

SCHAUM'S OUTLINE SERIES

THEORY AND PROBLEMS OF

Introduction to BUSINESS ORGANIZATION and MANAGEMENT

JOEL J. LERNER

INCLUDING 410 SOLVED PROBLEMS

SCHAUM'S OUTLINE SERIES IN BUSINESS

McGRAW-HILL BOOK COMPANY

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THEORY AND PROBLEMS

of

Introduction to
BUSINESS ORGANIZATION
and MANAGEMENT

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by

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Schaum's Outline of Theory and Problems of
INTRODUCTION TO BUSINESS ORGANIZATION AND MANAGEMENT

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Preface

The purpose of this book is to present in a clear and systematic way all the essential information needed for an understanding of contemporary business theory and practice. The book is intended as a supplement to all current introductory texts in the fields of business and management, although some may find it sufficiently rigorous and thorough to be used in place of a formal textbook.

Each chapter begins with a concise presentation of theory and definitions supported with illustrative examples. This is followed by summary sections of defined business terms and review questions with answers. A group of solved problems completes each chapter; these serve to illustrate and amplify the theoretical principles in a learning-by-doing methodology, providing the student with the active reinforcement so vital to effective learning. Finally, five examinations typical of those given in two- and four-year colleges are included, with answers.

I would like to express my gratitude to Professor Joe Shambley who reviewed and commented on the developing manuscript, as well as to those members of the McGraw-Hill staff who provided untiring editorial assistance. Finally, I thank my family, Anita, Marc, Steven, and Caren, for accepting the time restraints I placed on each member of the group.

JOEL J. LERNER

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SECTION I: Introduction to Business Organizations

Chapter 1

The Nature of Business

1.1 THE OBJECTIVE OF BUSINESS

The objective of business is to produce and sell for a profit goods and services that satisfy society's needs and wants. Such goods and services are made available in a market, the place where buyers and sellers meet.

For a market to function, there must be an exchange or transfer of title to the goods. It is here that supply (reflecting the availability of goods and sellers offering them for sale) and demand (reflecting the desire and the purchasing power of buyers) are consummated in a purchase-sale transaction at a specific price.

In a money economy, the term *profit* refers to the excess of income over expenses associated with the production and sale of goods or services. The profit motive is the seller's primary inducement to engage in business.

EXAMPLE 1

In its first year of operation, the Thompson Company had a gross income from sales of \$675,000 and total expenses of \$575,000. Its profit, or *net income*, was \$100,000 for the year.

EXAMPLE 2

Suppose instead that Thompson had expenses of \$700,000. It would then have sustained a \$25,000 loss for the year.

1.2 FROM BARTER TO MONEY ECONOMY

In early times, business was conducted by means of a barter system, in which goods of one kind were exchanged for other goods of equal value. The problems in determining equivalent value of the trading items needed by both parties led to a *money economy*, in which the buyer exchanges an amount of cash specified by the seller for needed goods or services.

1.3 GROSS NATIONAL PRODUCT

The *gross national product*, or *GNP*, is a statistical device used to measure economic growth. It is defined as the total value of all final goods and services produced in one year in a given country.

EXAMPLE 3

Since the measurement of economic growth is primarily concerned with the quantity produced, the effect of price fluctuations on output from year to year must be considered. Suppose that a comparison of GNPs in Year A and Year B is made. Assuming no fluctuation in the price level, an increase in total output value (GNP) from \$100 billion in Year A to \$105 billion in Year B represents a 5% increase in economic growth. However, if the price level has risen 5% between Year A and Year B, the \$5 billion increase would have been the result of prices, not an expansion in actual output, and there would have been no economic growth. In this case, Year A is the *base year* (which is arbitrarily selected) to which Year B was compared, and growth was measured in terms of the *constant dollar*, the value of output in the base year. The effects of changes in the price level are thus eliminated.

1.4 CAPITAL AND RISK

Two basic types of businesses are *industrial* (engaged in production, extraction, and construction) and *commercial* (involving marketing, finance, and services).

A business functions by means of capital, of which there are two kinds: capital funds and capital goods. The term *capital funds* refers to the money needed to operate a firm, while the term *capital goods* refers to the equipment (tools, land, building, and machinery) needed to make and market the product or service.

In operating a business, capital is *risked*, meaning its expenditure can result in loss. Risks which may cause losses include such things as product obsolescence, labor disputes, managerial misjudgment, extraordinary forces (e.g. fire, flood, theft), and failure to meet competition.

According to Adam Smith, there is an *invisible hand of competition*. This means that many individuals enter business, but because some business firms compete more successfully than others, the relatively inefficient ones get weeded out. The weeding out is the invisible hand.

EXAMPLE 4

The Saunders Company almost went out of business when its line of transistorized calculators lost out to the hand-held integrated circuit calculators introduced by its competitor. The company successfully made the switch to integrated circuit calculators, however, and began to show a rapid recovery. Then one day its employees went out on strike. The strike lasted so long that production and marketing objectives were not met. Once again the company was on the verge of bankruptcy.

1.5 PRIVATE SECTOR AND PUBLIC SECTOR

Organizations that make a profit are called, in the aggregate, the *private sector* (of the economy). The *public sector* comprises organizations whose objectives are not money profit but *social profit*, meaning a benefit to society in general. The latter are *nonprofit enterprises*. Examples of nonprofit organizations are charities, transit systems, boards of education, churches, and public hospitals.

1.6 ECONOMIC SYSTEMS

The four major forms of economic systems in the contemporary world are capitalism, socialism, fascism, and communism.

Capitalism. Economic theories have been developed to explain the operation of capitalism. These theories range from macroeconomics (the functioning as an organic whole) to microeconomics (decisions by firms regarding prices and profits). Capitalism is an economic philosophy, not a form of government. In capitalism, individuals are free to own property, own a business, compete freely in the market, and determine their own future. Providing there is a market need, an individual is free to determine which goods and services he or she wants to produce and the manner of production. This freedom is known as *laissez faire*.

According to the free enterprise system, the *entrepreneur* supplies money and organizes a business. Entrepreneurs are free to make as much money as they can — or, of course, lose the invested money. Entrepreneurs are the prime movers of capitalist economic activity; they vitalize the economy.

Socialism. Socialism can be both an economic system and a form of government. Under socialism, the government decides, in the best interest of society, what kinds and what quantities of goods and services shall be produced. The individual is relatively free to choose an occupation, but the government exerts pressure, attempting to fit individuals into overall societal needs.

In a socialist government, if the enterprises are judged essential to the nation's economy and therefore need to be more efficiently exploited, the government can take over a business of an entire industry simply by compensating the owners.

Communism. Communism too is both an economic system and a form of government. Under communism, there is little or no private property and no (money) profit motive. The state is the

employer, and everyone works for the benefit of society as a whole. The government decides who may produce what goods or services, how much, for whom, at what recompense, and by what means. As with fascism, political freedom is radically controlled.

In contrast to the pure economic forms described above, most countries have *mixed economies*. In the United States, for example, capitalism has in it an element of socialism in that the government not only intervenes in the private sector (passing restrictive legislation such as antitrust laws) but is sometimes invited to do so (e.g. rescuing a needed railroad from bankruptcy or, as in the case of the Chrysler Corporation in 1980, the granting of huge loans). Therefore, there is no such thing as pure laissez faire capitalism.

At the same time, communist countries have introduced a wage system that pays employees not according to the job but according to individual performance, which contradicts the tenets of pure communism by introducing competition and unequal pay for the same skill. Also in recent years, individuals in the U.S.S.R. have been permitted to own small gardens and to grow produce of their choice — private property.

Table 1-1. Comparisons of Economic Systems

| Factor | Socialism | Communism | American Capitalism |
|-----------------------|----------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|-----------------------------------------------------------------|
| Capital | Investment in state's bonds and by prices paid for goods. | Generated by the state from taxes gotten from production. | Private investors and lending institutions supply most capital. |
| Risk and loss | Risks and losses of state-owned industries borne by citizens through higher taxes or prices. | Government accepts all risks. | The responsibility of private individuals. |
| Ownership | State owns and operates certain basic industries (utilities, transportation, and steel). | State owns all productive assets. | Private ownership. |
| Labor | Free choice of work, but state encourages some forms of employment | State dictates the place of work and is the only employer. Workers have some choice of occupation. | Freedom to work at whatever job one chooses. |
| Incentives | Wages related to a judgment of the value of each person's contribution to society. | Work standards with incentives (public recognition, status, and awards). | Wages and profits directly related to one's ability to serve. |
| Competition | Private businesses may compete, but state-owned facilities operate according to master plan. | Generally prohibited. | Free choice to compete. |
| Products and services | Basic products and services determined by central planning. | Commanded entirely by state's economic and political plans. | Determined by consumer demand and amount of profit. |
| Consumer choice | Generally unrestricted. | Limited to planned supply. | Enormous variety. |

Business Terms

Barter economy. An economy in which goods and services are traded for other goods and services.

Business. The organized effort by individuals to produce goods and services, to sell these goods and services in a marketplace, and to reap financial reward for this effort.

Capital. Can be capital funds or capital goods. Capital funds refer to the money needed to start and operate a business. Capital goods include the equipment used to manufacture and sell the goods and services.

Capital funds. Consist of money available to a business from profits, financial institutions, loans, and the entrepreneur's personal resources.

Capital goods. Consist of such things as tools, equipment, buildings, fixtures, patents, land, raw materials, and merchandise for sale.

Constant dollar. A statistical concept concerned with adjusting the dollar so that it will measure the same quantity of goods and services.

Entrepreneur. An individual who conceives an idea for a new product or service and then finds some way of raising capital to form a business to produce that product or service.

Firm. An individual business producing goods and services.

Free enterprise. The system of business characterized by the freedom to engage in the business of one's choice.

Gross national product (GNP). The total value of all goods and services produced by a country in one year.

Laissez faire. A French term translated by economists to mean no interference by a government in business or the private sector

Product. A complex of tangible and intangible attributes including packaging, color, price, manufacturers' prestige, retailers' prestige, and manufacturers' and retailers' services that the buyer may accept as offering satisfaction of wants or needs

Profit. The excess of revenues over expenses.

Recession. An absence of growth of the GNP for two successive quarters.

Risk. The possibility of loss.

Review Questions

Part I: True or False

- _____ 1. Capitalism is a social and economic system that has no social classes.
- _____ 2. The purpose of business is to produce and market needed products.
- _____ 3. The three basic features of capitalism are private property, freedom of choice, and the profit motive.
- _____ 4. Profit is computed by combining income and the seller's expenses.
- _____ 5. Entrepreneurs are employees of a business.
- _____ 6. Competition determines the price at which sellers will offer a particular product
- _____ 7. The most basic concept in the marketplace is that of supply and demand.
- _____ 8. No country in the world has a mixed economy.
- _____ 9. Pure laissez faire capitalism is theoretical.
- _____ 10. The concept of entrepreneurship is as applicable to communism as it is to capitalism
- _____ 11. Firms, organizations, and enterprises are different forms of business.
- _____ 12. All organizations are in business to make a profit.
- _____ 13. A free market exists wherever people must buy goods and services to live.

- ____14. A political official may be correct when he says "The government cannot control the supply or demand for goods."
- ____15. An important difference between capitalism and communism is the power of central planning in controlling the economy.
- ____16. Communism attempts to eliminate the profit motive.

Answers:

- (1) False. Communism has no social classes.
- (2) True.
- (3) True.
- (4) False. Expenses are subtracted from income, not combined.
- (5) False. Entrepreneurs are those people who begin a business.
- (6) True
- (7) True.
- (8) False. Most countries have mixed economies.
- (9) True.
- (10) False. Only to capitalism because of risk.
- (11) True.
- (12) False. Some are nonprofit organizations.
- (13) True.
- (14) True.
- (15) True.
- (16) True.

Part II: Multiple Choice

1. Which of the following is not a common business risk? (a) Theft, (b) competition, (c) bookkeeping procedure, (d) changes in style.
2. Only one of these systems is an economic philosophy and not a form of government: (a) capitalism, (b) fascism, (c) socialism, (d) communism.
3. Laissez faire economics is found only in (a) communism, (b) capitalism, (c) socialism, (d) none of the above.
4. The objective of business is to (a) produce and sell goods, (b) satisfy the needs and wants of society, (c) produce and sell goods to satisfy the wants and needs of society, (d) produce and sell goods and services for a profit.
5. The GNP measures (a) all goods and services produced by a country, (b) all industrial goods and services produced by a country, (c) all industrial goods and services plus the natural resources of a country, (d) all final goods and services produced in one year in a given country.
6. Capital goods do not include (a) tools, (b) land, (c) machinery, (d) personnel.
7. In the United States, business believes in both free enterprise and government regulation. Although this appears to be a contradiction, the reason is (a) the government is itself in business, (b) society benefits from the regulation, (c) a regulated society is a more stable one, (d) profits are equitably shared in this way.
8. Business comprises such organizations as (a) manufacturing firms, (b) service industries, (c) all firms that deal with other firms and the public, (d) all of the above.
9. Most business failures are caused by (a) depression, (b) inflation, (c) competition, (d) mismanagement.
10. Government accepts all risks under which system? (a) Capitalism, (b) free enterprise, (c) socialism, (d) communism.
11. Of the total number of business enterprises in the United States, small businesses make up (a) 80%, (b) 60%, (c) 52%, (d) less than 10%.
12. An entrepreneur is (a) one who takes a risk in business, (b) an employee of a business, (c) the ultimate consumer, (d) none of the above.
13. Most entrepreneurs go into business in order to (a) make a profit, (b) do good for society, (c) create a demand, (d) meet the needs of the public.
14. If supply exceeds demand, prices (a) normally fall, (b) normally rise, (c) remain the same, (d) none of the above.

15. What type of firm converts natural resources into raw materials? (a) Manufacturing, (b) extractive, (c) mercantile, (d) none of the above.
16. Under capitalism, most of the capital is owned by (a) the government, (b) the media, (c) individuals and businesses, (d) the banks.
17. Under capitalism, the government protects property rights by (a) not intervening, (b) determining profit levels (c) enforcing contracts, (d) determining production methods.
18. The outstanding feature of business in a communistic country is (a) central economic planning, (b) decentralized economic planning, (c) laissez faire controls, (d) none of the above.
19. Desire and the purchasing power of buyers are reflected by (a) supply, (b) profit, (c) demand, (d) none of the above.

Answers: (1) c, (2) a, (3) b, (4) d, (5) d, (6) d, (7) b, (8) d, (9) d, (10) d, (11) a, (12) a, (13) a, (14) a, (15) b, (16) c, (17) c, (18) a, (19) c.

Part III: Matching

Choose the economic system in Column A that is best described by the items in Column B.

| Column A | Column B |
|------------------------|----------------------------------------------------------------------------------|
| (a) Private enterprise | (1) Private ownership is encouraged. |
| (b) Socialism | (2) Limited private profit is allowed. |
| (c) Communism | (3) Government owns all means and facilities of production. |
| | (4) Competition is encouraged. |
| | (5) The state owns and operates the main production and distribution industries. |
| | (6) Competition usually is not allowed. |
| | (7) Consumer demand dictates production. |
| | (8) Limited competition is allowed. |
| | (9) The profit motive is dominant for businesses. |

Answers: (1) a, (2) b, (3) c, (4) a, (5) b or c, (6) c, (7) a, (8) b, (9) a.

Solved Problems

- 1.1** Assuming a base-year GNP of \$100 billion in Year A, determine the level of economic growth in Year B if (a) the price level remains the same and the GNP is \$105 billion, (b) there is a 5% increase in the price level and the GNP is \$105 billion, (c) there is a 10% increase in the price level and the GNP is \$120 billion, and (d) the price level decreases by 10% and the GNP is \$108 billion.

SOLUTION

- (a) Since there was no change in the price level, economic growth in Year B was 5%, or \$5 billion.
- (b) In this case, the \$5 billion increase in GNP is due entirely to an increase in the price level, and there is no growth in physical output. (See Example 3.)
- (c) Constant dollars are determined by means of a *price index*, which reflects changes in the base-year price level (i.e. base-year level, 1.00; 10% increase, 1.10; 5% decrease, .95). The actual economic growth is associated with a GNP of \$120 billion and a 10% increase in the price level is calculated as follows:

$$\$120 \text{ billion} \div 1.10 = \$109 \text{ billion}$$

or, in constant dollars, output expanded from \$100 billion in Year A to \$109 billion in Year B, an increase of 9%.

- (d) A 10% decrease in the price level with a GNP of \$108 is reflected in constant dollars as follows:

$$\$108 \text{ billion} \div 0.90 = \$120 \text{ billion}$$

In this case, a decrease in the price level has resulted in economic growth of \$20 billion, or 20% in base-year constant dollars.

- 1.2** Would it be an economic boon to have the GNP of the United States continue to grow indefinitely, with a concomitant rise in the standard of living?

SOLUTION

Only up to a point Many environmentalists feel that an unrestricted growth in GNP could lead to a serious depletion of national and world resources, if not ecological disaster. The United States has less than 6 percent of the world's population and occupies only 7 percent of the world's land mass, yet it enjoys more than 33 percent of the world's goods and services. In effect, therefore, barring changing conditions, an indefinitely continuing rise in the American standard of living would cause a disproportionate depletion of the world's resources.

- 1.3** Laissez faire means that the government should not interfere in business. Discuss the credibility of this statement.

SOLUTION

Business does have restraints placed on it, such as, for example, antitrust laws. Therefore, it is not altogether free to act as it wishes. Laissez faire means only that the government should not interfere with or restrain competition between private businesses but instead allow them to respond to the market according to supply and demand. This system is known as free enterprise.

- 1.4** Compare the economic systems of capitalism and socialism.

SOLUTION

| Capitalism | Socialism |
|--------------------------------------------------------------------|----------------------------------------------------------|
| Private ownership of property and means of production | Government ownership of property and means of production |
| Strict limitation of government intervention in business decisions | Almost total government control of business decisions |
| Production for profit | Production for society's welfare |
| Prices set by supply and demand forces in free markets | Prices set by government authorities |
| Competition determines which producers survive or fail | Periodic government review of performance of industry |

- 1.5** The role of the entrepreneur is important in a capitalist society. Describe this unique position.

SOLUTION

Entrepreneurs are risk takers; they assume these risks with the expectation of making a profit. Entrepreneurs organize business firms, make business decisions, and hire personnel. They combine property, labor, and capital to create and provide for the operation of their firms. Entrepreneurs are key individuals in a capitalist society; without them, no capitalistic situation could exist.

- 1.6** Explain, with the use of a diagram, how a firm fits into the economy.

SOLUTION

An individual enterprise is a *firm*, and all firms of the same kind form an *industry*. All industries combined are the *business system*, and the business system forms a part of the *economy*. See Fig. 1-1.