning** is the last phase in the STP process. A product's positioning is the place the product occupies in the minds of customers. Through product positioning, marketers influence the manner in which customers perceive the characteristics of the brand relative to those of competing products. The intention is to influence demand by creating a product with specific characteristics and a clear image that differentiates it from competitors. Kulula.com has for instance positioned itself as a low-fares airline compared to many of the other airlines in South Africa. Their well-known slogan "Now anyone can fly" clearly reflects this image.



#### Activity 5.5

Identify and analyse the various criteria according to which a market segment for luxury, upmarket furniture can be selected.



These criteria are:

- **Demographic:** refers to the objective characteristics of consumers, that is factual data like age, income and gender. One would think that for upmarket furniture, the lower income groups should be excluded.
- **Geographic:** refers to consumers living in the same geographical area. Marketers could target consumers in upmarket areas of the different provinces, for example in Gauteng (eg Waterkloof in Pretoria and Sandton in Johannesburg) and the Cape (eg Camps Bay in Cape Town)
- **Psychographic:** refers to subjective characteristics of consumers, that is data that are difficult to classify factually, for example personality, lifestyle and social class. In this case, it is assumed that only consumers from more affluent social groups could be targeted.
- **Behaviouristic:** refers to the things that consumers do when purchasing a particular product, for example how often they buy, how sensitive they are to price or quality, how loyal they are to a brand, and what benefits they seek. Marketers could aim at consumers who want the benefit of prestige when they buy the upmarket furniture.

**NB:** Identifying the characteristics of consumers in a particular segment leads to a segment profile.

## SUMMARY

You now have basic insight into the factors that influence the marketing process. In the next study unit you will study the marketing instruments. These are product decisions, price decisions, distribution decisions and marketing communication decisions.



## SELF-ASSESSMENT QUESTIONS

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- (1) *The process of consumer decision-making progresses systematically through different phases. Place these phases in the correct sequence:*
  - (a) *becoming aware of an unsatisfied need*
  - (b) *evaluating possible solutions*
  - (c) *seeking information on how to solve the problem*
  - (d) *deciding on a course of action*
  - (e) *doing post-purchase evaluation*
  - (1) *b a c d e*
  - (2) *a d c b e*
  - (3) *a d b c e*
  - (4) *a c b d e*
- (2) *Which of the following statements on market segments are wrong?*
  - (a) *In a market segment, members share common preferences.*
  - (b) *Such members have different consumption patterns.*
  - (c) *Members make similar product choices.*
  - (d) *The marketer selects a target market from a number of segments.*
  - (e) *A marketer often has only one target market.*
  - (1) *a b*
  - (2) *b e*
  - (3) *c d e*
  - (4) *a b d*
  - (5) *a b c d e*

- (3) You are interested in starting a cosmetics company which sells different ranges of cosmetics. How can you use demographic segmentation to segment the market for your products and to determine who your customers will be?



### Question 1

The correct answer is option 4 (a c b d e).

Every time consumers take a decision to purchase, risks are involved. For example, if the product is not up to standard or does not work as the consumers expect it to, they feel they have wasted their money. There are also social risks involved in deciding to purchase a product. Marketing management must know how consumer decisions are reached. Consumer decisions are not made suddenly, and so the process of decision making progresses systematically through sequential phases.

In phase 1, consumers become aware of a problem or an unsatisfied need (statement a). Consumers realise that they can resolve the problem or satisfy their need by making a certain purchase.

In phase 2, consumers look for information on how best to solve the problem (statement c). They consult friends and look around in shops, and so forth. Of course, the marketer must ensure that this information is available to these prospective consumers in order to make a sale.

In phase 3, consumers evaluate all the possible solutions (statement b). This evaluation involves consideration of certain criteria such as price, quality and other aesthetic qualities, and then they gauge the contribution which the product will make to their need satisfaction and lifestyle.

In phase 4, consumers must decide on a course of action (statement d). If consumers intend to purchase the product, there is no definite proof that they will in fact purchase. Therefore, the marketer should encourage them to purchase through persuasive advertising and perhaps allow terms of payment, because doubtful consumers could suddenly decide against purchasing.

In phase 5, consumers make a post-purchase evaluation (statement e) to assure themselves that the purchase was a good one. Satisfied consumers will usually advise their friends to make the same purchase themselves, a situation which could boost sales for the marketer.

If your answer was wrong, please refer to section 12.7.2 and figure 12.4 in the prescribed book.

### Question 2

The correct answer is option 2 (b e).

A specific market offering does not satisfy the needs of only one individual but rather the needs of a group of consumers, known as a market segment. A characteristic of market segments is that their members are homogeneous in such respects as demographic and behavioural criteria (see table 12.2). Therefore, in a market segment, members have common characteristics and preferences (statement a).

Statement b is wrong because members of a segment have similar consumption patterns, as explained in the paragraph above. Likewise, as in statement a, members in a particular segment will make similar product choices (statement c).

From all the many different market segments, the marketer carefully selects a target market (statement d), or even several target markets.

*It seldom happens that a business has only a single target market: there could be more than one. So statement e is wrong.*

*If your answer was wrong, please refer to section 12.8 in the prescribed book.*

### **Question 3**

*You can use different demographic variables to segment your market. The table below indicates some of the criteria that you can use.*

<i>Age</i>	<i>13–28; 29–45; 46–55 and older than 55</i>
<i>Gender</i>	<i>Male and Female</i>
<i>Income</i>	<i>Middle and higher income groups</i>

*You could decide to focus on the female, middle income segment of the market and to concentrate on the older age groups, for instance the 46–55 group and the above-55 group. Your products should thus cater to the needs of these groups, for instance cosmetics which help reduce wrinkles and sun damage. Your prices should be moderate and your promotion messages should emphasise the age-defying properties of your products.*

# Study unit 6

## The marketing instruments

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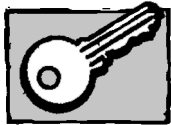
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### Key concepts

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product offering	price determination
consumer products	final price adaptations
brand decisions	distribution channels
packaging decisions	channel leadership
kinds of packaging	market coverage
packaging design	advertising
product differentiation	personal selling
product obsolescence	sales promotion
multiproduct decisions	publicity
new product development	product life cycle
public relations	

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### Learning outcomes

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When you have worked through study unit 6 you should be able to:

- describe the composition of a product by identifying the components and classification categories of consumer products
- analyse the product decisions that form part of the marketing strategy of a business by highlighting decisions regarding the brand, packaging, product differentiation, obsolescence, and multiproduct and new product decisions
- explain how price decisions are taken in a business by summarising the price determination process and adaptations to the final price
- demonstrate an understanding of the distribution strategy of a business by highlighting decisions regarding the choice, channel leadership and physical distribution activities

- describe the marketing communication elements that can be used to communicate with consumers by summarising decisions regarding advertising, personal selling, sales promotion, publicity and public relations
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## GETTING AN OVERVIEW



Read section 12.10 in the prescribed book.

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A marketing mix is a combination of strategic tools used to create value for customers and achieve company objectives. There are four primary tools or elements in a marketing mix: product, price, distribution (placement), and promotion. All successful businesses include these four elements in their marketing strategies. For instance, McDonalds offer a wide variety of products at different prices, from Quarter Pounders to MacChickens. They have outlets in most suburbs, where it is easy for customers to park or drive in and place orders, and they use many promotion methods to persuade customers to buy their products, from advertisements on radio, television and magazines to sales promotions such as competitions and discounts. This study unit focuses on these four marketing instruments: product, price, distribution and promotion.

## 6.1 PRODUCT DECISIONS



Study section 12.11 in the prescribed book.

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A product is a bundle of perceived tangible and intangible attributes that has the potential to satisfy present and potential customer wants and is received in exchange for money or other considerations. A person who goes for psychiatric counselling receives an intangible service, while a person who buys a packet of paperclips buys a tangible product. In between these two extremes, a person who buys a restaurant meal receives a combination of an intangible service and a tangible product. Practically all the products we buy are a combination of an intangible service and a tangible good. A product is thus more than the physical article itself. It is the total package, which includes the service that goes with it (eg the guarantees), the image of the product (eg the latest fashion shoes that show the owner is "with it") and the packaging (eg a high quality gift wrapping that adds to the "value" of a gift).

When planning an effective marketing strategy it is important to classify the type of consumer product being marketed. (Please note that the prescribed book concentrates mainly on consumer products, which often differ from industrial and agricultural products.) Consumer goods may be classified on the basis of consumer buying habits, even though a watertight classification is not always possible, since the same product may be a luxury speciality product for one customer and a shopping product for another. One consumer may insist on buying only Youth Dew perfume from Estée Lauder. For her, perfume is

a speciality product. Another consumer may try out several perfumes before deciding which one to buy. For her, perfume is a shopping product. The question the marketer of perfume has to answer is: Do most women insist on a specific brand of perfume, or do most of them “shop around”? The answer is that for most women, perfume is a speciality product, since most of them insist on buying a specific product.

Each product has a **life cycle** that goes through four phases: the introductory phase, growth phase, maturity phase and declining phase. The actual cycle may vary from product to product, as illustrated in figure 12.9 of your prescribed book, but the product will eventually go through all four phases. For some products this life cycle is very short, especially when it comes to fashion. For some products the life cycle may be very long.

Take the example of Pepsi-Cola. The product went through a declining phase in South Africa some years ago, but right now is in a revival cycle. How long will we still have Pepsi on the market? Who knows?

One of the most important attributes of the product is the **brand**. A brand is a name, term, design, symbol, or any other feature that identifies one business’s product or service as distinct from those of other businesses. Customers often say “I’d like to buy a Volvo”, or “I have a craving for a Big Mac” or “We could really improve our presentation if we used Powerpoint”. These are all brands that differentiate the products from those of competitors. When a customer becomes committed to buying the same brand over and over again, this is known as brand loyalty. Most consumers are brand loyal to one brand when they purchase certain products such as cigarettes (eg Marlboro), mayonnaise (eg Crosse & Blackwell) and toothpaste (eg Colgate).

Brands can be classified according to the ownership of the brand. A **manufacturer’s brand** is a brand that is owned and used by the producer of the product, for example Levi jeans. A brand that is owned and used by a reseller (such as a retailer and wholesaler) is called a **dealer brand**, for example Donna Claire is used by Foschini. Many stores also stock **generic brands**, which are products named only by their generic class. Supermarket shoppers can find products ranging from paper towels to dog food to peanut butter packaged as generic products. Their packages bear no brand names or other seller identification, simply the type of product and any required information, such as ingredients on food items.

Companies have different options for their branding strategies. The option known as a family brand is a brand that is applied to an entire product mix or to all the products in a particular line. Gillette Company uses the family brand Gillette Series for a line of men’s shaving products, deodorants and aftershaves. To benefit from consumers’ positive views of Gillette’s sensor razor, the company advertises the Gillette Series with the same slogan used for the razor: “Gillette. The best a man can get.” A consumer who likes the sensor razor might be favourably predisposed to try Gillette’s other men’s shaving products. Companies can also use an individual brand for each product item, for example SAB Miller has Amstel, Carling Black Label and Hansa Pilsener.

### **Coke still making a name for itself<sup>9</sup>**

For the ninth consecutive year, Coca-Cola is the world's most valuable name, with more than 60% of its market capitalisation ascribed to the value of its brand – an estimated \$68.7 billion. This is according to the 2009 Business Week's annual ranking of the 100 Top Global Brands, undertaken with consultancy Interbrand.

IBM took second spot and Microsoft was labelled the world's third most valuable brand. All three leading beverage brands – Coke, Pepsi and Nescafé – are among the top 25 best global brands.

The rankings of the 100 Top Global brands rewarded companies that "ruthlessly" focused on every detail of managing their brands. Among the top gainers are Google, Amazon and Zara, with a 25%, 22% and 14% rise in brand value respectively. However, there were brands that fell right off the list of top 100 brands. These include Merrill Lynch (which ranked no 34 in 2008) and AIG (which ranked no 54 in 2008) – not only did they fall off the list; both brands required emergency assistance from the US government.

The recession presented brand stewards with the most severe test of their careers. Companies had to adjust rapidly as consumers re-examine their purchases and re-think brand loyalties. Marketing executives are balancing the temptation to chase short-term gains with discounts and promotions against the risk of cheapening their brands over the long term.

Coca-Cola's edgy campaigns continue to push boundaries, showing the rest of the marketing community what it really means to manage a brand. In 2009, the company expanded its Coke Zero brand to 107 countries and launched a new message for its marketing campaign. The campaign, "Open Happiness", was targeted to consumers longing for comfort and optimism in a tough time.

The fact that you show preference for specific brands (ie brand loyalty) is an obvious advantage for the marketer, since you will make a point of purchasing that specific brand each time.

The **packaging** of a product generally bears a label displaying the characteristic brand and other important information. Try to think of consumer goods with characteristic packaging that you normally select in preference to competing products. For example, you may know someone who prefers Kraft margarine for no other reason than the fact that once the margarine has been used up she can use the container for other purposes. Someone else may prefer another product because the packaging contains a competition or a recipe. Section 12.11.5 in your prescribed book provides many practical examples of the different kinds of packaging and package designs that can be used by companies.

The method used by a marketer to differentiate his or her product from those of competitors is referred to as **product differentiation**. It is extremely difficult to cultivate brand loyalty if a product cannot be distinguished clearly from its competitors. For example, a box of matches seldom has any product differentiation. One brand of matches is as good



as another, and very seldom will a person ask for a specific brand when buying a box of matches. But when it comes to a product like cigarettes, smokers don't simply ask for a packet of cigarettes – they ask for a specific brand. Where airlines are concerned, customers choose Kulula.com because its airfares are lower than many of the other airlines in South Africa.

Many marketers make use of **product obsolescence** in order to “compel” customers to make repeat purchases. That is why motorcar manufacturers change the shape of their cars every now and then. This “forces” car owners to purchase the newer model because “nobody wants to be seen driving an old model”.

Note the **multi-product strategies** described in section 12.11.8. This gives you an indication of some of the decisions that management have to make about the products of the business. You should also be able to describe the differences between product range extension, product diversification and product withdrawal. Johnson & Johnson extended its product range when it added its cradle cap treatment to its range of baby shampoos, creams and baby powder. Sony Corporation, on the other hand, diversified when it entered into a whole new field of digital cameras, competing with large companies such as Nikon, Canon and Pentax. Volkswagen followed a product withdrawal strategy in 1975 when it dropped its popular Beetle. However, its sales declined so much that it is now trying to reverse the decline by introducing a new version of the Beetle.

The **new product development process** is the series of activities by which a business generates new product ideas, evaluates them and develops them into new products that enter the marketplace. There is no way to guarantee that all new products will succeed. However, being systematic about developing new products increases the chances of success. Section 12.11.9 in your prescribed book indicates the phases in the new product development process.



### Activity 6.1

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Most of us have favourite brand names. Perhaps your favourite brand for ice cream is Nestlé, for example. Write down the brands to which you (or some of your friends and family) are loyal when it comes to purchasing different products.



*For example:*

- *My husband's favourite beer is Castle.*
- *My son's favourite ice cream is Dairy Maid.*
- *When I fill my car up with petrol, I always go to Shell service stations.*
- *I buy only Liqui-Fruit juice for my family.*
- *I only use Omo washing powder for my family's laundry.*
- *My husband buys only Nike tennis shoes.*

## 6.2 PRICE DECISIONS



Study section 12.12 in the prescribed book.

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Price is the only marketing instrument that generates an income for the business. The price that is paid by the consumer represents the income generated for the business. If the price is set too low, the business will have difficulty surviving and if this situation continues for an indefinite period, the business will go bankrupt. Avia, Phoenix and Sun Airlines are South African examples that bear testimony to this.

As far as consumers are concerned, the price that they pay must provide some form of value – thus a consumer buys the value of what the product can do for him or her. For example, a consumer who pays R450 for a Black & Decker drill is buying not only the drill, but also the value that the drill can provide (ie a hole in the wall, or a nicely buffed car).

Businesses follow a price determination process when setting prices. A **cost price** is set first of all. The price of a product must be high enough to cover the total cost of production and marketing. The **market price** is the price of competing products on the market, or the price that consumers are willing to pay. Businesses may set prices below, at or above those of competitors. Campbell's Soup has for instance been the low cost leader in the canned soup market because it has set its prices lower than those of competitors. The **target price** is the price that will reach the target rate of return. Lastly, the **final price** is set, which is a reconciliation of the market and target price. This is the price which is offered to consumers.

Once the final price has been set, certain adaptations have to be made. For instance, a **skimming price** can be set when a new, unique product is launched on the market such as Nevirapine, the pharmaceutical product that helps prevent the transmission of HIV/Aids from mother to child. The pharmaceutical company selects a high price to recover the costs of research and development as soon as possible – skimming the cream of rich profits. The opposite of a skimming price is a **penetration price**. Here an introductory price is set relatively low to gain deep market penetration quickly. For example, consumers are more likely to buy an innovative new sugar substitute if the price is low.

Another method used by companies is to set the price at the **market price level**, in other words at the price at which competitors' products are selling. A company can also use **leader prices**, which involves promoting one product at a sharply reduced price in the expectation that it will attract customers who will then purchase other items. Supermarkets, for example, often use milk as a leader because of its wide use, perishability and well-known regular prices. Clothing stores might select a jacket as a leader because it has many complements (ie trousers, ties and shirts). **Odd prices** are prices that are set a few rands or cents below a round number. For example, the price of a packet of Flings chips may be set at R1,69 a bag and the consumers of the chips think of the bag of chips as costing R1 and 60 something cents, rather than R2. Some businesses also use **bait prices**, which is the practice (often illegal) of advertising a product at a very low price to attract consumers, only to persuade them to buy a higher priced item when they respond. A

furniture store might, for example, advertise a recliner chair at a very low price, but a consumer who comes to inspect the chair will be talked out of buying it by the salesperson who points out its faults and discusses the advantages of buying a higher-priced chair.

Remember that price reflects the value of a product and that the consumer determines what that value is. One particular product may have cost a great deal to manufacture, but if the product has a price tag which in the opinion of the consumer is too high, the price is too high. Say that you recently saw a pair of casual shoes that you liked a lot in the window of a shoe store. When you enquired about the price you were told that these were shoes imported from Italy and that they cost R899. So you most probably just laughed and walked out. The shoes may have cost that much to import, but for you that was the wrong price for a pair of casual shoes. (At least that would be the average consumer's response!)



### Activity 6.2

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Identify and analyse the three "prices" involved in determining the final price.



- *The cost price. If a product is sold for less than what it cost, it is obviously going to mean a loss for the business. If those shoes cost R650 to import from Italy, but consumers are not willing to pay more than R250 for a pair of casual shoes, the business cannot set the final price at less than R650, or else it should not import/sell such shoes.*
- *The market price. This is the price that customers are willing to pay for a particular product. In the above case consumers are not willing to pay more than R250 for the pair of shoes. How will a business know what customers are willing to pay for a particular product? One way of finding out is to look at the prices that similar products are being sold for (eg by competitors). To set a price for a product that is higher than the market price will mean that the product is not likely to be sold, as in the case above. (There may of course be customers who are willing to pay R899 for a pair of casual shoes, in which case the market price would be R899, rather than R250.)*
- *The target price. Since every business wants to make a profit, this particular shoe store usually aims to achieve a 50% gross profit margin on its shoes. Therefore, if the cost price was R650, the target price would be  $R650 \times 1,50 = R975$ .*

These three prices now have to be weighed up against one another. Let's assume that the market price is R890 and the target price is R975; the shoe store might then decide that the final price should be somewhere in-between, namely R899.



### Activity 6.3

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What form of price does the final price of R899 in activity 6.2 represent?



*First, it is an example of an odd price, because the price is R899, and not R900. Second, it is a market level price since it is very close to the market price of R890. It is not a skimming price because the gross profit margin is a little less than what they usually aim for. It is not a market penetration price since the price is slightly above the market price. It is certainly not a leader price in the sense that they are offering the product at a considerably lower price than their competitors. For that reason it is also not a bait price.*

## 6.3 DISTRIBUTION DECISIONS



Study section 12.13 in the prescribed book.

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The distribution channel is the marketing instrument that delivers the product to the final consumer. In this process, wholesalers, retailers and other intermediaries are used to present a product, service or idea to the final consumer. For example, companies that manufacture CDs sell their products through intermediaries such as music stores (Musica and CD Warehouse), discount stores (Game and Dion) and supermarkets (Shoprite and Spar).

Different decisions can be made about the choice of middlemen or intermediaries. Products can, for instance, be marketed directly from the manufacturer to the consumer. A good example is the producer who sells his or her products at a flea market. This is a typical example of a manufacturer-consumer chain. Another example would be the case in which the product is custom-made. A tailor who manufactures suits for specific clients, for example, will not sell his product through a middleman. Another type of channel distribution is the manufacturer-retailer-consumer channel. This channel is widely used in South Africa among the large retailers like Pick n Pay and Shoprite/Checkers. Products are bought from the manufacturers by these retailers and then sold to consumers.

A factory situated in Boksburg may manufacture superb clothes, but if they did not make use of intermediaries it would mean that the customers would have to travel to the factory in Boksburg in order to buy the clothes. The chances are that only people living in Boksburg would purchase those products. However, if the company wished to sell the clothes countrywide, they would have to sell their products to clothing stores throughout South Africa. This might involve too many retailers who would order only small quantities at a time, so the clothing manufacturer is more likely to sell the clothes to a number of wholesalers in the major regions of South Africa. These wholesalers would in turn sell smaller quantities to retailers in their region, and the retailers would sell the clothes to customers in their vicinity. This is a typical example of a manufacturer-wholesaler-retailer-consumer distribution chain.

The business that controls the channel is known as the channel captain. If the manufacturer is the channel captain, it will be mainly responsible for advertising/marketing the product. For example, Volkswagen is the channel captain, and it will do most of the marketing of Volkswagen products on a countrywide basis.

On the other hand, if the retailer is the channel captain, the retailer will market the product, or in many cases, market itself. CNA is a typical channel captain when it comes to selling books. Occasionally they will advertise a particular product on TV, but more often than not CNA advertises itself as a store ("First with the goodies") rather than advertising a specific product. And even when a specific product is advertised, a strong message is included about the store itself. The same can be said of Pick n Pay. You can see from watching television how often a store will advertise itself, rather than a specific product.

Make sure that you understand the different types of market coverage. The easiest way to remember is as follows:

- Intensive market coverage. This is a manufacturer's strategy of making a product available to buyers in as many outlets as possible for maximum market exposure. Manufacturers of convenience products such as cigarettes, chewing gum and cold drinks want intensive distribution.
- Exclusive market coverage. This type of coverage involves a manufacturer selling products through only one wholesaler or retailer in a particular area. Rolex watches, Ferrari cars and Steinway pianos are examples of products that are exclusively distributed.
- Selective market coverage. Here, a few specialist intermediaries are selected even though they stock competing products. Appliances and sporting goods are products that are distributed in this way.



#### Activity 6.4

Read through the case below and identify the type of market coverage used by Coca-Cola.<sup>10</sup>

**Vending machines are an important distribution channel in Coca-Cola's ..... distribution strategy**

The Coca-Cola corporation runs a/an ..... distribution policy for its products and aims to get the product to the consumer no matter where they are or what they are doing. They operate a/an ..... channel strategy, which makes use of every conceivable channel option. Central to their policy of being able to find a Coca-Cola to drink wherever the consumer looks for one is the use of vending technology. You find vending machines offering Coca-Cola and other drinks in every "nook and cranny" possible. On the floors of hotels next to the ice machine, in university residences and teaching areas, in schools, sports centres, garages, railway stations, airports, subways, art galleries, museums and a host of similar locations. Vending machines fill the "gap" left by the more conventional channels for this beverage.

Coca-Cola Inc. is determined the demand will be met by making the product widely available in all of the areas you expect someone to want to purchase the product. This is achieved through the policy of ..... distribution using supermarkets, smaller stores, bakeries and sandwich shops, delicatessens, public houses, cafés and cinemas, plus a plethora of other less conventional channels.



*The answer is straightforward. Coca-Cola make use of intensive market coverage or distribution. The case study clearly shows that they sell their products through as many intermediaries as possible.*

## 6.4 MARKETING COMMUNICATION DECISIONS



Study section 12.14 in the prescribed book.

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When companies such as Sony, Defy or Toyota develop new products, the only way for consumers to become aware of these products is for the companies to communicate the existence and attributes of these products to them. No product can sell without effective marketing communication messages.

Marketing communication is the process of informing, persuading and reminding consumers, and it comprises six elements: advertising, personal selling, direct marketing, sales promotion, publicity, and public relations.

Selecting the right combination of methods presents a challenge to the marketing department because as circumstances change, the whole combination must change as well. Not only does the composition of the marketing communication methods change, but so do the messages and the different techniques and media used.

We will now discuss the marketing communication elements that can be used in a specific combination to communicate with consumers.

### 6.4.1 Advertising

Advertising has a pervasive influence in our daily lives. Can you imagine not being exposed to a Coca-Cola or BMW advertisement? How consumers respond to an advertisement often depends on the purpose of the advertisement. Typically, advertising embodies one or more of the three fundamental objectives in respect of its target market: to inform, to persuade and to remind consumers. IBM, for instance, might advertise on television and in magazines to inform consumers of the attributes of a new computer which it has on the market, while Edgars might advertise a shoe sale in newspapers and on radio in order to persuade consumers to buy its shoes. Toyota might place a TV advertisement to remind consumers of the good quality of its motor vehicles. These companies design their advertising messages for the different media in different ways. They make use of headings, illustrations and copy in the print media, while radio advertisements make use of words and sound. Television advertisements, on the other hand, make use of spoken and written words as well as visual images.

Companies differ in the amount of the sales revenues they spend on advertising. Companies that make soft drinks often spend a greater percentage of their sales revenues on advertising than many industrial product manufacturers do. Charles Revlon, the founder of Revlon, said he made his money by selling hope – the kind that comes in a jar. Because cosmetic companies sell hope, they can charge high prices for products that do not cost that much to make. However, the hope ingredient requires a lot of expensive and effective advertising!

## 6.4.2 Personal selling

Personal selling is an active effort to communicate with high-potential buyers on a direct, usually face-to-face, basis. Salespeople are a vital source of information to consumers contemplating a purchase. As consumers, we depend on salespeople to provide key information to help us make purchase decisions. Can you imagine buying a new car, washing machine or lounge suite without a lengthy, information-gathering session with salespeople?

A company's salespeople provide the most direct link to its customers. In fact, to many customers the salesperson is the company, and the customer's image of the company is determined by the quality of the personal selling effort. Because of their direct contact with the market, salespeople are a valuable source of feedback. They provide feedback about the company's products, about competitors and their products, and about customers' requirements.

## 6.4.3 Direct marketing

We now know that the Internet, radio and television are types of advertising media used to communicate information about a product or service to customers. Kalahari.net is a website which customers can visit online to purchase DVDs, CDs and books. Information about these products is communicated directly to the customer, who is then able to respond directly by purchasing the product online via the Internet. The type of marketing communication being used here is called direct marketing. Other advertising media such as radio and television can also be used for direct marketing.

Many consumers prefer direct marketing as they can make their purchases from the comfort of their own homes. This marketing communication element allows businesses to offer their customers a pleasurable experience and greater convenience.

The benefits of direct marketing are listed below:

- A long-term relationship can be developed with the customer.
- The message can be directed at a specific customer.
- A customer database can be developed.
- The results of a direct marketing campaign can be measured directly.

## 6.4.4 Sales promotion

When Pick n Pay make use of coupons to sell their products and Clinique hand out samples of their perfume to consumers, they are using sales promotion methods to increase sales. Sales promotion can be defined as those methods that cannot be classified under personal selling, advertising or publicity, but which complement them in transmitting the marketing message to potential consumers and resellers.

Sales promotion methods aimed at consumers include the following:

- Sampling. This can be defined as any method used to deliver an actual or a trial-sized product to prospective consumers. Consumers are offered an opportunity to try the product without any commitment to buy it.
- Price incentives. These are reductions in products' regular prices.
- Coupons. Using coupons is a promotional device that provides a cash saving to consumers who redeem the coupon.
- Premiums. These are articles of merchandise provided free or at a reduced price to consumers as incentives to encourage them to buy a product. An item could be offered inside or attached to the product package.
- Contests and competitions. These offer consumers the opportunity to win cash, merchandise or travel prizes.
- Point-of-purchase promotion. One of the most important forms of sales promotion in retail stores is a display. Displays and the variety of display materials used are designed to attract consumer attention by enhancing the prominence or attractiveness of the products. Point-of-purchase promotion material covers a wide range, such as name cards which can be affixed to shelves, placards which stand on the floor or hang from the ceiling, tubs piled high with products, stalls for demonstrations or special displays and specially designed racks for, say, sweets and razor blades.
- Gifts. The gifts used in this kind of promotion are also known as "advertising specialties" because an advertising message is usually printed on them. Examples are key holders, lighters, T-shirts and diaries.

#### **6.4.5 Publicity**

Publicity involves supplying information about the company's product or service to the media, and hence obtaining a favourable and free review. This can be done by means of news or press releases, sponsorships and news articles. All the media can be used to carry the marketing message – the press, radio and television. Because the message appears in the editorial part of the press, and not in advertisements, it has greater credibility. It is almost as if someone impartial is reporting on the product or the company. The same happens when the company or its product receives favourable mention in news reports on television or radio. Consumers are then more inclined to accept the message.



## McDonald's in Moscow

Before opening a branch in Moscow, McDonald's launched a communications campaign that received the broadest possible publicity any company in the world ever received – from TV, radio and print coverage in North America to front pages and newscasts in Japan, Europe and the rest of the world. The communications campaign, "The McDonald's magic", was in the form of four stories that introduced McDonald's as a company having fun while running a successful business.

The campaign went as follows:

- Two and a half years before the opening day in Moscow, a press conference was called to announce the signing of the agreement (the result of negotiations that lasted 14 years).

The next newsworthy event was the sign-raising ceremony marking the beginning of construction.

- The laying of the cornerstone of the food-production plant, the largest in eastern Europe, received worldwide publicity.
- The first Russian managers arriving at McDonald's in Oak Brook, Illinois, to be trained at the "Hamburger University", created worldwide interest.
- Just before the opening of the restaurant in Moscow, it was announced that 27 000 Russians had applied for the 6 000 jobs at McDonald's. This really was news!
- Approximately 400 journalists attended the opening day and the event was the main news item on television and on front pages worldwide. British television showed thousands of Russians queuing for the "ultimate happiness symbol and their first taste of *glasnost* – a hamburger!"
- A month after the opening, McDonald's Moscow sold their millionth hamburger and was serving about 50 000 people daily. Nobody knows how many extra hamburgers were sold worldwide as a direct result of the publicity campaign.
- McDonald's launched a television advertisement in the USA, "Magic in Moscow", showing scenes of the opening day. The advertisement received wide publicity.

Of course, negative publicity can do the company a great deal of harm. The media tend to seek negative publicity because it has news value. Unfavourable publicity may arise from a spectacular accident such as a fire or an explosion where an investigation reveals negligence or mismanagement on the part of the company. Potentially harmful products or packaging, environmental pollution, fraud, poor working conditions and exploitation of workers are all issues that have attracted negative publicity.

### **Is negative publicity always detrimental?**

Benetton, the large international manufacturer of children's clothing known for its shocking advertising campaigns, has probably gone too far in using bloodied uniforms of Croatian soldiers in advertisements. The Italian Advertising Authority banned the advertisements in Rome. Previous shocking advertisements also resulted in an outcry and negative publicity – but despite this, sales kept increasing!

#### **6.4.6 Public relations**

Public relations (PR) refers to the management of all communication between an organisation and its publics in order to create a positive image of the company. Examples of such publics are customers, opinion leaders, media, industry, pressure groups and suppliers. The organisation's public relations department is concerned with image-building methods of communication, while its marketing department is responsible for the promotion and sale of its products and services.

Various media can be used to carry the messages of the public relations department in order to create a positive image of the company. These methods are discussed in section 12.14.7.2 in the prescribed book and include print media such as newspapers, magazines and company publications, as well as sight and sound media, for example radio, television, film and video. Special events such as press conferences, visits to the company, receptions and exhibitions can also be used. Crisis management is also considered to be a communication medium for public relations. Although the crisis itself is not the medium, it may be an opportunity for management to convey a positive message about the business. The Internet has also become a very important medium for public relations. Public relations tools such as the use of web sales, intranet operations and use of the Web to communicate with the public are increasing in popularity.

## **Sticky Pedals Accelerate Toyota's PR crisis<sup>11</sup>**

Toyota consistently played down recurring complaints of unintended acceleration, breaking what PR experts said is the cardinal rule in crisis management: assume the worst.

Toyota continued to blame loose floor mats for the problem. This eventually spread to potential problems with accelerator pedals and faulty electronic throttle control systems.

While the problem faced by consumers was evident way into 2009, Toyota President Akio Toyoda, the grandson of the company's founder, had not yet formally addressed the public or media on the recall problems by February 2010.

This is what two PR experts had to say about the PR crisis:

- Ong Hock Chuan, a technical adviser of a PR consultancy  
*People want to see a company take full responsibility, be empathic to the victims and their families and be in control by outlining the problem and how they intend to solve it. They also expect the CEO to do all this. Toyota seems to have failed on all counts.*

- Masato Takahashi, a public relations consultant  
*There should have been a more convincing explanation, including from the president.*

*Even when they announced the recall initially, you can't just say, "We're going to do a recall". They should have gone further in way of explanation, and there should have been a heartfelt apology from the top.*

Worldwide, Toyota PR people dithered and dallied and eventually started saying the right things far too late. If they had been at least halfway efficient it would have reduced the number of people (26%) who said they would not buy a Toyota now. The cost of dithering instead of doing can be counted in millions of dollars in lost short-term sales.

Thousands of Toyota vehicles in South African also had to be recalled in participation in the worldwide recall as a precautionary measure to the reported problem. Something that the Toyota recall has shown is that so many corporate PR departments are hopelessly unprepared for a crisis.

In South Africa, Toyota's crisis communications effort followed a fairly typical local motor industry scenario which consists of putting heads in the sand for a few days, hoping that the problem would stay overseas and not come here.

## Managers at SAA handle strike badly, analysts say<sup>12</sup>

As management and workers at embattled state-owned SAA at last sat down with mediators yesterday to resolve their wage dispute, several labour analysts said that the five-day strike had been an expensive public relations disaster that underlined the urgent need for parastatal managers to reform outdated, top-down management styles.

They cited the apparent refusal of SAA management to call in the Commission for Conciliation, Mediation and Arbitration (CCMA) for dispute resolution until virtually ordered to do so on Monday by labour minister Membathisi Mdladlana; the “flaunting” of SAA’s newfound corporate financial recovery by chief executive Khaya Ngqula by his lavish lifestyle; and even the “unwise” continued airing of TV advertisements while the strike was at its height.

Ngqula’s decision to take a weekend off at a luxury resort as the strike got under way also reportedly earned him a reprimand from SAA chairman Jakes Gerwel.

But SAA strongly defended itself, insisting it had “followed all the necessary processes involved”; the unions had been intransigent by refusing to budge on their demands; SAA had not been ordered by Mdladlana to call in the CCMA; and it would definitely not comment on Ngqula’s alleged cavalier attitude to the strike.

But analysts, including independent consultant Gavin Brown and 3 others who declined to be named, agreed that SAA had had its “nose bloodied” for the first time after it had “miscalculated badly” in the way that it had handled unions’ demands for an 8% wage increase ...

SAA refused to call in the CCMA until Madladlana said that a “speedy resolution (to the strike) is in the public interest”. But by then, the strike had done its image immense damage, analysts said ...



### Activity 6.5

Sam Sequera is a manufacturer of various food items which he sells to a number of retailers. He manufactures breakfast cereal, baking powder, orange juice, tinned food, coffee and snacks, all bearing the brand name “Sam’s”. Sam wants to encourage repeat purchases of his products and he has asked you, a marketing communications consultant, for your opinion on how he can use sales promotion techniques to achieve his objective. Advise him on the matter.



*The following are the various methods that Sam could use:*

- *Sampling.* Sam could arrange for demonstrators to set up tables in various retail stores and then have them prepare and hand out small samples of one of his light snack foods (Sam’s Snacks) to the shoppers. This is a very effective technique since consumers get to taste the snack and the demonstrator can give them more information during the sampling.
- *Price incentives.* Sam could offer consumers a saving on the purchase of his product. Sam could, for instance, offer a 60c price reduction on all Sam’s tinned food. This cents-off

reduction could be printed on the tins. He could also offer an 80c refund on the purchase of a large tin of Sam's Coffee.

- *Coupons.* Sam's strategy could involve the issue of certificates to consumers, redeemable at retail outlets, giving consumers a specified price reduction on a particular product. He could, for instance, place a 35c coupon for Sam's orange juice in the national newspapers.
- *Premiums.* Sam could offer a free Superman sticker in Sam's breakfast cereal or he could attach a small toy to the breakfast cereal box.
- *Contests and competitions.* Sam could hold a contest in which participants have to write, in ten words or less, why Sam's is their favourite cereal. The participant with the best answer would win a free weekend at a popular holiday resort.
- *Point-of-purchase promotion.* In this case, Sam could provide specially designed racks for his products, as well as placards to hang from the ceiling to draw attention to them.
- *Gifts.* Sam could provide certain gifts, bearing the Sam's brand name, to retailers, who would then give them to customers. These gifts could include pens, calendars, T-shirts and key rings.

## SUMMARY

In topic 3 you obtained insight into the marketing function. In topic 4 you will study financial management.



### SELF-ASSESSMENT QUESTIONS

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- (1) *A very small profit is made on ..... products.*
  - (a) *leader price*
  - (b) *skimming price*
  - (c) *bait price*
  - (d) *market price level*
- (2) *Which of the following statements are correct?*  
*The advantages which brands offer the consumer, are that they .....*
  - (a) *facilitate the identification of products.*
  - (b) *assure a quality standard.*
  - (c) *serve as a warning against products not meeting certain requirements.*
  - (d) *make product differentiation possible.*
  - (1) *a b c*
  - (2) *a b*
  - (3) *a c d*
  - (4) *c d*
  - (5) *a b c d*
- (3) *Which of the following statements on publicity are correct?*
  - (a) *Publicity is more credible than advertising.*
  - (b) *Marketing management has no direct say in formulating the publicity message.*
  - (c) *Publicity can also have a negative effect.*
  - (d) *Publicity is not always free.*
  - (1) *1 a c*
  - (2) *b d*
  - (3) *a b d*
  - (4) *a b c d*

- (4) You are the Public Relations Manager of Foodies, a large supermarket chain. Explain any three communication media that you can use to create a favourable image of Foodies.



### Question 1

The correct answer is option 1.

The options given in this question refer to adaptations of the final price, and the final price is the price at which the product is offered to consumers. The final price is determined through a reconciliation of the market price and the target price.

The leader price concerns special offers widely used by retailers, which represent the “specials” or special offers. These special products are sold at prices lower than the current market price, but for a limited period only. The retailer uses this method to draw consumers to his or her shop. Because of the lower than usual price, the profit generated on these specials is therefore also small. And so option 1 is correct.

If the product is an innovation, and therefore a unique product, the final price or skimming price would be high and would result in a high profit margin. Some consumers may be prepared to pay the high price simply for prestige reasons. Others will not pay the high price. Option 2 is therefore wrong.

A bait price product has a particularly low price and would be widely advertised. The bait price is used merely to attract consumers and the retailer does not really intend to sell this low-priced product. In fact, the retailer may not even have such an item in stock, in which case there would be no question of any profit. So option 3 is wrong.

The market price level is related to dealing with competition. If the marketer sets the final price of his or her product higher than the competitors’ final prices, consumers will tend to buy from the competitors. If the price is lower than competing prices, consumers may not buy the product because they will think there is something wrong with it. And so option 4 is also wrong.

If your answer was wrong, please refer to section 12.12.3.4 in the prescribed book.

### Question 2

The correct answer is option 1 (a b c).

The brand is a mark that is unique to the product items or ranges produced and marketed by a certain business. The brand is chosen to distinguish the business’s products from similar competing products. The brand of a product includes the brand name and a specially designed trademark. Consumers use this name when they intend to buy the product. The concept of a brand name is much narrower than that of a brand.

Brands offer the consumer a number of advantages. They facilitate the identification of products when the consumer is in the process of purchasing (statement a). Brands also assure consumers of a quality standard they can count on (statement b). And brands serve as a warning against products that do not meet requirements set by consumers (statement c). The prescribed book also mentions other advantages.

Statement d is wrong because brands make differentiation possible only to the marketer – not to the consumer.

If your answer was wrong, please refer to section 12.11.4.2 in the prescribed book.

### Question 3

*The correct answer is option 4 (a b c d).*

*The main feature of publicity is that it should provide a message which has some news value. For that reason, publicity is more credible than advertising (statement a) because the audience is more receptive to a newsworthy message.*

*Marketing management has no direct say in formulating the message (statement b): the editor of the publication usually decides what should be published.*

*Unless due care is taken, publicity can also have a negative effect (statement c) when bad news is published.*

*Contrary to the term in the definition, publicity is not always free (statement d). A business must often spend a lot of money on the publication of a favourable piece of news in the media.*

*If your answer was wrong, please refer to section 12.14.6 in the prescribed book.*

### Question 4

*Three possible communication media:*

*The print media. Foodies could make use of a news report in a national newspaper in order to announce an important event, such as its sponsorship of a large, national soccer tournament.*

*Sight and sound media. You could design prestige advertisements of Foodies, emphasising its fresh products, good prices and friendly service. This could create a good image of the chain.*

*A public relations official of the supermarket chain could also take part in an interview on radio or television. It is essential for the person to present good arguments and speak well in order to create a favourable image of Foodies.*

*Special events. Members of the public could be invited to visit Foodies in order to learn more about its operations, for example its products, prices, distribution strategy and purchasing techniques. The person who conducts the tours must have sufficient knowledge to be able to answer the questions asked by the visitors. Please refer to section 12.14.7.2 in the prescribed book.*





# TOPIC 4

## Financial management

### AIM

The aim is to explain the nature of the financial function and financial management, the cost-volume-profit relationships, time value of money and financial analysis, planning and control. This topic also explains the management of assets and provides insight into the principles and implementation of capital budgeting techniques. It describes the money and capital markets and explains short-term financing, and describes the forms and sources of long-term financing and the cost of capital.



### Learning outcomes

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When you have worked through topic 4 you should be able to:

- demonstrate an understanding of the concepts of capital, income, cost and profit
  - analyse and interpret an income statement
  - analyse and interpret a balance sheet
  - perform a breakeven analysis
  - apply the principles of the time value of money by demonstrating the concepts of discounting and compounding
  - calculate and interpret the liquidity, solvency and profitability ratios by using a balance sheet and income statement
  - calculate the weighted average cost of capital
  - understand the management of current assets
  - evaluate long-term investment decisions using capital budgeting techniques
- 

### OVERVIEW OF THE TOPIC

Topic 4 comprises the following study units:



TOPIC 4		
Study unit 7	Study unit 8	Study unit 9
The financial function and financial management	Asset management: the investment decision	Financing decisions

# Study unit 7

## The financial function and financial management

### Contents

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Key concepts

Learning outcomes

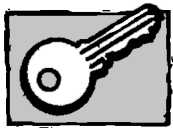
Getting an overview

- 7.1 The financial function and financial management
- 7.2 Concepts in financial management
- 7.3 Objective and fundamental principles of financial management
- 7.4 Cost-volume-profit relationships
- 7.5 The time value of money
- 7.6 Financial analysis, planning and control

Summary

Self-assessment questions

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### Key concepts

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capital	shareholder wealth
assets	liabilities
fixed costs	variable costs
break even	present value
financial ratios	budgets

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### Learning outcomes

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When you have worked through study unit 7 you should be able to:

- discuss the financial function and financial management
  - explain concepts in financial management
  - identify objectives and fundamental principles of financial management
  - calculate cost-volume-profit relationships
  - calculate present value and future value
  - calculate and interpret certain financial ratios
-

## Getting an overview



Study section 13.1 in the prescribed book.

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In this study unit we will first look at the importance of financial management and introduce the basic financial management concepts. Thereafter, we will discuss the objective and fundamental principles of financial management. The concept of present and future value as core elements of the time value of money will also be discussed. Lastly, we will discuss the concepts of financial analysis, planning and control.

## 7.1 THE FINANCIAL FUNCTION AND FINANCIAL MANAGEMENT



Study section 13.2 in the prescribed book.

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All businesses need funds. In financial management terms, the word “capital” refers to funds invested in the enterprise. These funds are needed to pay for the required assets, resources and labour.

The primary objective of the enterprise is often summarised as creating wealth for the stakeholders. The word “stakeholder” refers not only to the owners and/or the shareholders of a business enterprise, but also to the investors of loan capital and, more importantly, the employees of the enterprise.



### Activity 7.1

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Identify the three important tasks which the financial manager must perform in order to carry out his or her duties effectively.



*To contribute to the goal of creating wealth, the financial manager must:*

- *cost effectively obtain the funds needed for the enterprise*
- *invest those funds in assets that will give the highest possible return*
- *analyse, plan and control the flow of funds as accurately as possible*

## 7.2 CONCEPTS IN FINANCIAL MANAGEMENT

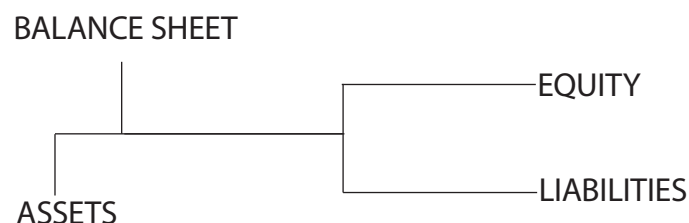


Study section 13.3 in the prescribed book.

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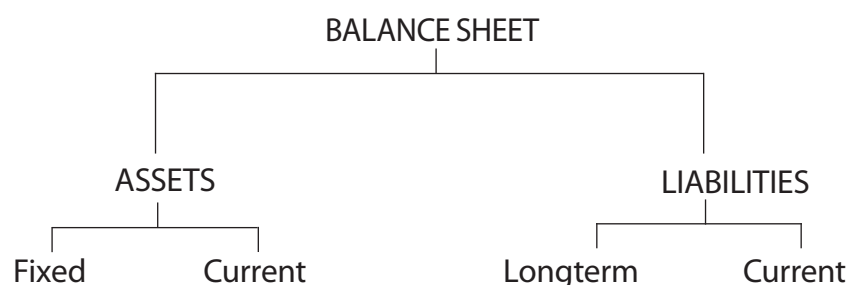
The first (and perhaps the most important) concept to understand is the balance sheet. Let's draw a balance sheet diagrammatically:

There are two major sides: assets on the left, and owner's equity and liabilities on the right.



Assets refer to the “possessions” of the enterprise while liabilities refer to the “debts”. Equity refers to the money invested by the owner(s) of the enterprise. Ordinary equity does not have to be paid back to the shareholder at a specified date and no interest on the equity is payable.

Assets and liabilities can each be subdivided further:



The prescribed book explains quite clearly which items fall into each category. Fixed assets (also called non-current assets) are long term whereas current assets are more short term. Typical current assets are cash inventory (stock) and accounts receivable. The expectation is that inventory and accounts receivable will be converted into cash during the next accounting period. In the same way there are long-term liabilities and current liabilities, for example a mortgage bond that is usually repaid over 20 years and bank overdrafts that are paid within a year.

Shareholders’ funds can be split into ordinary share equity and preference share capital. Owners’ equity refers to ordinary shareholding (remember that the ordinary shareholders are the owners of the enterprise), and undistributed profits and reserves. In the balance sheet total assets must always equal equity plus liabilities.

Another concept that warrants discussion is that of costs. Firstly, there is the difference between total costs and cost per unit. If an enterprise’s total cost is R240 000 and it manufactures 80 000 products (units), then the cost per unit will be  $R240\,000 \div 80\,000 = R3$ . If another enterprise also has a total cost of R240 000, but manufactures only 60 000 units, the cost per unit would be  $R240\,000 \div 60\,000 = R4$ . So to determine the cost per unit you have to divide the total costs by the number of units produced.

Secondly, note the difference between fixed cost and variable cost. Fixed cost refers to depreciation, interest, salaries, rent, or lease instalments for example, which will not change regardless of the number of units manufactured and sold. Variable cost refers to the

costs which will increase with every additional unit manufactured and sold, for example the raw materials that went into the product and the packaging material. It follows that the greater the number of units manufactured, the higher the total variable cost will be.

What about fixed cost per unit and variable cost per unit? If the total fixed cost is R120 000, this will remain the same (“fixed”), regardless of how many units are produced. However, the fixed cost per unit is calculated by dividing the total fixed cost by the number of units. If we manufacture 10 000 units, then the fixed cost per unit will be R120 000 divided by 10 000, which equals R12. If we change the volume of production, say to 20 000 units, the total fixed cost would still be R120 000 but the fixed cost per unit will now be R120 000 divided by 20 000, which equals R6.

If it costs R5 to manufacture a unit (eg a chair), then the variable cost per unit will be R5. Whether we manufacture 20 or 200 chairs, the variable cost per unit will always be R5 because it doesn’t change with a change in production volume. However, if we manufacture 20 chairs, the total variable cost will be 20 times R5, which equals R100. If we manufacture 200 chairs, the total variable cost will be 200 times R5, which equals R1 000. So the variable cost per unit does not change with a change in production volume, but the total variable cost will change with a change in production volume.

Another important concept to understand is the income statement. The income statement indicates the make-up of the profit or loss for the particular period. Knowing the sequence of the deductions as they occur in the income statement will enable you to calculate ratios accurately at a later stage of the unit’s production (see activity 7.2).



### Activity 7.2

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Memorise the sequence of deductions set out in the income statement in figure 13.9.



*Knowing the sequence of these deductions will enable you to calculate the ratios accurately. Refer to activity 7.3 in which these calculations will be done.*

## 7.3 OBJECTIVE AND FUNDAMENTAL PRINCIPLES OF FINANCIAL MANAGEMENT



Study section 13.4 in the prescribed book.

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The long-term objective of the business should be to increase its value. This will be achieved by investing in assets that add value and by keeping the cost of capital of the business as low as possible.

The short-term financial objective should be to ensure the profitability, liquidity and solvency of the business. Financial management is based on the risk-return principle (the higher the risk taken, the higher the expected return), the cost-benefit principle (discussed in section 7.4 below) and the time value of money principle (discussed in section 7.5 below).

## 7.4 COST-VOLUME-PROFIT RELATIONSHIPS



Study section 13.5 in the prescribed book.

---

Breakeven analysis can give management valuable insight into the interrelationships of sales volumes and prices, on the one hand, and the fixed and variable costs that constitute the total cost structure of the business, on the other.

Breakeven analysis can contribute to the preparation of budgets and setting of targets, and forms the basis for strategic decisions, for example changing the firm's pricing structure or deciding whether future investment should be in capital-intensive rather than labour-intensive facilities. (The former entails higher fixed costs in proportion to the total costs, while the latter entails a higher proportion of variable costs.)

The greater a business's fixed costs, the greater its exposure will be to the negative effects of a decline in sales. Fixed costs are related to specific periods and are not influenced by production and sales volumes, whereas variable costs are largely controllable in accordance with changes in production or sales volumes. If, for example, fewer products are manufactured, the total cost of raw materials will also be lower. Breakeven analysis therefore indicates the impact on profits of possible variations in sales volume and/or possible changes in production costs.

The key to understanding the concept of the breakeven point is the fact that a business will always have fixed costs even before anything has been manufactured (or any service has been provided). Suppose that a business has a total fixed cost of R100 000. It manufactures computers, and the variable cost per unit is R1 000. The computers sell for R3 000. This means that a variable profit of R2 000 is made on each computer manufactured and sold. If the business manufactures and sells 40 units (computers), it would make a total variable profit of  $40 \times R2\ 000 = R80\ 000$ . This can also be calculated by taking the total income from sales ( $40 \times R3\ 000 = R120\ 000$ ) and subtracting the total variable cost ( $40 \times R1\ 000 = R40\ 000$ ).

However, since the fixed costs are R100 000, the business would actually be making a loss of R20 000. The question is then: How many units would the business have to manufacture and sell before it breaks even, that is makes no loss? In the above case it is easy to see: the business would have to manufacture and sell 50 units, in order to make a variable profit of R100 000 which would then cover the fixed costs of R100 000. If the business manufactures and sells more than 50 units it would be making an overall profit.

Now let's apply the above figures to the breakeven formula, where N represents the number of units to be manufactured in order to break even:

$$N = \frac{F}{(SP - V)}$$

$$N = \frac{100\ 000}{(3000 - 1\ 000)}$$

$$N = \frac{100\,000}{2\,000}$$

$$N = 50$$

## 7.5 THE TIME VALUE OF MONEY



Study section 13.6 in the prescribed book.

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The key to understanding this concept is the fact that money changes in value because of interest rates. If you were given the choice of receiving R100 today or R110 in one year's time, which would you choose? The answer depends on the current interest rate that can be obtained. If the current interest rate is 5% per annum, and you accept the R100 today and invest it at 5%, you will earn R5 interest after one year, and you will then have R105. It would therefore be more advantageous to choose the R110 in one year's time. On the other hand, if the current interest rate is 15% per annum, then by investing the R100 today you would earn R15 in interest after one year, giving you R115, and it would therefore be to your advantage to accept the R100 today.

It becomes a little more difficult to calculate if the choice is R100 today or R140 in three years' time, because it is not just a question of multiplying the interest of R5 by 3. This is because after one year you will have R105, and during the following year you will earn interest not on R100 but on R105. So after two years you would have  $R105 \times 5\% = R110,25$ , and the following year you would earn interest of 5% on R110,25, giving you R115,76. This is known as compound interest. To make it easy to calculate what the future value of a given amount is, we have drawn up some tables. If you look at the future value table in your prescribed book, you will see that there are three columns for three different rates of interest and a number of rows for each year. (Note that such tables can be worked out for every possible interest rate for any number of years, but for study purposes we have limited them to three interest rates for a period of 10 years.)

To calculate the future value of R100 after three years if the interest rate is 5%, we would have to multiply R100 by 1,1576 (the factor in the future value table), which comes to R115,76 (the same amount we calculated the long way). Thus taking the R140 in three years' time would definitely be the better option. If the interest rate was 15% then we would calculate R100 times 1,5209, which equals R152,09. In that case it would be preferable to take the R100 today.

There is also another way of calculating the time value of money. We can calculate an amount to be received in the future back to its present value. For example, if we knew that we would receive R200 in four years' time, we could calculate what that amount would be worth today if the interest rate were 10%. To make this calculation we now have to turn to the discounting table in the prescribed book. Look under the 10% column. The factor for four years is 0,6830. So if we multiply the R200 by 0,6830 we get R136,60. We can therefore say that an amount of R200 in four years' time is worth R136,60 today.

Just to make sure, let's calculate how much an amount of R136,60 today would be worth in four years' time if the interest rate were 10%. Look up the future value factor for 10% after four years. This factor of 1,4641 is then multiplied by R136,60. This gives us R200,00. This confirms that an amount of R200 in four years' time is worth R136,60 today (ie its present value) and, conversely, an amount of R136,60 today will be worth R200,00 in four years' time (ie its future value).

You will observe that all the factors in the future value tables are greater than 1, since cash invested now will be worth more in the future. To arrive at this greater future value, the cash invested now must be multiplied by a factor greater than 1. Conversely, the discounting tables all have a figure less than 1, since the value of money to be received at some future time will be less now. Therefore the future value must be multiplied by some factor less than 1 to obtain a reduced sum for its present value.

For examination purposes, the discount factors and future value factors will be given, as will the cash flows at various intervals. All you need to know is how to calculate the present and future values.

## 7.6 FINANCIAL ANALYSIS, PLANNING AND CONTROL



Study section 13.7 in the prescribed book.

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When you have worked through this section you should understand why the balance sheet, income statement and funds flow statement are essential sources of information for the financial manager: this data will enable him or her to ascertain the performance and financial soundness of the business – particularly the extent to which owner or shareholder wealth is being maximised over the long term.

The financial ratios described in section 13.7.1.5 are useful tools for evaluating a business's financial health. You must know how to calculate these ratios, because they will definitely be asked in the examination.



Activity 7.3

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Please complete the following without looking at the prescribed book:

### The liquidity ratios

The current ratio =  $\frac{\text{Current .....}}{\text{Current liabilities}}$

The acid test ratio =  $\frac{\text{..... less stock}}{\text{Current liabilities}}$

### The solvency ratios

The debt ratio =  $\frac{\text{Debt}}{\text{.....}}$



The gearing ratio =  $\frac{\text{.....}}{\text{Debt}}$

**The profitability ratios**

Rate of return on total capital (before tax) =  $\frac{\text{.....}}{\text{Total capital}}$

Rate of return on total capital (after tax) =  $\frac{\text{.....}}{\text{Total capital}}$

Yield on shareholders' interest =  $\frac{\text{.....}}{\text{Shareholders' interest}}$

Yield on owners' equity =  $\frac{\text{.....}}{\text{Owners' equity}}$



*The answers to this activity are given in section 13.7 of the prescribed book. Check to see whether your answers are correct.*

The last section of this chapter deals with budgets. Make sure that you understand the differences between the various responsibility centres.

Finally, make sure that you know the differences between the various types of operating budgets and financial budgets.



**Activity 7.4**

Obtain a set of financial statements (especially the income statement and balance sheet) of a company. You should find these in the business supplement of a newspaper or in a financial magazine. Using these statements, calculate the company's solvency and profitability ratios.



*Did you succeed in calculating these ratios? If not, do not despair! You will sometimes find that these statements do not always provide the firm's results in detail; instead, the results often appear as a summary. When the results are given in sufficient detail, do these calculations and see what levels of ratios (high or low) firms abide by in order to survive.*

*You will also see that the balance sheet may be drawn up in different ways and not necessarily in the form appearing in the prescribed book. These other forms are also acceptable in the business world.*

*Refer once again to section 13.3 in the prescribed book concerning the structures of the balance sheet and income statement, and their significance.*

**SUMMARY**

In this study unit we analysed the nature and meaning of the financial function and its management, that is financial management. The relationship between financial management, other functional management areas, related subject disciplines and the environment were then shown, followed by an introduction to some basic concepts and techniques used in financial management. The goal and fundamental principles of financial manage-

ment were also explained. Finally, we discussed one of the tasks of financial management, namely financial analysis, planning and control.

In the next study unit you will study the management of assets through the investment decision.



## SELF-ASSESSMENT QUESTIONS

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- (1) Given the following information, which of the following calculations are correct concerning cost-volume-profit relationships?

Selling price per unit =	R10
Total variable costs =	R600
Fixed costs per unit =	R3
Total fixed costs =	R300

- (a) Number of units sold = 200 units  
(b) Total profit generated = R100  
(c) Number of units to break even = 75 units  
(d) Marginal income per unit = R4

- (1) a b c  
(2) a b d  
(3) b c d  
(4) a c

- (2) Which of the following statements on the time value of money are correct?  
The higher the discount rate, the higher the present value of a given future amount will be.

- (a) The discounting factor for a certain period and a given interest rate is  $(1 + i)^n$ .  
(b) The greater the risk, the greater the interest rate should be in both the compounding and discounting factors.  
(c) The time value of money is directly related to the opportunity rate of return.  
(d) The greater the risk, the greater the need will be to receive incoming funds as quickly as possible.

- (1) a c  
(2) b d  
(3) b c d  
(4) c d e

- (3) On 1 January 2007, a person deposits R3 000 in a saving account at a rate of return of 10% per annum. On 1 January 2009, he deposits another R1 000 in that account. On 31 December 2009, he closes the account and invests the total proceeds in another account on 1 January 2010 at a rate of return of 15%. How much money will he have in the account on 31 December 2011?

- (a) R6 735,49  
(b) R6 255,42  
(c) R6 162,53  
(d) R5 723,30



### Question 1

The correct answer is option 3.

First we need to calculate  $N$  (number of units sold). From the information given, total fixed costs are R300 and fixed costs per unit are R3. Therefore  $N = R300/3 = 100$  units. Therefore alternative a is incorrect, which makes alternatives b, c and d correct.

Let us solve for profit as illustrated below:

$$P = (N \times SP) - [(N \times V) + F] \text{ (section 13.5)}$$

Where:

$N$  = number of units sold

$SP$  = selling price per unit

$V$  = variable cost per unit

$F$  = total fixed costs

$$P = (100 \times R10) - (R600 + R300)$$

$$P = R1\,000 - R900$$

$$P = R100$$

Therefore alternative b is correct.

Let us solve for the number of units to break even, which is  $N = F/SP-V$  (section 13.5),

where:

$N$  = number of units to break even

$F$  = total fixed costs

$SP$  = selling price per unit

$V$  = variable cost per unit

Since we have not been given variable cost per unit, we can calculate it by dividing total variable cost by number of units sold, which is  $R600/100 = R6$ .

$$\text{Therefore } N = R300/R10 - R6$$

$$N = 75 \text{ units}$$

Therefore alternative c is correct.

Let us now confirm alternative d, the marginal income per unit, which is  $SP-V$ ,

where:

$SP = \text{selling price}$

$V = \text{variable cost per unit}$

$$= R10 - R6$$

$$= R4$$

### Question 2

The correct answer is option 4.

Alternative a is wrong because the discount rate has the effect of reducing the future cash amount. So if you increase the discount rate (which is always part of the denominator) you increase the denominator. This has the effect of decreasing the present value.

Alternative b is also wrong, because the discounting factor for a certain period and a given interest rate is  $\left[ \frac{1}{(1+i)} \right]^n$   $n$  is the compound interest factor.

### Question 3

The correct answer is option 1.

First, we calculate the value of R3 000 invested on 1 January 2007 as at 31 December 2009 when the account is closed. From the time line we can see that this period is three years.

$$\begin{aligned} \text{Therefore } FV_3 &= PV (FVIF_{10\%, 3}) \\ &= 3\,000 (1.3310) \\ &= R3\,993,00 \end{aligned}$$

We then calculate the value of R1 000 invested on 1 January 2009 as at 31 December 2009 when the account is closed. From the time line we can see that the amount was invested for one year only.

$$\begin{aligned} \text{Therefore } FV_1 &= PV (FVIF_{10\%, 1}) \\ &= 1\,000 (1.1) \\ &= R1\,100 \end{aligned}$$

The value of the combined investment on 31 December 2009 is  $R3\,993 + R1\,100 = R5\,093$ . The R5 093 is invested in another account for a period of two years (from 1 Jan 2010 to 31 Dec 2011).

$$\begin{aligned} \text{Therefore } FV_2 &= PV (FVIF_{15\%, 2}) \\ &= R5\,093 (1.3225) \\ &= R6\,735,49 \end{aligned}$$

On 31 December 2011, the person will have R6 735,49 in the account. The correct answer is thus option 1.

# Study unit 8

## Asset management: the investment decision

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Getting an overview

8.1 The management of current assets

8.2 Long-term investment decisions and capital budgeting

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Self-assessment questions

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### Key concepts

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current assets

long-term investment decisions

marketable securities

debtors

stock

cash

capital budgeting

investment projects

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### Learning outcomes

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When you have worked through study unit 6 you should be able to:

- manage current assets
  - make long-term decisions
- 

### Getting an overview

In order to achieve the main objective of the firm, you need to effectively manage the investment in the assets (current and fixed) of the business. This study unit explains the management of cash and marketable securities, debtors and stock in order to successfully pursue the main objective of the business. We also discuss the long-term investment decision and capital budgeting, where the concept of net present value (NPV) is introduced. You need to understand NPV because this is a technique that you will be using to evaluate capital projects.

## 8.1 THE MANAGEMENT OF CURRENT ASSETS



Study section 13.8 in the prescribed book.

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### 8.1.1 The cost and risk of investing in current assets

Over-investment in current assets is costly because the capital tied up in current assets could be invested profitably elsewhere. For example, if one business has an inventory of R200 000, and this stock level were to be reduced to R100 000, the surplus R100 000 could be invested in a short-term deposit, say at 10%. Thus the company would be earning R10 000 per annum instead of having the surplus stock lying in a warehouse (ie over-investment) where it is not earning any income.

The ideal, of course, would be to have no capital tied up in stock, but that would mean that the suppliers would always have to deliver the raw material exactly when it is needed, or the factory would have to deliver the finished product exactly when a customer wanted it. But this under-investment is risky because if there is an unforeseen delay somewhere along the line, there might be a serious delay in the factory (which is very costly), or the customer will buy the product elsewhere.

Make sure that you understand the figures in table 13.13 which shows that a higher investment in current assets leads to a higher liquidity (as in the case of business B), while a lower investment in current assets leads to a higher rate of return (as in the case of business A).

### 8.1.2 The management of cash and marketable securities

You must understand the three basic reasons (motives) for having a certain amount of cash on hand. Let's take the example of a gardening services provider. The provider wins a contract to lay out the gardens of a new building. The job should take approximately two months, and the contract price will be paid on completion of the job (ie after two months). In the meantime, the contractor needs cash to purchase plants, grass, fertiliser, and so on. He also needs cash to pay his labourers their weekly wages (after all, they cannot be expected to wait two months before they are paid). This is the transaction motive.

But what if the client does not settle her debt on completion of the job? Or perhaps she delays payment for three weeks? The wages and other expenses still have to be paid. So the contractor needs some additional cash as a precautionary motive.

Then one day he hears that a competitor has gone bankrupt, and that a large quantity of gardening equipment and tools can be bought at relatively cheap prices. If our contractor doesn't have any available cash on hand, he will not be able to make use of this opportunity to obtain some valuable equipment at a very low price. So he also has a speculative motive to keep some extra cash (or marketable securities) on hand.

When you look at the cash budget in table 13.15, note that the net cash position is the difference between cash receipts and cash disbursements, plus or minus the cash on

hand or shortage that the business started with. For example, in the month of May, the difference between cash receipts and cash disbursements is a positive cash flow of R19 000. However, since the firm started the month with a cash shortage of R32 000, the net cash position is a cash shortage of R13 000.

The example of the business that made a profit each month, but had to discontinue its operations because it ran out of cash, may be a little confusing. Try to calculate the four items yourself, namely the increase in net profit, the increase in the debtors, the increase in inventory and the subsequent decrease in cash. What actually happened was that, despite making a profit, the business's current assets shifted from liquid assets (cash) to less liquid assets (inventory and debtors). At the beginning of January its current assets were as follows:

Cash	R 75 000
Inventory	R112 500
Debtors	<u>R150 000</u>
TOTAL	R337 500

The business made a profit of R187 500 during the next four months, so its current assets should have increased by that amount, giving us R525 000. That is exactly what happened, but the current assets are now made up as follows:

Cash	R0
Inventory	R225 500
Debtors	<u>R300 000</u>
TOTAL	R525 500

Unless this business is able to obtain funds from somewhere else, it will not be able to continue production and may have to be liquidated.

### 8.1.3 The management of debtors

What can a business do to shorten its cash cycle? One way is to reduce the amount owing to it by debtors. This is because the greater the amount of money that is owed by debtors, the greater the likelihood of bad debts (ie debts not paid by debtors) – and therefore the more capital that is tied up in debtors. To reduce the number of debtors, a business can grant less credit to customers, tighten up on the credit terms, and/or enforce the collection policy more strictly. The firm could also offer discounts for prompt settlement of accounts.

However, there are risks to reducing the amount invested in debtors. If the business grants less credit (eg by refusing to grant credit to anyone who does not have an exceptionally high credit rating) it may well lose sales. If it tightens up on its credit terms (eg demanding settlement of accounts within a shorter period) it may also drive some customers into the arms of a competitor who has a more lenient credit policy. If it enforces the collection

policy more strictly (eg taking customers to court if they do not settle their debts within the specified period) it may also frighten off potential customers.

Managing debtors successfully therefore requires maintaining a fine balance between keeping customers and at the same time maintaining liquidity.

### 8.1.4 The management of stock (inventory)

Another way to shorten the cash cycle is to reduce the level of inventory, be it raw materials or finished goods. Again this requires maintaining a fine balance between keeping inventory costs at a minimum and at the same time keeping the loss of sales or delays in production (as a result of unavailable stock) to a minimum.



#### Activity 8.1

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Use the financial statements you obtained from the business supplement or financial journal and calculate the company's liquidity ratio. Decide whether a conservative or aggressive approach is being used to finance current assets.



*If the liquidity ratio is high (say, 4:1), then more long-term funds are being used to finance current assets than if the ratio was, say, 2:1. This is considered to be a conservative approach to financing current assets. If the liquidity ratio is 2:1, then fewer long-term funds and more short-term funds are being used to finance current assets than if the ratio was 4:1. This is known as the aggressive approach.*

*As the level of risk rises, it would be safer to adopt the conservative approach, in which case liquidity will tend to be higher than in the aggressive approach. The amount of the long-term funds may be found by subtracting current liabilities from current assets. This difference is referred to as "net current assets". If the liquidity ratio is, say, 4:1, then net current assets would be represented by  $4 - 1 = 3$ .*

## 8.2 LONG-TERM INVESTMENT DECISIONS AND CAPITAL BUDGETING



Study section 13.9 in the prescribed book.

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The first aspect of capital investments is the magnitude. Many of these capital projects require large sums of money, and if the wrong decision is made this may have a serious effect on the business's profitability, and may even lead to the bankruptcy of a business.

An investment in a capital project is risky in terms of the large sums of money involved, but is even more risky because of the long-term nature of such a project. Think of the risk of investing millions in building another Sasol plant. During the years of sanctions it made sense to increase our capacity to manufacture our own fuel. Now that sanctions have been lifted, the question may well be asked whether it is still profitable to continue with such a project. Another example of a risky capital project was Moss gas which cost



R12 000 billion, and turned out to be a huge loss. However, at the time it seemed like a risk worth taking.

The net cash flow is simply the difference between the amount of money that flowed into the business (by way of sales, investment income, etc) and the amount of money that flowed out of the business (cost of materials, wages, interest, taxes, etc). Instead of adding and subtracting all the items, we can simply look at the income statement where the net profit gives us the same figure, with one significant exception. To arrive at the net profit, an amount for depreciation was deducted. The fact that plant and machinery loses its value (just like a car loses its value the older it becomes) is an expense for the business, but it does not involve an actual cash outflow. Therefore, to calculate the net cash outflow, one needs to use the following approach:

$$\text{EBIT (1-tax)} = \text{NOPAT}$$

$$\text{NOPAT} + \text{depreciation} = \text{net cash flow}$$

(Otherwise interest is double counted, ie in CF and in WACC.)

Different investment projects will yield different cash flows at different times, so it becomes very difficult, if not impossible, to compare the benefits of different projects unless we reduce them to the same base. In other words, we have to compare apples with apples. If we wish to compare investment projects, we have to determine the net cash flows (inflows minus outflows) in each year of the project's life and calculate each net cash flow back to its present value. Then by adding up the present values of each net cash flow, we can compare with the initial investment to arrive at a net present value. If the various present values add up to less than the initial investment, we have a negative net present value. If they add up to more than the initial investment, we have a positive net present value.

Obviously a project yielding a negative present value should not be considered because it will not increase the wealth of the stakeholders. The prescribed book says that all projects with a positive NPV should be accepted. However, it could happen that two projects under consideration both have a positive NPV, but that only one of them can be selected. In this instance, the project with the higher NPV is likely to be chosen.

Tables 13.18 and 13.20 clearly set out how the benefits of two potential projects can be compared with one another. The present values of project X's cash flows add up to R9 386. That means that the expected income of project X over a period of five years would be worth R9 386 in today's terms. Since the project requires an investment of R10 000 (today), the investor's "wealth" would actually decrease by R614. This project should therefore be rejected.

Compare that with project Y where the present values of the cash flows add up to R11 340. In other words, the investor's wealth would increase by R1 340. The project would therefore be quite acceptable.

What would be the position if the initial investment in project X was R9 000 and the initial investment in project Y was R11 000? In that case the NPV of project X would be R386,

and the NPV of project Y would be R340. Both projects would therefore be acceptable, but if only one project had to be selected, project X would be preferable since it would increase the investor's wealth slightly more than project Y.

## SUMMARY

You now have basic insight into the management of the asset structure of a business. In the next study unit you will study financing decisions.



### SELF-ASSESSMENT QUESTIONS

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- (1) Which of the following statements on the operating objective when managing stock are correct?

The operating objective is to

- (a) keep the lowest possible supply of stock.
- (b) keep the stock turnover as high as possible.
- (c) keep as much stock as possible to ensure that the business is never without stock.
- (d) ensure that production interruptions never occur.

- (1) a b
- (2) a c
- (3) b c
- (4) b d
- (5) c d

- (2) Which of the following reasons for keeping extra cash on hand is based on the precautionary motive?

- (a) to make provision for unforeseen events
- (b) to make provision for delays in receiving payments from debtors
- (c) to buy inventory from an insolvent competitor at bargain prices
- (d) to make provision for expenses that have to be paid in cash

- (1) a b
- (2) a b c
- (3) b c
- (4) b c d

- (3) Assume you are evaluating an investment that requires you to invest R100 000 at time 0. Following this investment, you will not receive anything for 2 years, and then you will receive R200 000 for 3 successive years. If the cost of capital is 12%, should this project be accepted?



#### Question 1

The correct answer is option 5.

Alternatives a and b are profit objectives and not operating objectives.

#### Question 2

The correct answer is option 1.

Alternatives a and b are precautionary motives which entail keeping cash for contingencies (ie unforeseen events). Alternative c is a speculative motive, which entails capitalising on good

opportunities. Alternative d is a transaction motive, which entails making provision for cash expenses before cash income has been received (eg paying wages).

### Question 3

First, draw a time line:

0	1	2	3	4	5
±R100 000	0	0	R200 000	R200 000	R200 000

Secondly, find the present value of the cash inflows from year 3 to year 5. We ignore years 1 and 2 because the cash flows are 0:

$$PV = \frac{R200\,000}{(1.12)^3} + \frac{R200\,000}{(1.12)^4} + \frac{R200\,000}{(1.12)^5} = R382\,945,04$$

Then subtract the initial investment from the PV to get the NPV:

$$NPV = R382\,945,04 - R100\,000 = R282\,945,04$$

Since the NPV is positive, accept the project.

# Study unit 9

## Financing decisions

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- 9.1 Financial markets
- 9.2 Short-term financing
- 9.3 Long-term financing decisions

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### Key concepts

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financial institutions	long-term financing
financial markets	shareholders' interest
primary markets	long-term debt
secondary markets	cost of capital
money markets	long-term financing decisions
capital markets	risk
short-term financing decisions	
forms of short-term financing	

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### Learning outcomes

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When you have worked through study unit 9 you should be able to:

- describe the money and capital markets as providers of finance
  - explain the types of short-term financing and the short-term financing decision (the financing of current assets)
  - describe the forms and sources of long-term financing
  - explain the cost of capital
  - explain the long-term financing decision
-

## Getting an overview



Study section 13.10 in the prescribed book.

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In this study unit we first examine financial markets and the sources and forms of short-term finance. This is followed by a discussion on the sources and forms of long-term finance and the cost of long-term capital.

## 9.1 FINANCIAL MARKETS



Study section 13.10.1 in the prescribed book.

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Individuals (or organisations) with surplus funds (referred to as a surplus unit) can invest those funds in businesses requiring finance (referred to as deficit units). However, it would be rather difficult, especially for an individual, to find out where the investment opportunities are. It would also be difficult for businesses to deal with a large number of small investors, especially if they want to invest their money for short periods of time only. Thus intermediary organisations, known as financial institutions, have been established to act as a go-between. For example, a large number of people may open savings accounts with a bank (ie a financial institution). The bank uses these savings to invest in businesses requiring finance. The fact that individuals withdraw their money from their savings accounts and then deposit money again into their savings accounts does not affect the bank's investment in the businesses. In this way, such a financial institution meets an important need, because it allows the surplus units (investors) the flexibility of investing and withdrawing their funds at short notice, while the deficit units are assured of a relatively stable supply of funds.

In the same way, it would be very difficult for a large business to sell shares directly to an investor, and then buy them back again when the investor needs the cash. That is why stock exchanges are established, where shares can be bought and sold without the company concerned being exposed to frequent fluctuations in the availability of funds. The prescribed book describes a number of these financial institutions (including the Johannesburg Stock Exchange) that operate within the "financial market".

Bear in mind that there is a formal financial market (where business is done through financial institutions) and an informal financial market (where business is done privately). If you are a shareholder in a private company, for example, and you sell your shares to a friend, you are operating in an informal financial market.

A further classification of the financial market is the primary market, which refers to the issue of financial claims for the first time, and the secondary market, which refers to the trading of those claims. A financial claim refers to any form of evidence that the holder has invested funds in a particular institution. It can range from a savings account deposit

book to a share certificate. When such claims are negotiable (ie they can be traded), they are referred to as financial instruments.

The financial market is also classified in terms of time. The money market refers to the trading of short-term financial instruments (eg 30-day deposits), while the capital market refers to the trading of long-term financial instruments (eg shares).

## 9.2 SHORT-TERM FINANCING



Study section 13.10.2 in the prescribed book.

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The financing of current assets (short-term financing) is also referred to as the financing of working capital, which may be performed by using one of three approaches: the matching, aggressive and conservative approaches.

Make sure that you understand how each of these forms contributes to the short-term financing of a business.

The matching approach means that fixed assets and permanent current assets are financed by long-term funds and the short-term assets are financed by short-term funds.

The aggressive approach means that some of the fixed assets and permanent current assets are financed by short-term funds. This kind of financing costs less, but there is always the danger that the funds have to be repaid without sufficient cash on hand. The result is that the business either has to obtain more funds elsewhere, or cease operations.

The conservative approach means that some of the long-term funds are used to finance short-term assets. The result is that the business remains very liquid, but the cost of financing is so much higher.

## 9.3 LONG-TERM FINANCING DECISIONS



Study section 13.11 in the prescribed book.

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To understand the various forms of long-term financing, study table 13.23 carefully. Make sure that you know what the characteristics, advantages and disadvantages of the various forms of long-term financing are.

When the prescribed book uses the words “listed company” it refers to a public company whose shares are quoted (listed) on a securities exchange.

For any company, the balance sheet entity referred to as “shareholders’ equity” represents the investment of the shareholders as a group in that particular company. In other

words, “shareholders’ equity” represents the amount of the shareholders’ claim against the assets of the company.

There are two types of long-term funds or long-term capital: shareholding and long-term debt. Financing a business through the issue of shares is possible only if the business is a registered company. If it is a private company, the shares are sold to private individuals. If the company is a public company the shares can be sold on the JSE securities exchange.

The prescribed book sets out the differences between ordinary shares and preference shares. It is important that you understand these differences, as well as the advantages and disadvantages of both types of share.

The prescribed book distinguishes between two types of long-term debt: loans and leasing. Again you need to make sure that you can explain the difference between these types of loan.

The prescribed book describes two types of leasing: direct leasing and leaseback agreements. The difference between an operating lease and a financial lease is that in the case of the former the equipment is returned to the lessor after it has been used for a certain period of time. In other words, the lessee pays only for the use of the equipment. In a financial lease, the lessee becomes the legal owner of the asset.

In a leaseback agreement, the lessee is the original owner of the asset. This asset is sold to the lessor, and the lessee now pays a rental to the lessor. For example, a retail business may own the building in which the shop is situated. However, if the business needs finance, it may approach a financial institution, like an insurance company, to purchase the building and then lease it back to the business. The insurance company will then pay the retail company for the building, giving it the needed finance, and the retail company will continue to occupy the building, but pay a monthly rental (lease) to the insurance company.

Another factor that needs to be considered when making the financing decision is the cost of capital. Accurate determination of the overall cost of a company’s capital is particularly important for decisions on investment in capital assets. If the company’s cost of capital is likely to exceed the expected rate of return on such capital asset investment, the company will incur a loss and the investment must be declined. Put differently, when the company incurs losses it will find it extremely difficult to attract future investors.

Since there are different types of long-term capital with different costs, we need to calculate the weighted average cost of capital to arrive at an overall cost of capital. In calculating the weighted average cost of capital, one must take the proportion of each type of capital into account.

For example:

If we had the following three types of raw materials that go into a particular product, what would the average cost of the raw materials be?

3 kg of material A @ R4 per kg = R12

3 kg of material B @ R8 per kg = R24

3 kg of material C @ R3 per kg = R9

The answer is easy to calculate. We calculate the total cost for the 9 kg and divide that by 9 to get a cost per kg. Thus we would add  $R12 + R24 + R9 = R45$ . That would give us an average cost of R5 per kg ( $R45 \div 9$  kg). An even easier way would be to simply add up the three figures and divide by 3. That would give us an average cost of  $R15 \div 3 = R5$  per kg. We could calculate it that way because an equal amount (3 kg) of each type of raw material goes into the product.

However, if the materials were made up as follows:

2 kg of material A @ R4 per kg

5 kg of material B @ R8 per kg

2 kg of material C @ R3 per kg

What would the average cost of the raw materials be now? We would have to work out the total cost for all 9 kg and then divide that by 9 to get a cost per kg. In this case it would be  $R8 + R40 + R6 = R54$ . That would give us an average cost of R6 per kg ( $R54 \div 9$  kg).

This can also be calculated by taking the proportion that each type of raw material makes up of the total materials and multiplying it by the cost per kg. The calculation would then be:

$$\frac{2}{9} \times R4 = R0,89$$

$$\frac{5}{9} \times R8 = R4,44$$

$$\frac{2}{9} \times R3 = R0,67$$

If we add these three figures together, we will get to the same answer:

$$0,89 + 4,44 + 0,67 = R6,00$$

When calculating the weighted average cost of capital, we use the same approach: we first determine what proportion each type of capital makes out of the total long-term capital. This proportion is then multiplied by the actual cost, and these figures are added up. Note, however, that since the cost of long-term debt is tax-deductible, we must first



adjust the cost of that long-term debt to an after-tax cost. If, for example, the interest rate of a long-term loan is 16% and the tax rate is 40%, then we can in fact adjust the cost by 40% in order to get the real cost. The actual cost would really be 60% of 16% or, put another way, the after-tax cost would be  $16\% \times (1 - 0,4) = 9,6\%$ .

In the example given in the prescribed book, the total capital amounts to R1 000 000.

Owners' equity is R500 000, so its proportion is:

$$\frac{500\,000}{1\,000\,000} = 0,5$$

Preference share capital amounts to R300 000, so the proportion is:

$$\frac{300\,000}{1\,000\,000} = 0,3$$

The long-term debt is R200 000, so the proportion is:

$$\frac{200\,000}{1\,000\,000} = 0,2$$

Note that the interest rate on the long-term debt is 13,5%, but with a tax rate of 46%, the actual cost is  $13,5\% \times 0,54 = 7,29\%$ . That is why the long-term debt proportion of 0,2 is multiplied by the after-tax cost of 7,29%.

## SUMMARY

This topic dealt with financing decisions. In the next topic you will study purchasing and supply management as part of the functional management of the organisation.



### SELF-ASSESSMENT QUESTIONS

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(1) Which of the following are forms of short-term financing?

- (a) registered term loans
- (b) financial leases
- (c) factoring of debtors
- (d) trade credit
- (e) bank overdrafts

- (1) a b c
- (2) b c d
- (3) c d e
- (4) a b c d e

(2) Which of the following statements do not describe characteristics of the ordinary share?

- (a) The accountability of the ordinary shareholder is limited to the number of shares he or she holds in a business.

- (b) *The term of availability of ordinary share capital is limited.*
- (c) *Ordinary shares bear no legal and financial obligations for a company.*
- (d) *An enterprise must pay dividends on its issued ordinary shares.*
- (e) *An ordinary share gives a right of ownership to a shareholder.*

- (1) *a c*
- (2) *b d*
- (3) *c e*
- (4) *a b d*
- (5) *b c d e*

(3) *You are given the following information on the cost of capital of BEC Co Ltd:*

<b>Cost</b>	<b>Amount</b>
<i>Owners' equity</i>	<i>20% R1 400 000</i>
<i>Preference share capital</i>	<i>10% R 300 000</i>
<i>Long-term debt (after tax)</i>	<i>9% R 500 000</i>

*Use the information to calculate the company's weighted average cost of capital.*

- (1) *16,13%*
- (2) *18,50%*
- (3) *20,08%*
- (4) *23,20%*



### **Question 1**

*The correct answer is option 3.*

*Alternatives a and b are wrong because registered term loans and financial leases are forms of long-term finance, that is the funds must be repaid after a year.*

### **Question 2**

*The correct answer is option 2.*

*Statements a, c and e describe characteristics of ordinary shares. Statements b and d do not describe characteristics of ordinary shares.*

### **Question 3**

*The correct answer is option 1.*

*To solve this problem, you need to complete the information given in a table as follows:*



<i>TYPE OF CAPITAL</i>	<i>AMOUNT</i>	<i>PROPORTION</i>	<i>COMPONENT-COST OF CAPITAL</i>	<i>WEIGHTED COST</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(3) x (4)</i>
<i>Owners' equity</i>	<i>R1 400 000</i>	<i>0,64</i>	<i>20%</i>	<i>12,8</i>
<i>Preference share capital</i>	<i>R300 000</i>	<i>0,13</i>	<i>10%</i>	<i>1,3</i>
<i>Long-term debt (after tax)</i>	<i>R500 000</i>	<i>0,23</i>	<i>9%</i>	<i>2,07</i>
<i>Total</i>				<i>16,17</i>

*The WACC is therefore 16,17%.*



# TOPIC 5

## The purchasing and supply function

### AIM

The aim is to introduce the most important aspects of the purchasing or sourcing function within the broader context of supply management, including new concepts in the field, the management of the function, the purchasing or sourcing cycle and the most important activities associated with the purchasing and supply management field.



### Learning outcomes

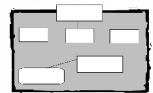
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When you have worked through topic 5 you should be able to:

- demonstrate an understanding of the purchasing (or sourcing) function within the broader context of supply management, by highlighting the types and activities of purchasing and supply and its management tasks
  - formulate the activities involved in the sourcing decision by summarising the purchasing and supply process, decisions regarding quality, quantity, pricing and the selection of suppliers as well as the timing of purchases
- 

### OVERVIEW OF THE TOPIC

Topic 5 comprises the following study units:



TOPIC 5	
<b>Study unit 10</b>	<b>Study unit 11</b>
Purchasing and supply management	Sourcing activities

# Study unit 10

## Purchasing and supply management

### Contents

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Key concepts

Learning outcomes

Getting an overview

10.1 Purchasing and supply in perspective

10.2 The importance of the purchasing and supply function for the business

10.3 The management task of the purchasing and supply manager

Summary

Self-assessment questions

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### Key concepts

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purchasing and supply function

purchasing management

supply management

provision function

expenditure

inventory holding

profit leverage

management task

purchasing and supply planning

hierarchical level

strategic management level

tactical management level

operational management level

purchasing and supply organisation

organisational structure

centralisation

decentralisation

cross-functional sourcing teams

purchasing and supply control

assessment

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### Learning outcomes

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When you have worked through study unit 10 you should be able to:

- demonstrate an understanding of the purchasing (or sourcing) function within the broader context of supply management
- describe the broadening of the provision function by summarising other concepts in or approaches to the provision of materials to a business
- demonstrate an understanding of the importance of the purchasing and supply function to the business by summarising the reasons for its importance
- describe the management task of the purchasing and supply function by highlighting its planning, organising and control

- demonstrate an understanding of the tools available to purchasing and supply by summarising each tool respectively
- 

## Getting an overview



Study section 14.1 in the prescribed book.

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Purchasing and supply management is one of the greatest areas of opportunity in any organisation. This is because purchased equipment, inventory and services make up the lion's share of the overall cost structure of any enterprise. Successful organisations today understand that managing the purchasing or sourcing cycle within a broader supply context is a key capability for improving product and service performance, and should be elevated to the same level of importance as that of engineering or finance.

Leading purchasing, sourcing and supply executives now deal with a broad range of complex issues. This requires a multidisciplinary focus and the engagement of business unit leaders across the enterprise, in order to deliver major performance gains. In top-performing organisations, purchasing goes well beyond the traditional function of providing the right requirements at the right place, purchased from the right source, at the right price in the right quantity. Achieving more than all this is by no means an easy task!

Fortunately, there are a vast number of international (and some South African) organisations who have pushed the purchasing, sourcing and supply frontiers forward. Purchasing is given a strategic slant, focusing on the sourcing and management of an optimal number of suppliers with whom an organisation can establish long-term relationships to the mutual benefit of all. Not only can we learn lessons from their examples, but we can also identify the critical factors that make it possible for purchasing and sourcing to add value and be recognised at the highest levels, within the broader context of supply management.

Purchasing, sourcing and supply management leaders should have a strategic vision of what the function can deliver, with an organisation to support this vision. That means aggressive targets backed up by the right incentives and resources, as well as an executive management team pushing line executives to make the hard decisions needed to advance the interests of the whole company over parochial preferences. Consider the case of South African Breweries (SAB). The company has realised the importance of these elements in the purchasing and supply strategy. In 2007 SAB launched a new strategy named the five-year R5-billion capital-project strategy to address these needs. To make this strategy successful SAB has to manage their relationships with the suppliers, have the right quantities of products available and also have the right systems and processes in place.

In this study unit, we put the purchasing and supply function in perspective, explain its importance and discuss the management tasks and tools.

## 10.1 PURCHASING AND SUPPLY IN PERSPECTIVE



Study section 14.1 in the prescribed book.

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This section in the prescribed book introduces you to the purchasing and supply concept by discussing the following:

- purchasing and supply in perspective
- a definition of the purchasing and supply function
- the purpose of the purchasing and supply function
- a definition of purchasing and supply management

The author points out quite correctly that purchasing and supply as a function does not always receive sufficient attention from management – and yet it plays a major part in most organisations. Note that there are three types of purchases:

- Items (equipment, stationery, cleaning materials, etc) necessary to facilitate the operations in the business. All businesses make such purchases.
- Raw materials for the production of goods (such as Consol's acquisition of sand for the production of glass bottles or jars). This applies mainly to manufacturers.
- Finished products for the purpose of reselling them. This applies mainly to retailers (such as Pick n Pay, Game or Edgars).

Note that although most of the examples refer to the purchasing of goods, this function is also responsible for the purchasing of services. For example, a business might purchase a cleaning service, rather than employ cleaning staff to do the job or employ garden services rather than maintaining their grounds themselves.



### Activity 10.1

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Read section 14.1 in the prescribed book once more and then summarise the activities involved in the purchasing and supply function. This will help you get a good overview of what the work entails.



*The purchasing and supply function includes the following activities:*

- *choosing the right supplier(s)*
- *determining the quality, quantity, and price*
- *placing the orders and arranging for delivery*
- *expediting delivery and arranging to receive the goods*
- *storing the purchased products*

*Can you add more activities to the list? We suggest that you revisit your answer to this activity once you have mastered the material covered in topic 5.*



## 10.2 THE IMPORTANCE OF THE PURCHASING AND SUPPLY FUNCTION FOR THE BUSINESS



Study section 14.2 in the prescribed book.

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Four specific points highlight the role of the purchasing and supply function. The first is that in many businesses, particularly retail organisations, purchasing makes up a very high percentage of costs. In such businesses, a saving in purchasing costs has a major impact on the business's entire cost structure. The second point is the high cost of holding inventory. Goods kept in storage (whether raw materials or finished products) represent "money lying idle". For example, if a business's inventory was valued at R2 million (and the current interest rate is 10%), it is actually costing the business R200 000 per annum to keep that inventory. If that inventory could be reduced to R1 million, it would mean a saving of R100 000 per year.

These two factors contribute to the third point: the profit leverage effect. The more a business spends on purchasing, the higher the profit leverage will be. Section 14.2.3 illustrates that the business would have to sell 20% more products to create the same extra profit that a saving of 4% in purchasing would bring about. Remember that if purchasing costs are only a small proportion of the total costs, the impact of a saving in purchasing costs on the business's profit would not be all that great.

The last point applies particularly to retailers. If the purchasing and supply function is not carried out well, this will have a major impact on marketing the products. What would happen if the purchasing and supply manager of a fashion store like Foschini or Truworths purchased clothes that didn't appeal to the consumer? Not only would sales drop, but the business would also be stuck with a lot of stock that they can't sell, or else they will have to offer it at considerably reduced prices, thereby lowering their profit margins.

## 10.3 THE MANAGEMENT TASK OF THE PURCHASING AND SUPPLY MANAGER



Study section 14.3 in the prescribed book.

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In describing the management task of the purchasing and supply manager, the author touches on only three of the tasks: planning, organising and control. The management task of leadership is not dealt with – perhaps because the task of leading people does not differ from function to function.

### 10.3.1 Purchasing and supply planning

Three levels of planning are discussed.



## Activity 10.2

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Identify the three components of strategic planning in the purchasing and supply function.



The three components are:

- *securing the provision of materials*
- *developing sources of supply*
- *maintaining a competitive position*
- *This is a long-term approach to ensure that the business will always be assured of sufficient materials, equipment, and so on, in the future.*

Planning at the tactical level involves factors such as budgeting, designing the purchasing system (ie methods, procedures, etc), negotiating purchasing contracts and finding ways to cut costs.

At the operational level, planning involves the day-to-day running of the purchasing and supply department, such as allocating tasks, setting priorities, expediting orders and getting quotes.

### 10.3.2 Organising in the purchasing and supply function

Certain important topics about the organisation of the purchasing and supply function are discussed in section 14.3.2 of the prescribed book. The first topic concerns the place of the purchasing and supply division in the organisation structure. Two sub-topics are dealt with: centralisation or decentralisation, and the hierarchical level of the purchasing and supply function. The second topic concerns the internal organisation of the purchasing and supply function. The third topic concerns purchasing coordination, while the fourth topic concerns cross-functional teams. These matters are explained below.

It is important that you understand the advantages of a centralised structure and of a decentralised structure. A centralised structure has the advantage of standardisation, it can make the most of the business's concentrated purchasing power and it allows staff in the purchasing and supply function to develop into specialists.

The advantage of a decentralised structure is that the purchasing and supply department can meet the unique requirements of users. For example, if all the purchasing for a chain of furniture retail stores is done from head office (ie centralised purchasing) it means each store in the chain would sell the same products. However, the requirements and tastes of customers in Stellenbosch in the Western Cape are likely to be very different from customers in Secunda in Mpumalanga. A decentralised structure means each store manager can purchase the products he or she believes will best meet the needs of the store's particular customers.

Another advantage (which is closely linked to the first one) is that the buyers are in much closer contact with customers (whether they are retail customers as in the above example, or production departments in the same factory). This leads to the third advantage of a decentralised structure: that buyers can react more quickly to their customers' needs.

For example, Eskom's purchasing offices are decentralised – so a supplier needs to approach more than one office because Eskom's buying is not done by one department in one place. In fact, Eskom has a number of buying offices in a number of main centres. Eskom's computer systems registering suppliers are also decentralised and each Eskom group has its own system. A company needs to register as a supplier with each Eskom group to whom it wishes to sell.<sup>15</sup> The Game purchasing team, on the other hand, is centralised in the Durban Mass Discounters' Corporate Office. A merchandise director manages seven merchandise executives who control the selection of ranges and purchasing for 92 departments across seven major divisional categories.<sup>16</sup>

The second sub-topic is the hierarchical level of the purchasing and supply function. Note that not all purchasing and supply managers will be positioned at senior management level. The author lists factors that will determine at what level in the organisational hierarchy the purchasing and supply function will be placed.

The third sub-topic is briefly mentioned: the integration of the purchasing and materials flow activities, with a sample diagram to illustrate the corresponding organisational structure. When it comes to the internal organisation of the purchasing and supply function, the author mentions two possibilities (besides the one where everybody does everything). The first possibility is to structure the purchasing and supply department per product. The second possibility is to structure it per activity. There is also a third possibility: to structure the department per supplier. Here, each buyer in the purchasing and supply department is responsible for all the purchases from a specific supplier (or suppliers), while another buyer is responsible for all the purchases from another group of suppliers. Each structure has its advantages and disadvantages, and although they are not all listed in the prescribed book, you should be able to figure them out for yourself.

The third topic under the subheading "Organising" is purchasing and supply coordination. This coordination is important in three areas:

- coordination within the purchasing and supply department
- coordination with suppliers
- coordination with user departments

The fourth topic deals with cross-functional teams. Here, the purchaser cooperates in a team with colleagues in other functional areas to perform tasks such as supplier selection, negotiation of prices and conditions, determination of supply levels and evaluation of suppliers' performance. Such collaboration may initially encounter resistance, as it has at many companies. But the proven principles of teaming up with users invariably create the conditions for success.

At Legrand North America (LNA), a leading manufacturer of electrical supplies, users from major functional areas worked with buyers on cross-company category teams. For example, the head of human resources of this \$700 million business joined the effort to tackle health insurance expenditure, the marketing director helped tackle advertising and printing, and the engineering executives collaborated on important make-or-buy and global sourcing opportunities.

One of the world leaders in the implementation of cross-functional teams is IBM. The late Gene Richter, IBM's first chief purchasing officer, set the tone which John Paterson, the current chief, maintains by focusing on shared processes and linked objectives. IBM global purchasing owns the sourcing function across all business units and also manages the daily execution of purchase orders. This mission is supported by a set of common processes, ranging from sourcing to fulfilment activities, which allows IBM to achieve scale economies in its spending while offering enough flexibility to take advantage of changing market conditions.

Other groups within IBM heavily influence purchasing's objectives, in part because these groups and purchasing staff share cost reduction and quality goals in their business objectives. Global commodity councils, convening technical specialists and buyers from myriad IBM divisions set and execute sourcing strategy. Production inputs have been sourced in this manner for many years, and over the past decade IBM has used this approach on the rapidly growing expenditures for many services it procures, both to support manufacturing activities and to supply human capital for the IBM global services unit.

At the senior management level, successful sourcing programmes typically include a steering committee composed of the major business unit heads and chaired by the CEO or COO. The CEO must ensure that the unit heads participate actively in the analytical work, push their people to work on cross-functional spending teams, make decisions as a group, and are ready to move ahead and put those decisions into practice. The buyer-user relationship is at the heart of the cross-functional approach, ensuring that requirements are well understood, that specifications are not overly constraining, that lifecycle costs are considered, and that both the realities and opportunities of the potential supply base are considered. Staff from other functions may need to be engaged around this duo as well. Real engagement by these team members depends on visible involvement by their bosses – hence the CEO's critical role on the steering committee.<sup>17</sup>

### **10.3.3 Control in the purchasing and supply function**

In the discussion of control of the purchasing and supply function, two matters are assessed: purchasing and supply management and purchasing and supply activities. In the evaluation of purchasing and supply management the author lists a number of questions that have to be asked (evaluated). Make sure you can identify what has to be evaluated when it comes to exercising control over purchasing and supply activities.

It is a poor reflection on the state of management in South African companies that very few purchasing and supply functions are ever evaluated in accordance with these norms.

## **SUMMARY**

You now have basic insight into the purchasing or sourcing function within the broader context of supply management, including the management task of the purchasing and supply manager and the importance of the purchasing and supply function.

Different perspectives related to purchasing, sourcing and supply chain management underscore the need for a deeper and broader understanding of these concepts – particularly among those not directly working within the purchasing, sourcing and supply space. Employees and organisations who ignore this need will be left wondering why they failed to meet their expectations of purchasing, sourcing and supply management. The reason is that eventually, if purchasing, sourcing and supply management fails to provide the advantages promised by its proponents, it will end up on the scrap heap with all the other business fads that promised so much but delivered so little. In the next study unit we'll be looking at the most common purchasing or sourcing activities performed by most organisations.



## SELF-ASSESSMENT QUESTIONS

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(1) *Four main issues are involved in the organisation of a purchasing and supply department. Which of the following statements on the issue of cross-functional sourcing teams are correct?*

- (a) *The purchaser heads the team in value analysis and new product development.*
- (b) *The aim is to reach decisions on performance in an individual field of management.*
- (c) *Individual fields of management may well have conflicting aims.*
- (d) *Suppliers may be included in a cross-functional team for certain tasks.*
- (e) *Personnel of firms in the supply chain may also be included in a purchasing team.*

- (1) *a b*
- (2) *d e*
- (3) *a b c*
- (4) *c d e*
- (5) *a b c e*

(2) *Which of the following are elements of purchasing and materials management?*

- (a) *production*
- (b) *organisation*
- (c) *technology*
- (d) *planning*
- (e) *control*

- (1) *a b c d e*
- (2) *a c e*
- (3) *b d e*
- (4) *b d*
- (5) *a e*

(3) *Which of the following are criteria for gauging the effectiveness of the execution of the purchasing and supply activities?*

- (a) *price proficiency*
- (b) *supplier satisfaction*
- (c) *timeliness*
- (d) *cost saving*
- (e) *purchasing costs*

- (1) *a b*
- (2) *b c d*
- (3) *a c d e*
- (4) *a b c d e*



### Question 1

*The correct answer is option 4 (c d e).*

*Cross-functional teams play an important part in organising a purchasing and supply department. Alternative a is incorrect: a design engineer would assume leadership in all the value analysis and new product development matters concerning purchasing and supply, because a purchaser does not have the correct technical knowledge to execute these tasks. Alternative b is also incorrect because the aim of cross-functional teams is to reach decisions that will be best for the business and customers, and not necessarily to reach decisions on performance in an individual field of management. Alternatives c, d and e are correct.*

*If your answer was wrong, please refer to section 14.3.2.4 in the prescribed book.*

### Question 2

*The correct answer is option 3 (b d e).*

*The elements of the management task of purchasing and supply discussed in section 14.3.1/2/3 include organisation (alternative b), planning (alternative d) and control (alternative e). Alternative a – production – is regarded as a separate function of the organisation, and is therefore incorrect. Technology (alternative c) is an enabler for the effective execution of purchasing and supply management, but is not regarded as one of the elements of the management task of purchasing and supply management, and is therefore also incorrect.*

*If your answer was wrong, please refer to section 14.3.1/2/3 in the prescribed book.*

### Question 3

*The correct answer is option 3 (a c d e).*

*The criteria applied for gauging the effectiveness of the execution of the purchasing and supply activities include price proficiency (alternative a), timeliness (alternative c), cost saving (alternative d) and purchasing cost (alternative e). Supplier satisfaction (alternative b) is very important to maintaining an optimal relationship between the buying organisation and the supplier and to ensuring continuous improvement in their performance, but cannot be used to measure the effectiveness of purchasing and supply activities within an organisation.*

*If your answer was wrong, please refer to section 14.3.3.2 in the prescribed book.*

# Study unit 11

## Sourcing activities

### Contents

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- 11.1 The purchasing and supply process
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- 11.3 Deciding on purchasing and supply quantities
- 11.4 The selection and management of suppliers
- 11.5 Pricing decisions
- 11.6 Timing of purchases

Summary

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### Key concepts

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sourcing activities	pricing decisions
purchasing and supply activities	price determination
purchasing and supply process	price comparison
quality decisions	timing of purchases
purchasing and supply quantities	scheduling of purchases
inventory holding	market structures
inventory costs	purchasing and supply policies
inventory control systems	long-term supplier relationships
selection and management of suppliers	
supplier performance	
developing suppliers	

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### Learning outcomes

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When you have worked through study unit 11 you should be able to:

- demonstrate an understanding of the purchasing and supply function by highlighting the steps in the purchasing and supply process
- analyse quality decisions as a purchasing and supply activity by summarising the considerations on which the quality of products and services rests
- describe the determination of purchasing and supply quantities by highlighting inventory holding, costs and control systems
- demonstrate an understanding of the selection and management of suppliers by summarising the most important components of the selection, evaluation and development of suppliers

- analyse price determination by identifying the methods used to determine the best price
  - put the right time for purchasing in perspective by highlighting the aims, influencing factors, market structures and policies
- 

## Getting an overview

Study section 14.4 in the prescribed book.

This study unit deals with the purchasing and supply process. A number of activities are associated with this process:

- determining quality
- determining quantity
- choosing and managing a supplier or suppliers (including the outsourcing decision)
- making pricing decisions
- timing purchases
- doing purchasing and supply research
- negotiating in purchasing and supply management

Note that the steps and activities in the purchasing and supply cycle may differ from business to business and from purchase to purchase.

## 11.1 THE PURCHASING AND SUPPLY PROCESS



Study section 14.4.1 in the prescribed book.

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The purchasing and supply process can be regarded as a “check list” or as steps in executing a logical and systematic purchasing transaction. Learners working in a purchasing and supply division may not even be aware of performing some of these steps during a transaction; yet developing such a check list can be a tremendous help towards preventing unsatisfactory purchasing transactions.

The nine steps in the purchasing and supply process have been clearly set out in the prescribed book. Note that not all the steps are carried out with each purchase. The prescribed book points out that some of the steps can be omitted or executed simultaneously in certain purchasing situations. For example, if a standardised product needs to be re-ordered from an existing supplier, it will not be necessary to choose a supplier and determine the price. If the supplier delivers the goods soon after the order has been placed, there will be no need to expedite the order. What is important is that each of the steps should be performed somewhere along the line.

Read the extract below to familiarise yourself with the purchasing and supply procedure utilised by Transnet. Note the different approach they take to the purchasing and supply procedure by making use of tenders and tender boards.<sup>20</sup>



## **Transnet's procurement policy at a glance**

**Introduction:** Prospective tenderers for the supply of goods and services often want to know more about Transnet Limited and what they can expect when dealing with the company. All transactions relating to the procurement of goods and services and the sale of surplus goods are being dealt with in terms of Transnet's Procurement Policy Framework and Procedures, which is aimed at assisting it to operate as a responsible and competitive enterprise.

**Transnet vision:** "Africa's undisputed world champion in transport and logistics solutions."

### **Composition of the company**

Transnet operates and controls South Africa's major transport infrastructure and is accordingly managed to support the initiatives of Government in its efforts to build a strong economy over and above the creation of economic value. Effective corporate governance ensures optimum transparency and accountability.

Transnet is a public company involved in all aspects of transport and harbour operations as well as related services. The Company's services in these fields are enhanced and complemented by rendering logistical services and supply chain management. Furthermore, the Company endeavours to optimise the utilisation of its property portfolio and productively employs assets identified as surplus to its normal business requirements.

Main businesses of the Company are as follows:

- Spoornet – Rail Transport
- Portnet – Harbour Management and Operations
- South African Airways (Pty) Ltd – Air Transport
- Metrorail – Subsidised Suburban Rail Transport
- Petronet – High Pressure Pipeline Transport
- Freightdynamics – Road Transport and Parcel Distribution Services

Related businesses are:

- Transtel – Telecommunications
- Arivia.Kom – Computer support
- Transwerk – Heavy engineering
- Protekon – Design, project management and construction management service
- Propnet – Property management and development

Business units focusing on employee wellbeing are:

- Transnet Housing
- Pension Fund Administration
- Transmed Administration
- Esselen Park Centre of Excellence

## **Commercial policy**

When Transnet purchases or sells goods and obtains services, it strives to obtain optimum value for money, whilst ensuring that open and fair competition prevails, bearing in mind the following important factors:

Transnet's own divisions and business/service units are given the right of first refusal. Only if they cannot deliver the goods or services, or their prices are not market related, may such goods or services be sourced externally.

The promotion, development and support of businesses from the previously disadvantaged communities.

The promotion of national and regional local suppliers before considering overseas suppliers in terms of extant Government policy.

Moral values and an ethical code that underpin the above, based on sound business practices. This value system governs all commercial behaviour within Transnet.

Transnet views its relationship with local contractors who provide substantial support as mutually beneficial commitments whereby all parties integrate their talents, resources and actions in order to provide stipulated requirements, whilst continuously striving to improve its service. Transnet's viability in a deregulated transport market cannot succeed without a reliable supply chain of the right goods and services with the right quality, at the right time and place at the right price. Transnet looks forward to creating and maintaining a good, sound business relationship with the tendering public.

## **Standards**

Transnet subscribes to the following standards of commercial practice:

All our transactions are to be conducted in an efficient and professional manner in support of Transnet's interests.

We insist on unimpeachable honesty and integrity at all times and will not tolerate any form or manifestation of improper influencing, bribery, or any other unethical conduct.

All tenders or quotations are required to be handled in the strictest confidence. No information regarding prices of goods or services will be divulged to competitors or unauthorised personnel of Transnet.

Any conditions of contract are to be clearly and unambiguously stated in writing at the time tenders are invited to ensure that all tenderers tender on the same basis.

Contractual commitments with Transnet are to be respected and met in accordance with good business practice.

Employees who may possibly have a personal interest in a specific tender, quotation or offer, or who are in any way connected or related to a tenderer or his direct relatives, shall recuse themselves from the receipt, adjudication or acceptance thereof.

All transactions are subject to periodic review by our auditors and where applicable by our Tender Board.

### **Gifts and entertainment**

Employees are not permitted to accept gifts or buy goods or services at artificially low prices, which are not available to the public, or accept personal favours and hospitality which might, or might be deemed by others, to impinge upon the employee's sound business judgement.

For the purpose of fostering interpersonal business relations, exceptions of the following nature are allowed:

- advertising material of small intrinsic value,
- incidental business hospitality which the employee is prepared to reciprocate,
- complementary tickets to sports meetings and other public events but excluding the cost of transport and accommodation which the employee must bear. Invitations to official functions should be addressed to the Manager of the commercial component who may delegate a representative.

### **Procedures**

The tendering system is Transnet's main buying and selling mechanism as it ensures open and fair competition for any person or enterprise who wishes to tender for Transnet's business.

Tender responses for the procurement of goods and services are obtained by advertising tenders in newspapers, electronic and other private tender bulletins to which tenderers subscribe.

There are, however, instances where the calling of open tenders is just not possible or practicable (for example, low value transactions, or crisis situations where human lives are at stake or where Transnet's property or assets are at risk) and where there is not sufficient time to call for open tenders. All these exceptions from the open tender system are governed by internal policies and procedures to prevent abuse.

Tenders or quotations which arrive after the specified closing time or which are deposited at an incorrect address will be regarded as late/inadmissible tenders and will not be considered.

No communication is permitted between a Transnet employee and a tenderer or vice versa during the period between the closing date of a tender and the official notification of the successful tenderer of the acceptance of his offer. Should a tenderer wish to communicate anything to Transnet during this period, he may only communicate with the Chairman of the Divisional Tender Board/Committee, or in his absence,

with the Secretary of the Board/Committee. An employee of Transnet may, with due authorisation, communicate with a tenderer regarding his tender or quotation for limited purposes to facilitate evaluation of his tender.

Changes in specifications, plans, or tender conditions are permitted provided all tenderers or prospective tenderers are duly advised thereof and are given the opportunity to tender or retender by a revised closing date and time.

Evaluation criteria include price, conformance with specifications, experience, equipment, financial standing and previous performance based on timeliness, quality and service bearing in mind Transnet's policy for the development and support of the previously disadvantaged.

Only persons with delegated powers have the authority to enter into contracts on behalf of Transnet.

A request to tender or quote implies a serious intention on the part of Transnet to do business, and only under exceptional circumstances will it withdraw a tender/enquiry.

### **Role of Transnet group tendering and policy function and divisional tender boards**

The Transnet Tendering and Policy Function is responsible for the receipt and opening of all the major (high value) tenders and quotations. Such tenders and quotations are issued by the divisions or business units themselves but close at the Transnet Tendering Office at 10:00 on specified Tuesdays.

After evaluation of all tenders or quotations by the division or business unit concerned, a recommendation on the award of business is made to the relevant Divisional Tender Board or Tender Committee. Each of the six main transport divisions listed on page 1 has its own Divisional Tender Board and the business units/related businesses listed on page 2 are represented by Tender Committees.

The Divisional Tender Boards/Committees monitor and report to the Group Tendering and Policy Function on compliance with all internal policies, rules and instructions governing the administration of all tenders and contracts.

Prices tendered by tenderers for Transnet's requirements are treated with the same confidentiality as the tenderers themselves treat their prices, and therefore tendered prices are not disclosed. The only information Transnet is prepared to make available is the names of all the tenderers who responded to a particular tender invitation and the name of the successful tenderer (but not the tender price). Unsuccessful tenderers are advised in whichever category they were unsuccessful, eg price, quality, delivery etc upon request.

During evaluation of the tenders received, several factors such as price, delivery, quality, BEE involvement, after sales service, etc are taken into account, which means that Transnet does not necessarily have to accept the lowest priced tender. The Divisional Tender Boards act as Transnet's watchdog and ensure that fair competition both in the eyes of Transnet and the public at large has prevailed and that optimal value for money is obtained, within Transnet's Procurement Policy.

### **Transnet's policy on black economic empowerment (BEE) or development and support of disadvantaged suppliers and contractors**

Transnet decided to support the Government's Reconstruction and Development Policy by actively promoting the effective and efficient development of suppliers and contractors from the historically disadvantaged communities. To this end it introduced a mechanism which will allow the targeted groups to enter the mainstream economy, without preventing those who fall outside such target groups from tendering or from ultimately winning the business.

The following are a few basic principles on which Transnet's BEE Policy is based:

- BEE should help all participants to become self-sufficient and contribute towards the economy of the country.
- The identification and development of black entrepreneurial potential is necessary to advance BEE. BEE should be aimed at the upliftment and development of black entrepreneurs who have the potential and skills to become self-sufficient and who would in time be able to compete on an equal basis with established businesses.
- Quality workmanship, service levels and timely delivery are prerequisites for an effective BEE Policy.
- BEE is aimed at the development of independent entrepreneurs and not merely the creation of jobs.
- The use of black persons as fronts for established businesses which have been advantaged by the previous dispensation, is not acceptable. Transnet reserves the right to investigate such firms to establish the real owners as well as the extent of black participation, taking into account shareholding, ownership, day to day management, etc. Businesses which act merely as agents, representatives, or intermediaries and which do not add value or which are merely used as marketing channels for established business advantaged by the previous dispensation, do not qualify for consideration within the BEE Policy. Firms claiming to qualify on false pretences will be restricted from further business with Transnet.
- The BEE Policy will eventually be phased out. Socio-economic considerations and market forces will determine the duration thereof.

## 11.2 QUALITY DECISIONS AS A PURCHASING AND SUPPLY ACTIVITY



Study section 14.4.2 in the prescribed book.

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Note that quality does not necessarily mean the highest possible quality to a purchaser. If, for example, a manufacturer produces relatively cheap clothes for lower income groups, the quality of the material will probably not be the best obtainable, but it must be the best for the price that the manufacturer is willing to pay for the raw material. Quality is therefore not evaluated in absolute terms but in relative terms: that is, how suitable it is for the use to which it will be put.



### Activity 11.1

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Analyse the purchasing and supply manager's task in the determination of quality.



Purchasing and supply managers must:

- *ensure that they understand the precise quality requirements of the user (usually the production department)*
- *draw up a comprehensive quality description (with the help of the user department) to avoid any misunderstandings between the business and the supplier as to what quality standards are*
- *exercise quality control to ensure that the delivered materials meet the required quality standards*
- *be on the lookout for ways and means to improve quality, either through encouraging the supplier to improve the quality, or by investigating the use of other materials, or other suppliers*

Quality is often associated with standardising certain specifications. In various countries, national standards had already reached a settled state at the beginning of the 20th century, with bodies like the British Engineering Standards Association and the American Standards Association. Currently, there are national standards bodies in all the industrialised countries of the world, including the South African Bureau of Standards (SABS) in South Africa. Products carrying the SABS mark include building materials, electrical equipment, wooden products, textiles, paints, rubber products, metals and alloys. The SABS mark serves as a "guarantee" that the product satisfies a certain standard specification and that an accepted quality system is maintained for that purpose. For example material, quality, composition, design, safety, durability and performance are confirmed by such a mark.<sup>21</sup>

## 11.3 DECIDING ON PURCHASING AND SUPPLY QUANTITIES



Study section 14.4.3 in the prescribed book.

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One of the earliest problems investigated by businesses was how to ensure that the correct quantities of materials were purchased. The computerisation of inventories has resulted in a far better understanding of inventory management and has contributed to the solution of inventory problems.

Note that inventory control is (or should be) the responsibility of the purchasing and supply department since it determines to a large extent what the inflow of raw materials will be. It is also important to understand that inventory control is concerned not so much with keeping the inventory levels at a minimum as with keeping the inventory costs to a minimum. This requires preserving a delicate balance between the two components of inventory costs:

- costs of storing a large inventory with subsequent low ordering costs
- costs of frequent ordering with subsequent low storage costs

Figure 14.7 shows how the optimum balance between these two components can be achieved.

## 11.4 THE SELECTION AND MANAGEMENT OF SUPPLIERS



Study section 14.4.4 in the prescribed book.

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Game is regarded as one of South Africa's largest retailers. They believe that their suppliers are partners in their business, with whom they will develop long-term relationships founded on trust and to both parties' mutual benefit. Business activities between Game and their suppliers are conducted with integrity, sincerity and fair-mindedness, which they know encourages open communication at all levels. They believe in being open with their suppliers, dealing with them in a highly professional, knowledgeable and decisive manner, and sharing Game's business needs with them, while being sensitive to theirs. Formal trading agreements and sales targets are negotiated annually, which encourages growth and the resultant improvement in mutual profitability.<sup>22</sup>

As we see from the above example, suppliers hold the key to successful purchasing and supply management and, as a result, extreme care should be exercised in selecting, developing and motivating suppliers. However, selecting the right supplier is not enough.

The purchasing and supply manager needs to take action to develop and improve relations with suppliers. When manufacturer and supplier begin to see one another as "business partners", they will be more willing to help one another in times of crisis, to their mutual benefit. Most of the motor manufacturers, for example, have full-time personnel whose

sole task is to liaise with the company's suppliers, assess their performance and motivate them to improve their service to the business.

One of the reasons for developing suppliers is that a particular product or service is not available. Here the manufacturing company can help a supplier set up a manufacturing facility to produce the needed products. This approach, however, has the disadvantage that it gives the supplier a monopoly, so it may not be as competitive.

Many products in South Africa are supplied by only one or a limited number of businesses. A policy of constantly seeking to improve the service of suppliers could promote healthy competition in the market. In the 1980s sanctions on exports to South Africa also compelled businesses, previously dependent on foreign suppliers, to resort to the development of local South African suppliers. Since 1994 a strong need has arisen for the development of suppliers who have previously not had the opportunity to compete in the market. Such affirmative action steps have provided an added dimension to the whole question of evaluating suppliers.

Standard Bank is committed to actively assisting broad-based black economic empowerment (BEE) initiatives in the South African economy. The group's supplier transformation programme will contribute to the creation of a more equitable society, while aligning the group with South African business imperatives. Standard Bank will support these entities by purchasing goods and services from them where appropriate, as well as encouraging its own suppliers to work with BEE suppliers in respect of the goods and services provided to the group. The group promotes the principles of openness, integrity and fairness in its drive to implement best procurement practices. The group's supplier transformation policy, the small and medium enterprises (SME) procurement policy and the preferential procurement policy, together with the requirements of the charter, will govern the supplier transformation process across the group. The group is also an active participant in the interbank charter working group which is formulating guidelines that will govern procurement processes in line with the charter requirements.<sup>23</sup>

## 11.5 PRICING DECISIONS



Study section 14.4.5 in the prescribed book.

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What is the "best" price? It is not necessarily the lowest price, because factors like quality and service also play a significant role. The key to determining the best price is value. Motorcars are sometimes described by motoring editors as having "the best value for money", implying that there might be cheaper cars on the market, but that the price asked for the particular model they are referring to gives the best value in terms of quality, efficiency, performance, and so on.





## Activity 11.2

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Identify the three basic methods of price determination.



- *The Published price lists. This method is most suitable for the purchasing of standard materials of a low monetary value, for example screws and stationery.*
- *Quotations (written or verbal). In this case suppliers are asked to make an offer. This method is suitable for standard materials and non-standard or custom-made materials with a high monetary value.*
- *Tenders (open or closed). Here suppliers are also asked to make an offer. Tenders are suitable for the purchase of custom-made materials with a high monetary value when there is plenty of time and many suppliers who are competing in the market. Refer back to Transnet's procurement policy included earlier in the study unit.*

*Note that the words "price list" do not necessarily mean a piece of paper with the prices written down. They mean that the supplier is asking a fixed price for the article that is not subject to negotiation. Price tags on articles in a retail store represent a "price list".*

*Negotiation is not a price determination method on its own, but rather a follow-up on one of the above three methods. In other words, a supplier may publish a price and the purchaser may then negotiate for a lower price. The purchaser can respond in the same way to a quotation or a tender.*

## 11.6 TIMING OF PURCHASES



Study section 14.4.6 in the prescribed book.

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The decision about when to buy can never be taken in isolation. It is very much influenced by price and quantity. The best time to buy is when prices are low. However, low prices are often linked to large quantities, which may lead to increased inventory costs. In other words, although these three factors are discussed separately, the purchaser takes all three into account simultaneously.



## Activity 11.3

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Describe the factors that influence the time at which purchases should be made.



*The factors that influence the timing are:*

*(1) Internal factors*

- *Business policy*
  - *For example, to forbid any speculative purchasing.*
- *Availability of funds*
  - *If limited funds are available, the purchaser cannot always purchase at the best time.*
- *The needs of the production or marketing departments*
  - *If these departments need the products, they have to be purchased whether the time is right or not.*
- *The availability of storage space*

— It may be difficult to buy a large volume at low prices if there is no place to store the goods.

(2) External factors:

- Market conditions. In times of recession, prices are likely to be considerably lower.
- The lead time and reliability of suppliers. The longer the lead time, or the less reliable a supplier, the more reason to purchase required goods well in advance.
- Government policy (affecting international trade). If there are government restrictions on the money that can flow out of the country to pay for imports, this will place an obvious restriction on purchasing from overseas suppliers. In such cases the purchases will have to be timed to coincide with an adequate supply of foreign capital.
- Market structures. The timing of purchases is far more critical in volatile markets than in stable markets.

## SUMMARY

You now have basic insight into purchasing and supply management as well as sourcing activities such as the purchasing and supply process, determining purchasing quantities, price and timing of purchases, and purchasing and supply research. Effective first steps for purchasing, sourcing and supply management are to set more aggressive goals and to establish a pact with the CEO of the organisation: "We will deliver against the goals, if you will support the programme." The CEO's support will be needed to grease the wheels in working with other functions, to approve the allocation of resources and funds, and to provide oversight and governance of the sourcing programme. We have never seen a CEO turn down this offer when it is proposed as a two-way agreement with a commitment to make a major impact on the business. Purchasing, sourcing and supply management thus offers a real chance to boost operating performance and promote dynamic cultural norms that can raise the profile of the function and make a major difference in delivering value to shareholders. This study unit concludes the topic on purchasing and supply management.



### SELF-ASSESSMENT QUESTIONS

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- (1) Which of the following documents are used by other departments to convey their requirements to the purchasing and supply department?
- (a) economic order quantity
  - (b) materials list
  - (c) order chart
  - (d) specification list
  - (e) requisition
- (1) a b  
(2) a e  
(3) a b c  
(4) b c d  
(5) b c d e
- (2) Which of the following statements on the basic steps in the purchasing and supply process are wrong?
- (a) The specification describes not only the kind of material required but also the quality.

- (b) *The complexity of the decision on the choice of supplier will depend on whether the order is a new purchase.*
  - (c) *This complexity will also depend on whether the order is a repurchase.*
  - (d) *It is the task of the financial department to authorise payment to the supplier.*
- (1) *a b c*
  - (2) *b c*
  - (3) *a d*
  - (4) *d*
- (3) *Which of the following are the main policies which affect the scheduling or timing of purchases?*
- (a) *scheduling purchases according to needs*
  - (b) *advance purchasing*
  - (c) *speculative purchasing*
  - (d) *minimum purchasing*
- (1) *a b c d*
  - (2) *b c d*
  - (3) *a c*
  - (4) *d*



### **Question 1**

*The correct answer is option 5 (b c d e).*

*The documents used by other departments to convey their requirements to the purchasing and supply department include a materials list (alternative b), an order chart (alternative c), a specification list (alternative d), and a requisition (alternative e). An economic order quantity (alternative a) is only calculated once the requirement has already been identified, and is used to ascertain what the optimal amount of the product or service is when purchasing occurs. Alternative a is therefore not correct.*

*If your answer was wrong, please refer to section 14.4 and figure 14.6 in the prescribed book.*

### **Question 2**

*The correct answer is option 4.*

*The specification describes not only the kind of material required, but also the quality of the material that needs to be purchased. Alternative a is thus correct. It is true that the complexity of the decision on the choice of supplier will depend on whether the order is a new purchase or a repurchase. Alternatives b and c are therefore also correct. It is the task of the purchasing and supply department to authorise payment to the supplier, but the financial department must execute such a task. Alternative d is therefore incorrect.*

*If your answer was wrong, please refer to section 14.4 in the prescribed book.*

### **Question 3**

*The correct answer is option 1 (a b c d).*

*The main policies which affect the scheduling or timing of purchases include the scheduling of purchases according to needs (alternative a), advance purchasing (alternative b), speculative purchasing (alternative c) and minimum purchases (alternative d).*

*If your answer was wrong, please refer to section 14.4.6.2.*

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