Cengage

20th Edition

SMALL BUSINESS MANAGEMENT

Launching & Growing Entrepreneurial Ventures

Longenecker • Petty • Palich • Hoy

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Small Business Management: Launching & Growing Entrepreneurial Ventures,
Twentieth Edition

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Brief Contents

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Part 5
Managing Growth in the Small Business

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Preface

> *I didn't realize how hard it was to run a small business.*
>
> ***—Andrew Mason, former CEO of Groupon***
>
> Andrew Mason, the founder of Groupon, is featured in the case for Chapter 19. Even though Mason created the company, he was eventually fired by the board. He clearly had a creative idea but discovered too late that building and running a successful business requires more than having a good idea. This concept, along with many others, will be explored in more depth throughout this latest edition of *Small Business Management: Launching and Growing Entrepreneurial Ventures.*

We welcome you to the 20th edition of *Small Business Management: Launching and Growing Entrepreneurial Ventures.* At its core, *Small Business Management* is organized to help students and future entrepreneurs achieve success in whatever field they choose. The wide spectrum of content, applications, cases, graphics, stories, and other details offered in *Small Business Management* has assisted many small business entrepreneurs in making their dreams come true. With a focus on learning, our features emphasize activities that capture student interest and guarantee practical knowledge.

In 1964, Halsey Broom and Justin Longenecker wrote the first edition of *Small Business Management: Launching and Growing Entrepreneurial Ventures.* As colleagues at Baylor University, they discovered that they shared a passion for teaching students about the importance and the opportunities provided from owning their own businesses.

At that time, courses in entrepreneurship and small business management were almost nonexistent. In those days, business curriculums at practically all colleges and universities taught students only how to work for someone else. But Broom and Longenecker believed there was another alternative, and a good one, for students to achieve their professional goals through owning a business of their own. They contended that owning a business was a way to make life better for others, while building wealth for themselves, and at the same time providing a way to give back to their communities.

From that small beginning in 1964, *Small Business Management* is now in its 20th edition. Few textbooks survive even three editions, much less 20! By 2022, we estimate that some 3 million readers who aspire to become entrepreneurs have benefited from the book. From our knowledge, no other small business management textbook has even come close to this number of readers. Also, we are aware that many students have chosen to keep *Small Business Management*, rather than sell it at the end of a semester, making the book a part of their permanent library. As one student explained, "*Small Business Management* is one of the few books from my college days that I have kept for future reference." This comment is representative of countless other similar remarks that students have made over the years after having read and studied the book for class. Looking back, we can see that these two college professors were ahead of their time.

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Why has *Small Business Management* continued to be a leader in preparing students to own their own small businesses for nearly six decades now? We believe there are a number of reasons, a few being:

- Most importantly, the *Small Business Management* author team over the years have never become complacent. We have continued to live the dream started by Broom and Longenecker. As they did, we believe that what we are doing matters in the lives of our readers. It is about more than just presenting facts and figures—so much more. It is about life itself.
- Our **Integrated Learning System** uses each chapter's learning objectives to give structure and coherence to the text content, study aids, and instructor's ancillaries, all of which are keyed to these objectives.
- *Small Business Management* provides instruction and guidance that will greatly improve your odds for success as you take your own entrepreneurial journey. We continue to present the best information available today about launching and growing small businesses.
- Examples throughout the textbook demonstrate that there is not a single path to success. The goal is to help you find one that will work best for you.
- We emphasize the importance of building relationships along the way. Even if you are the company's only employee, you still have relationships with and depend on others, including your family, a banker, suppliers, and customers. To succeed you must be effective in your relationships with other people. The bottom line: You cannot accomplish anything of any significance by yourself!
- Many readers of *Small Business Management* have limited training and experience in understanding the valuable information provided by financial statements. There are just some things that cannot be understood about the business except through the numbers. Our textbook gives the reader a more thorough, but intuitive, presentation on financial statements than do most other textbooks focused on small business management.
- Readers have described how the chapters on managing the business have kept them from making the kinds of mistakes that Andrew Mason and others have made.

We could continue discussing the textbook's primary features, but hopefully the list above is sufficient to gain a sense of the book. But while *Small Business Management* offers a great foundation for an entrepreneurial career, we also encourage you to continue learning every day, building on the foundation provided by this text. This advice is supported by the words of Richard Branson, founder and chairman of the Virgin Group, which comprises more than 400 companies: "My biggest motivation? Just to keep challenging myself. Everyday I'm learning something new."

Follow Your Dreams

As you will see, *Small Business Management* focuses on essential concepts and building skills that you will need to grow and manage a business successfully. But at the core, we also consider a much broader concern—the pursuit of entrepreneurial dreams.

Entrepreneurs should be about fulfilling dreams—for themselves, their families, their employees, and their communities. The journey should always be about more than just the money. As a small business owner, what you do matters, not just to yourself, but to others as well.

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As you look to your future career path, there are definite advantages to initially working for someone else. It can allow you to learn an industry, build relationships, and develop important skills for the future. But many individuals choose to start their own company early in life:

- Michael Dell started assembling computer parts and selling personal computers in 1984 when he was a premed student at the University of Texas. From this humble start, Dell's company has gone on to become one of the largest technology companies in the world.
- Debbi Fields launched her business in 1977 when she was 21 years old, but it didn't take long for cookie fans everywhere to associate the Mrs. Fields name with the freshly baked specialty goods that they soon came to love. Though her venture was eventually acquired by an investment group, Fields has continued her involvement with the company and still serves as its spokesperson.
- Cecilia Ochoa Levine got her start in business sewing items for sale in local shops, but of course this limited her production. So, she moved to El Paso, Texas, and launched a company to make goods in Mexico for export to the U.S. That humble start, with only four seamstresses, led to a growing venture that now employs more than 400 people—but she still knows them all by name and even keeps up with news about their families. There is no question that Levine's impressive success as an entrepreneur has been built on a foundation of integrity and sincere generosity to others, a point that is explained further in Chapter 2.

This list could go on for pages. We all know entrepreneurs and small business owners who will not go on to become the next Elon Musk, but who will build or already own small businesses that create value and make a difference in the community. These small companies are the heart and soul of our economy.

So, we challenge you to give serious thought to joining them—and if you do, you may need to begin small, but *dream big if you want.* Follow a dream that you really care about and enjoy a life that you truly want to live! *Our best wishes to you for a challenging and successful learning experience!*

Change the Learning Model

When it comes to how we learn, the author team have become increasingly convinced over the years that what worked in the past no longer does for many individuals. More than ever, a learner's cooperation is required. That is, a student must take part in the process.

Learning can at times be hard work and requires a willingness to be engaged. However, it can be fun both for the teacher and student alike when the student is actively participating. Simply put, we believe that without engagement, there can be little meaningful learning. The intentionally crafted activities in MindTap simultaneously support learners in meaningful learning and aid busy instructors in teaching. Specific examples of this include scaffolded multiple-choice quizzes with robust feedback available to support student understanding, case activities that assess learner knowledge through cases that feature real small businesses and the challenges they experience, and study tools to help learners measurably succeed in the course.

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Access Everything You Need in One Place

Cut down on prep with preloaded, organized course materials in MindTap. Teach more efficiently with interactive multimedia, assignments, quizzes, and more. Give your students the power to read, listen, and study on their smartphone or tablet so they can learn on their terms.

Empower Your Students to Reach Their Potential

Distinct metrics give you actionable insights into student engagement. Identify topics troubling your entire class and instantly communicate with struggling students. Students can track their scores to stay motivated toward their goals.

Personalize Your Course to Your Objectives

Only MindTap gives you complete control of your course. You have the flexibility to reorder textbook chapters, add your own notes, and embed a variety of content, including Open Education Resources (OER) and third-party content. Personalize course content to your students' needs—they can even read your notes, add their own, and highlight key text to aid progress.

Count on Our Dedicated Team, Whenever You Need Them

MindTap isn't simply an online learning tool—it's a network of support from a personalized team eager to further your success. We're ready to help, from setting up your course to tailoring MindTap resources to meet your specific objectives. You'll be ready to make an impact from day one. And we'll be right here to help you and your students throughout the semester—and beyond.

New Updates in Content

A primary purpose of *Small Business Management* is to present current, relevant content in unique and interesting ways, drawing on an abundance of real-world examples to keep the reader more interested. Thus, the 20th edition of *Small Business Management* offers plenty of updates, including the following:

- A host of misconceptions about becoming a small business owner can cause you to give up your entrepreneurial dream. We have revised Chapter 1, "The Entrepreneurial Life," to help you better understand your motivations for starting a business and to avoid distorted concepts about what is required for you to be an effective business owner. Getting off on the right foot is critical to your success.
- Social entrepreneurship continues to be a major topic of conversation, both in small business practice and on college campuses. Recognizing this enduring trend, Chapter 2 introduces some of the important concepts and principles involved in the launch of a socially oriented enterprise. We have also included examples of socially minded entrepreneurs, such as Craig Gonsenhauser and Stacey Gorlick and their eco-friendly sunglasses start-up called Just Human, the community supporting work of Father Greg Boyle at Homeboy Industries, and Bart Weejuns and his venture that uses rats to sniff out unexploded landmines in war-torn nations around the world.

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- Prioritizing a small business owner's responsibility to major stakeholders can be difficult. With that in mind, Chapter 2, "Integrity, Ethics, and Social Entrepreneurship," presents several new case examples of small business owners who have determined how best to balance stakeholder interests. These efforts provide a model for others who wish to improve their venture results.
- Chapter 3 introduces a new concept called the Opportunity Kaleidoscope, which provides a new way to organize innovative ideas that can help to identify potential new business possibilities. The related section of the chapter has been significantly reorganized to lead readers through a range of different perspectives on opportunity recognition.
- In the 19th edition, Chapter 4 was titled "Franchises and Buyouts." In this edition, it is "Franchises and Independent Contracting in the Gig and Sharing Economies." This chapter addresses start-up ventures that partner with other companies in contractual relationships. Franchisees and franchisors enter into agreements that often last 10 years or more, but both remain independent businesses. Similarly, independent contractors perform specified tasks for other, usually larger, companies. The terms of their agreements are more likely to be determined by the work to be performed, rather than a specified time period. Many students have discovered that the gig and sharing economies are providing opportunities to become independent contractors, particularly with driving and delivery services. For some, this opens doors to new entrepreneurial endeavors. There was an increase in new venture creation during the COVID-19 pandemic, with independent contracting being a path chosen by many.
- The section on Buyouts that had been in Chapter 4 has been updated and moved into Chapter 5, now titled "The Family Business and Buyouts." We see that as a better fit because the transfer of ownership of a family firm is highly likely to be through a buyout. We replaced a subsection on the process of leadership succession with "Management and Ownership Succession" to highlight that two types of succession need to occur.
- The title of Chapter 6 has been changed from "The Business Plan: Visualizing the Future" to "The Business Model and the Business Plan" to place a greater emphasis on the importance of the business model than was reflected in earlier editions.
- We are delighted to continue offering *LivePlan* from Business Plan Pro, the unquestioned leader in business planning software. *LivePlan* has interactive features that guide you through the writing process in ways not previously available.
- The Formal Marketing Plan in Chapter 7 has been restructured to place more emphasis on taking action as opposed to conducting research. This reflects the behavior of entrepreneurial investors, including angels and venture capitalists, who have been calling for a shift away from the traditional planning process and toward business model development. A critical addition to the plan is a subsection on metrics, encouraging students to measure their progress toward marketing objectives. The marketing research section has been removed to prevent students from believing that they can become competent researchers based on the limited amount of information that the chapter could contain. We have added a new section on finding customers, a topic that is frequently expected to be integral to a business model. The chapter now introduces students to the Build-Measure-Learn Feedback Loop as a planning tool.

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- Chapter 8 covers the organizational plan for a start-up or small business, and it has been further developed to provide direction for alternative paths that small business owners may choose to take. The statistics in the chapter have been updated to provide an accurate picture of current trends. We have also provided a more complete description of legal forms of organization that can be adopted, including the B Corporation, so that the reader will be able to pick the organizational form most suitable for his or her needs and interests.
- The number of small businesses being launched online continues to grow. Chapter 9, "The Location Plan," includes an expanded section on effective models of e-commerce and emerging options that can lead to new business opportunities for entrepreneurs. This reflects the constantly changing landscape of online options available to small business owners who move to take advantage of these conditions.
- In a previous edition, we improved the presentation of financial statements (Chapter 10, "Understanding a Firm's Financial Statements") and the preparation of financial forecasts for small businesses (Chapter 11, "Forecasting Financial Requirements"). Our goal was to make the material more logical for the reader to follow. We have continued to build on this approach in the 20th edition to make the material even easier to grasp.
- Updated information on raising capital to grow a business, including best practices for raising money on the Internet (crowdfunding), is provided in Chapter 12, "A Firm's Sources of Financing." But stay tuned: Regulations concerning such topics are constantly evolving, and entrepreneurs must be aware of the fast-changing landscape of publicly raised capital.
- Because of the importance of establishing and improving relationships with customers, and the development of new and more sophisticated tools to make this more manageable, we continue to expand and update the sections on creating and using customer data in Chapter 14, "Building Customer Relationships." These sections now offer more practical instruction on CRM methods that make sense for small businesses, regardless of the level of sophistication, and provide insights on the most recently available software packages that may be most suitable for a small business. The chapter also introduces three popular assessment tools that can help evaluate the experience customers have when working with a small business and presents a new model to untangle the factors that determine customers' post-purchase satisfaction.
- Challenges related to product development continue to be among the most difficult that confront small firms, and Chapter 15 has been revised to reflect this. For this reason, the 20th edition includes, for example, more cutting-edge approaches in a significantly reworked section on the development of the physical product.
- Small business owners are discovering that social media can offer cost-effective ways of getting their message out. They are also learning that more and more customers rely on social media to make buying decisions. With this in mind, Chapter 17, "Promotional Planning," has been rewritten to place greater emphasis on social media marketing strategies.
- An increasing number of small business owners are considering options to grow their ventures via international expansion. However, many are realizing that overseas locations differ across many relevant variables. Chapter 18 provides more information about contextual conditions in specific country markets to guide entrepreneurs in their planning for global growth.

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- Because legal regulations related to human resource management practices continue to become more complicated and change constantly, Chapter 20, "Managing Human Resources," has been updated to be sure the information provided about the law and best practices in HR is accurate. Of course, it is important for small business owners to continue to seek further updates as laws and regulations in this area of practice are dynamic and always subject to revision.
- The world of health care and insurance provided by small businesses is undergoing major changes. Chapter 23, "Managing Risk in the Small Business," has been revised to help entrepreneurs adjust to recent changes.
- Updated Living the Dream features in each chapter capture entrepreneurs in action as they face small business and entrepreneurship challenges. The authors' personal conversations and correspondence with many of the entrepreneurs profiled add depth to these features and ensure accuracy.

  "Spotlight on Small Business" features at the start of each chapter profile an amazing collection of entrepreneurs whose unique insights into how to start, run, and grow a business will help readers identify and explore the full range of issues facing today's business owners.
- We have focused on providing new cases for most of the chapters of the book, with 15 of the 23 cases being new with this edition. Cases retained from the 19th edition have all been updated.

Updated and Enhanced Supplements

All resources and ancillaries that accompany *Small Business Management,* 20th edition, have been created to support a variety of teaching methods, learning styles, and classroom situations.

- ***Instructor's Manual.*** Lecture notes in the *Instructor's Manual* are grouped by learning objective and contain sources of other instructional materials, answers to the "Discussion Questions," comments on "You Make the Call" situations, and additional teaching notes.
- ***Test Bank.*** Questions in the *Test Bank* are grouped by learning objectives and include true/false, multiple-choice, and discussion questions. Metadata tags are attached to each question.
- ***Cognero® Testing Software.*** Cengage Learning Testing Powered by Cognero® is a flexible, online system that allows you to import, edit, and manipulate content from the text's *Test Bank* or elsewhere, including your own favorite test questions; create multiple test versions in an instant; and deliver tests from your LMS, your classroom, or wherever you want.
- ***PowerPoint® for Instructors.*** A complete PowerPoint® package is available to aid in lecture presentation. The PowerPoint® slides are available on the password-protected instructor resource website.
- ***LivePlan®.*** Students learn how to use the award-winning, best-selling professional software *LivePlan* to create a business plan. This online resource provides all the essentials to create winning business plans, including step-by-step instructions for preparing each section of a plan. Ready-to-customize samples, advice, a detailed marketing analysis with links to demographic and marketing tools, and helpful financial tools make it easy to create a solid plan. Video and written tutorials from Palo Alto Software founder Tim Berry ensure that students fully understand how to maximize *LivePlan's* dynamic tools.

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To the Instructor

As a final word of appreciation, we express our sincere thanks to the many instructors who use our text in both academic and professional settings. Based on years of teaching and listening to other teachers and students, *Small Business Management* has been designed to meet the needs of its readers. And we continue to listen and make changes in the text. Please write or call us to offer suggestions to help us make the book even better for future readers. Our contact information is Bill Petty (254-710-2260, bill_petty@baylor.edu), Les Palich (254-710-6194, les_palich@baylor.edu), and Frank Hoy (508-831-4998, fhoy@wpi.edu). We would love to hear from you, we seriously would!

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About the Authors

Justin G. Longenecker

Justin G. Longenecker's authorship of *Small Business Management* began with the first edition of this book. He authored a number of books and numerous articles in such journals as *Journal of Small Business Management, Academy of Management Review, Business Horizons,* and *Journal of Business Ethics.* He was active in several professional organizations and served as president of the International Council for Small Business. Dr. Longenecker grew up in a family business. After attending Central Christian College of Kansas for two years, he went on to earn his BA in political science from Seattle Pacific University, his MBA from The Ohio State University, and his PhD from the University of Washington. He taught at Baylor University, where he was Emeritus Chavanne Professor of Christian Ethics in Business until his death in 2005.

J. William Petty

J. William "Bill" Petty was Professor of Finance and served as the W. W. Caruth Chairholder in Entrepreneurship at Baylor University from 1990 through 2018. He was the founding executive director of the Baylor Angel Network, eventually consisting of over 100 angel investors. He holds a PhD and an MBA from the University of Texas at Austin and a BS from Abilene Christian University. He has taught at Virginia Tech University and Texas Tech University and served as dean of the college of business at Abilene Christian University. He has taught entrepreneurship and small business courses in China, Ukraine, Kazakhstan, Indonesia, Thailand, and Russia. Dr. Petty was designated a Master Teacher at Baylor and was named the National Entrepreneurship Teacher of the Year in 2008 by the Acton Foundation for Excellence in Entrepreneurship. His research interests included acquisitions of privately held companies, shareholder value–based management, the financing of small and entrepreneurial firms, angel financing, and exit strategies for privately held firms. He has served as co-editor for the *Journal of Financial Research* and as editor of the *Journal of Entrepreneurial Finance.* He has published articles in a number of finance journals and is the co-author of a leading corporate finance textbook, *Foundations of Finance.* He is a co-author of *Value-Based Management in an Era of Corporate Social Responsibility* (Oxford University Press, 2010). Dr. Petty has worked as a consultant for oil and gas firms and consumer product companies. He also served as a subject-matter expert on a best-practices study by the American Productivity and Quality Center on the topic of shareholder value-based management. He was a member of a research team sponsored by the Australian Department of Industry to study the feasibility of establishing a public equity market for small and medium-size enterprises in Australia. Finally, he serves as the audit chair for a publicly traded energy firm.

Leslie E. Palich

Leslie E. "Les" Palich is Professor of Entrepreneurship and the W. A. Mays Professor of Entrepreneurship and Strategic Management at Baylor University, where he teaches

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small business management, international entrepreneurship, strategic management, and international management to graduate and undergraduate students. He was also named a Fulbright Scholar to Ireland in 2022, where he conducted research on the ethical attitudes of small business owners and entrepreneurs and the impact these perspectives have on venture performance. Dr. Palich holds a PhD and an MBA from Arizona State University and a BA from Manhattan Christian College. His research has been published in the *Academy of Management Review, Strategic Management Journal, Entrepreneurship Theory & Practice, Journal of Business Venturing, Journal of International Business Studies, Journal of Management, Journal of Organizational Behavior, Journal of Small Business Management,* and several other periodicals.

He has taught entrepreneurship and strategic management in a host of overseas settings in Europe and Latin America and often serves as a visiting professor at the Centre Franco-Americain de Management International, Institute d'Administration des Enterprises de Caen at the University of Caen in France. His interest in entrepreneurial opportunity and new venture creation dates back to his grade school years, when he first started to experiment with small business ownership. That early experience became a springboard for a number of other enterprises. Since that time, he has owned and operated domestic ventures in agribusiness, automobile sales, real estate development, and educational services, as well as an international import business. Dr. Palich also owned and operated Lead Generation X, an Internet marketing firm that employs cutting-edge promotional methods to serve its clients and their customers.

Frank Hoy

Frank Hoy is Professor of Innovation & Entrepreneurship Emeritus and was director of the Collaborative for Entrepreneurship and Innovation at Worcester Polytechnic Institute. Dr. Hoy earned his PhD at Texas A&M University where he developed a small business outreach program for the Texas Agricultural Extension Service. Subsequently, he served on the faculty in the Department of Management at the University of Georgia, where he became director of the Small Business Development Center for the State of Georgia. He moved to Georgia State University in 1988 as the Carl R. Zwerner Professor of Family-Owned Businesses, the first endowed faculty position in the United States devoted to family business education and research. From 1991 to 2001, Dr. Hoy was dean of the College of Business Administration, and from 2001 to 2009, director of the Entrepreneurship Centers at the University of Texas at El Paso.

Dr. Hoy has been the recipient of numerous academic and professional recognitions for his contributions to small business and entrepreneurship education and research, including the Max S. Wortman/USASBE Lifetime Achievement Award from the United States Association for Small Business and Entrepreneurship, the first Mentorship Award given by the Entrepreneurship Division of the Academy of Management, the Freedoms Foundation Leavey Award for Excellence in Private Enterprise Education, the Regional Research Advocate of the Year from the United States Small Business Administration, selection to the El Paso, TX, Business Hall of Fame, and others.

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Chapter 1

The Entrepreneurial Life

Learning Objectives

The primary purpose of The Entrepreneurial Life chapter is to provide you an overall view of owning a small business and thinking like an entrepreneur. By studying this chapter, you should be able to . . .

1-1 Explain the importance of small businesses and entrepreneurship in our society.

1-2 Describe what it means to be a small entrepreneurial firm.

1-3 Identify how small businesses can compete against the giants.

1-4 Outline what might motivate you to be a small business owner with all its risks and uncertainties.

1-5 Describe ways to build a successful business as a part of your life legacy.

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Spotlight on Small Business

Energy Solutions of Texas

www.energysolutionstx.com

DARRELL AND RAY CLOUDT

Energy Solutions of Texas (ESOT) was founded in 2005 by Darrell and Ray Cloudt, a father and son team. Both men had previously worked for a well-known franchise company—the son in sales and the father in franchisee support. It was during that experience that the Cloudts began dreaming about starting their own business.

They had their eye on starting a solar energy business but then decided to pivot away from an industry that was still developing and was dependent on government incentives. Instead, they determined that there was a greater opportunity in commercial lighting retrofits, where profits would be more stable, in part due to the electrical power distribution companies incentivizing lighting projects as a way to reduce peak demand.

To gain a competitive edge over larger and more established competitors, including lighting equipment manufacturers, they planned to (1) offer a turn-key price (a set price from beginning to end), (2) provide assistance with incentive procurements from power companies, and (3) be present for installation and on-site start-up of the system.

They also recognized that they would face some daunting challenges:

1. Reliable equipment suppliers had to be identified.
2. Installation subcontractors and their crews needed to be vetted quickly.
3. An effective marketing strategy had to be developed.
4. Everything had to be done on a really tight budget.

To offset some of these challenges, they were able to get a foothold by purchasing an existing lighting retrofit business and hiring the founder as a project manager. Also, to control costs, the business was operated out of a home office and rented space for the first four years. Start-up funding came from personal savings and a line of credit underwritten by a family friend and successful businessman, who also became a trusted adviser and mentor.

The company's basic growth strategy was to go after the low-hanging fruit by identifying projects that (1) did not require a large capital expenditure by the customer, (2) allowed the customer to recoup the capital outlay in less than two years, and (3) would qualify for substantial incentives.

Initially, the market area was central Texas, targeting churches, schools, and smaller commercial facilities. Because the new technology was far superior to that used in the old lighting equipment, ESOT was profitable in the second year of operations and ready to expand sales to larger manufacturing facilities.

Fast forward to 2021, and the market area focus has widened to five south central U.S. states. Every lighting project now has LED technology that outperforms the equipment that ESOT was installing from 2005 to 2014. Also, ESOT has diversified with specialized fans to control the accumulation of combustible dust, commercial vacuum equipment, and thermal imaging cameras.

The diversification was a result of recognizing an opportunity while doing a lighting project in a diaper factory where airborne lint created fuel for fires and potential explosions. The electrical and mechanical skills of ESOT's subcontractors easily handled these additional projects and created a synergy of solutions to offer customers.

The Cloudts attribute their success to being able to inspire confidence in ESOT's capabilities by doing the following:

1. Having sound knowledge of what the equipment can do and how ESOT can offer a solution to a problem.
2. Being skilled at asking questions of the customer and listening with the intent of coming to a satisfactory solution.
3. Being on-site and communicating with the project manager at critical times during the project.
4. Following up with the customer by asking "Is there anything that we could have done better?" and "Is the equipment performing as expected?"

Both Darrell and Ray strongly believe that by using this relationship-building philosophy, ESOT will likely be invited to do projects in other customer-owned locations. They see a bright future as small business owners—and they love it.

Source: Adapted from personal communication with Ray Cloudt, March 12, 2021.

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As the co-authors of *Small Business Management: Launching and Growing Entrepreneurial Ventures*, we have spent decades interacting with entrepreneurs—as friends, as consultants, and even as investors. It has been a blast! These experiences have largely framed what we teach in class, our areas of research, and ultimately what we present in this book.

And now we want you to know what we have learned over the years, so that you will be prepared to own a small business—one that hopefully will make a difference in your life, as well in the lives of many others. We want your study of entrepreneurship and small business management to be more than just learning facts for an exam. *More importantly, we want to equip you with the necessary tools for a journey that could be life changing.*

To begin, we want you to understand the following:

- Owning a business is a noble profession—*especially if it's done well*. No other life's work does more to further your personal development and allows you to make significant contributions to society.
- The richest rewards of owning a small business come from (1) offering goods or services that improve the lives of your customers and make a difference in the community, and (2) developing an organizational culture that allows your employees to grow professionally and personally.

So, let's get started by looking at some big-picture issues for anyone wanting to think like an entrepreneur and be a small business owner.

1-1 Small Size, Big Significance

1-1 Explain the importance of small businesses and entrepreneurship in our society.

Without question, entrepreneurship is a major social phenomenon in the United States and in many other countries around the globe. In fact, the average level of entrepreneurial activity has increased over the past 19 years, with approximately 500,000 new businesses started each month.[1] Most importantly, owning a small business changes lives, both that of the entrepreneur and those of employees and customers. Much of this chapter will explain how owning your own business is closely connected to your life.

Small businesses also make significant contributions to the economy. Here are just a few more statistics, some good news and some bad, that you might find of interest:[2]

- There are 30.2 million small businesses in the United States with fewer than 500 employees, accounting for 99.7 percent of all businesses—and 89 percent have fewer than 20 employees!
- There are 11.7 million women-owned businesses, representing 36 percent of all small businesses.
- There are 9.2 million minority-owned small businesses in the United States, accounting for 29 percent of all small businesses.
- Fifty-nine million people work in small businesses, representing 47 percent of all employees and 42 percent of all salaries paid to employees.
- Many small companies have gone global, representing 97 percent of all exporters.[3]
- Two-thirds of all small businesses survive for at least two years, while around 33 percent survive over ten years. Fifty percent of the failures are due to cash flow problems, with 14 percent being the result of poor marketing strategies.
- Finally, 64 percent of small businesses begin with only $10,000 in capital. However, 27 percent of small businesses are not able to get the financing they need.

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Devra Gartenstein expresses it well:[4]

> Small businesses are important because they provide opportunities for entrepreneurs and create meaningful jobs with greater job satisfaction than positions with larger, traditional companies. They foster local economies, keeping money close to home and supporting neighborhoods and communities.

The importance of small businesses and entrepreneurship is also reflected in the interest that young people have in eventually owning their own business, as indicated by the number of college students enrolling in small business management and entrepreneurship classes.

So, small businesses are important contributors to our economy and deserve careful study by anyone contemplating becoming a business owner, especially the owner of a small firm that could become a medium or large business over time.

1-2 Describe what it means to be a small entrepreneurial firm.

1-2 Small Business and Entrepreneurship

Let's now look at the terms *small business* and *entrepreneurship,* and consider how small firms and entrepreneurs often go together.

1-2a What Is a Small Business?

What does it mean to be a small business? A neighborhood restaurant or bakery is clearly a small business, and Toyota is obviously not. To distinguish between small and large businesses, we naturally consider their relative sizes, but it is also helpful to think about a small firm's potential to grow. Consider, too, that small firms with different growth potential require different management.

Size

In this case, size is in the eye of the beholder. When we think about a firm's size, we typically use such criteria as the number of employees, its sales volume, its amount of profit, and the size of the company's assets. However, size standards are arbitrary and frequently adopted to serve a purpose. For example, the U.S. Small Business Administration generally defines a small business as having fewer than 500 employees. However, in specific cases, the government may define a small business differently—such as one with fewer than 10 employees—to exempt it from certain regulations if compliance would be too costly, given its small size. Therefore, using numerical criteria can be subjective at best.

Growth Potential

Small businesses also differ dramatically when it comes to their potential to grow and how they must be managed. They have commonly been differentiated as follows:

microbusiness
A small firm that provides minimal profits to its owner.

lifestyle business
A microbusiness that permits the owner to follow a desired pattern of living.

1. **Microbusinesses** make up the largest sector of the U.S. economy in terms of the number of businesses. This sector includes many small service companies, such as pool-cleaning businesses, dry cleaners, and appliance repair shops. These companies are also called **lifestyle businesses** because they mostly support an owner's desired lifestyle, not only by providing needed income, but also in allowing greater flexibility in their daily life. And that's not all bad.

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Living the Dream

Always Go the Extra Mile


JOHNNY STITES

When Johnny Stites, the former CEO of J&S Construction Company, talks to aspiring entrepreneurs, he often tells them that he learned an important lesson while still in college, which he carried into his 43 years in business.

> I sold books for Southwestern Publishing Company, door to door, in the summers between my college semesters. I learned that when I focused on making money or how many sales I had made, I did not enjoy my job nearly as much as when I focused on helping people. I also did not make as much money.
>
> I carried that into my construction career of 43 years. During that time, I realized again my time was much more enjoyable when I focused first on those I sought to help. I observed that my construction crews were far more fulfilled in their jobs when I started emphasizing and measuring the clients' reaction to our construction teams. It magnified the "self-worth" of construction workers, an industry with one of the lowest self-esteem on earth. When they began to focus on the needs of our clients, instead of their own issues at work, they enjoyed their day better and did a more professional job.

J&S Construction Company was founded in 1957 by Johnny's father, John D. Stites. He created the business's name for his vision of a J[ohn] & S[ons] Construction Company. At the time, Johnny was only 11 years old and his younger brother, Jack, was 9 years old. Johnny says, "Our dad was a great visionary, as evidenced by the planning in the name."

The company remained a small residential construction company operating in Cookeville, Tennessee, until the late 1960s when John D. Stites began to perform smaller commercial projects. In 1971, Johnny joined the company after graduation from college and a three-year tour in the U.S. Navy during the Vietnam conflict. Jack joined the business shortly afterwards.

Over the 43 years of their family leadership in the company, J&S Construction Company grew from five employees with annual sales of $250,000 in one small Tennessee community to a company of 125 employees with annual revenues of $46 million, performing work in six states.

Johnny maintains that their successful run would not have happened if not for the wisdom they gained from their faith.

> Even when we fulfilled our contracts completely, we did not develop deeply committed customers because they only got what they paid for. Ultimately, our company lost a very valued client because we only gave what was in the contract, and not a penny more. Over a few hundred dollars, the company lost $20 million of future construction revenue. From that experience, we decided to follow the faith-based principle of "going the extra mile" for others. We focused on treating others how we would like to be treated. We revised every aspect of our business to ensure every person was incentivized to go the extra mile and take care of our clients. We wanted every client to tell us that they were "delighted" at the end of their project; not "pleased," not "satisfied," and

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certainly not "disappointed." We made our best profits when everyone on every project was delighted. When customers would question me why laborers on their jobs were asking them if they were delighted, I knew we were getting close to true success.

Johnny Stites has since retired. But he has continued to make a difference. His first two years after retirement were spent advising the state of Tennessee on how to improve government contracting operations. His report provided a pathway for Tennessee to save $100 million annually in construction expenses through process improvement. The next two years were spent consulting with small businesses, showing them how to gain traction in order to achieve their visions.

Today, Johnny is managing his real estate holdings, traveling, and spending time with his four children and his 14 grandchildren—still making a difference!

Source: Personal conversation with Johnny Stites, March 15, 2021.

2. **Attractive small firms** offer substantial financial rewards for their owners, where profits may grow into the millions or even tens of millions of dollars. They can also provide rewarding careers for employees.
3. **High-potential ventures** (also called **gazelles**) are businesses with phenomenal prospects for growth. These firms usually deal with cutting-edge technology and have the potential to change how people live.

attractive small firm
A small firm that provides substantial profits to its owner.

high-potential venture (gazelle)
A small firm that has great prospects for growth.

small business
A business with growth potential that is small compared to large companies in an industry, has geographically localized operations, is financed by only a few individuals, and has a small management team.

entrepreneur
A person who relentlessly pursues an opportunity, in either a new or an existing business, to create value while assuming both the risk and the reward for their efforts.

entrepreneurship
The relentless pursuit of an opportunity without regard to owning all the resources needed to capture the opportunity.

So, how we think of a **small business** depends on how we define *small* and on the nature of the business in terms of its growth potential. For our purposes, we will primarily be interested in businesses with the following characteristics:

1. Compared to the largest firms in the industry, the business is small; in most instances, it has fewer than 100 employees.
2. Except for its marketing function, the business's operations are geographically localized.
3. No more than a few individuals provide equity financing for the business. Equity financing (discussed in Chapter 12) is money invested in the business by the owners and, possibly, by a few other individuals.
4. The business may begin with a single individual, but it must have the potential to become at least a mid-sized company, whether or not the owner chooses to capture that growth.

Obviously, some small businesses will fail to have these characteristics, but they may still be of interest to us.

1-2b What Is Entrepreneurship?

There is no single definition of *entrepreneurship*. Some focus on the willingness of a person (the **entrepreneur**) to create value while assuming both significant risks and rewards for their efforts in a new or existing business venture. Others target innovations created by entrepreneurs, while still others focus on the personality traits of entrepreneurs.

We prefer a working definition of *entrepreneurship* that focuses on the process: **Entrepreneurship** is the relentless pursuit of an opportunity without regard to owning all the resources needed to capture the opportunity. It involves a process that begins with identifying an opportunity and ends with exiting the business, or what is often called "harvesting the value of the company."

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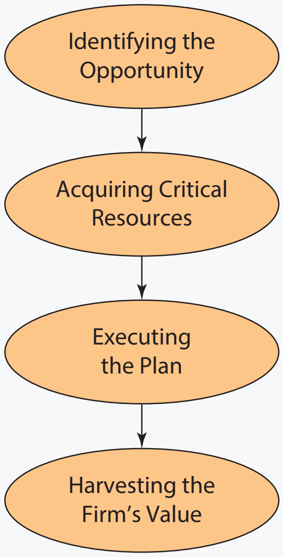
Exhibit 1.1 The Entrepreneurial Process



From beginning to end, entrepreneurship involves four stages, which are reflected in Exhibit 1.1:

1. *Identifying an attractive opportunity.* Understand that an opportunity is more than merely having a good idea. Real opportunities should be market driven, offering customers a product or service that is so appealing that they are willing to let go of their hard-earned money to buy it. (In Chapter 3, you'll learn how to identify good opportunities.)
2. *Acquiring the critical resources needed for growing the business.* In a small business, there is no issue more important than efficiently managing resources. Entrepreneurs need to find ways to do more with less. Thus, learning how to think about critical resources may mean the difference between success and failure.

   When entrepreneurs think about resources, they should not just think about money. Critical resources also include the right management team, the right partners, and access to the right assets, such as inventory and equipment. To gain the necessary resources, entrepreneurs sometimes must **bootstrap**, such as resorting to bartering, generating income from other sources, or using a personal credit card.
3. *Executing the plan.* The entrepreneur must now scale the business to make it economically attractive. Among other things, they need to know how the firm will make money, support growth, and create barriers to entry to keep the competition away.
4. *Harvesting the business.* At some point, an entrepreneur must think about exiting the business to capture the value that they have created over the years. This can happen by passing the business on to the next generation in the family, by selling the company to other investors, or in a few rare instances, by issuing the company's stock to the public. (These options will be explained in detail in Chapter 13.)

bootstrap
Doing more with less in terms of resources invested in a business, and, where possible, controlling the resources without owning them.

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Entrepreneurial Attributes

"Are entrepreneurs born or made?" That question has long been debated with little agreement. However, instead of trying to resolve that issue, Stephen Spinelli and Robert Adams have summarized research on entrepreneurial characteristics, including "desirable and acquirable attitudes and behaviors":[5]

1. *Leadership abilities*—The abilities to self-motivate and team-build, with a focus on honesty in business relationships.
2. *Opportunity obsession*—A keen awareness of the market and customer needs.
3. *Commitment and determination*—Tenacity, decisiveness, and persistence in problem solving.
4. *Motivation to excel*—Goal orientation and awareness of personal strengths and weaknesses.
5. *Courage*—Strong moral convictions and a willingness to experiment.
6. *Tolerance of risk, ambiguity, and uncertainty*—The ability to take risks and to minimize them, as well as to tolerate uncertainty.
7. *Creativity, self-reliance, and adaptability*—Open-mindedness, resilience, and a quickness to learn.

On the other hand, some personal characteristics are deadly for an entrepreneur. An almost certain way to fail as an entrepreneur, as many have learned by experience, is to do the following:

1. Overestimate what you can do.
2. Lack an understanding of the market.
3. Hire mediocre people.
4. Fail to be a team player (usually the result of taking oneself too seriously).
5. Be a domineering manager.
6. Fail to share ownership in the business in an equitable way.

Three Harvard Business School professors came to similar conclusions based on a survey that asked company founders what they got wrong when starting their companies.[6] Overall, they acknowledged not being good listeners in two areas:

- They did not listen to prospective customers as they were designing their product or service. Instead, they "built" what they thought customers would want without ever asking.
- Their passion and egos caused them to react negatively to criticism and to discount ideas from others for improving their products or services. We frequently hear that an entrepreneur must have passion, which is true, but *unchecked passion can be destructive.*

To some extent, these traits describe a leader who lacks humility, a quality that we believe serves business leaders well.

Clearly, successful—and unsuccessful—entrepreneurs share certain characteristics. However, entrepreneurs are not cut from a single mold. You have only to listen to their stories to hear the apparent differences in their priorities, perceptions, personalities, and behavior. Their success generally arises from having a clear mission, a desire to lead, and the recognition that business success requires hard work and long hours.

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Living the Dream

Pursuing Your Calling

There is no way around it, starting and building a successful business are hard. One excellent way to succeed is by pursuing a calling to make a difference in others' lives.

That's the path that April Anthony took. As the founder and CEO of Encompass Home Health & Hospice, she started and built her company during an industry recession, if not depression, that wiped out nearly a third of her competitors.

> My entry into home health care came accidentally. I wasn't looking for a career, I was simply looking for a short-term job on my way to becoming a stay-at-home mom. However, much to my surprise, when I entered the home health care industry, I not only found a job, I found my life's calling and my passion. When you find your passion, everything changes.
>
> I became so convinced about why we had to deliver exceptional care to our elderly patients that I was determined to figure out how to do it better than anyone else. When you find your calling, the hurdles that you face as an entrepreneur no longer seem so daunting. Instead, your commitment to overcome them becomes almost obsessive.
>
> After 28 years, I can honestly say that I love my work today as much as I ever have because it isn't really work—it is my calling, my passion, and my inspiration.


JEFF WILSON/THE FORBES COLLECTION/GETTY IMAGES

In 2021, Encompass Health is publicly traded and the fourth-largest Medicare-approved provider of home health care in the United States. However, since coronavirus was declared a global pandemic in early March 2020, Anthony has had to work diligently to keep her 8,000-plus nurses and therapists, along with 40,000 high-risk patients, safe from COVID-19.

Anthony says that nothing prepared her for COVID-19, but her experience, determination, and faith helped her face the really tough days. And in early 2021, the company was not only surviving, but once again prospering.

Sources: Personal correspondence with April Anthony, March 2021; and "How April Anthony Made a $700 Million Fortune in One of the Toughest Corners of U.S. Healthcare,"), June 22, 2020, https://www.forbes.com/sites/hayleycuccinello/2020/06/22/april-anthony-healthcare-self-made-women/?sh=35b706551fdc, accessed March 1, 2021.

Types of Entrepreneurs

Entrepreneurs are not only founders of new businesses. Many individuals approach entrepreneurship a bit differently—but are entrepreneurial just the same. Let's now consider several different types of entrepreneurs.

Second-Stage Entrepreneurs. At some point after a new firm is established, it may be purchased or taken over by a second-generation family member or another individual

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who may have been managing the company. These "second-stage entrepreneurs" do not differ greatly from founding entrepreneurs in the way they manage their businesses. Nevertheless, it is helpful to distinguish between entrepreneurs who start or substantially change companies from those who direct the continuing operations of established businesses.

Franchisees. According to the International Franchise Association, franchises (1) produce $1.64 trillion in economic output, and (2) create 13.2 million jobs, with one of every 12 Americans in the private sector working in a franchise business or with a job because of franchising.[7]

Franchisees differ from other business owners in the degree of their independence. Because of the guidance and standardized systems provided by contractual arrangements with franchising organizations, franchisees function within the boundaries set by franchisors.

The franchisee is authorized to market the company's products or services and expects the franchisor to provide support in operating the business. Such support usually includes operating systems, training, financing, advertising, and other services. In addition to paying an annual franchising fee, the franchisee usually pays a portion of the company's profits to the franchisor. (Chapter 4 presents more information about franchisees.)

Social Entrepreneurs. **Social entrepreneurship** involves focusing on a social purpose so that it becomes an integral part of the company. Typically, the primary objectives of a person who dreams of owning a business are to gain financial rewards by providing a product or service that makes life better for customers and to create jobs for employees. But, in recent years, more and more small businesses are being launched with the explicit purpose of addressing a social challenge or human need. Also, an increasing number of universities are offering courses and even full degree programs in social entrepreneurship. (The topic of social entrepreneurship will be examined in greater depth in Chapter 2.)

Intrapreneurs. The term **intrapreneurship** describes a person who has characteristics similar to those of an entrepreneur, but who works within an existing, usually larger, corporation as an employee. This individual assumes responsibility for taking a new idea and converting it into a profitable product, service, or even process that enhances the company's profitability or efficiency. Thus, an intrapreneur mostly creates value for the company, rather than starting their own new business. The corporate employer, however, should create an incentive structure that rewards the intrapreneur for developing a new idea and assuming the associated risk if it fails.

A primary benefit for an intrapreneur is having access to corporate resources, combined with the economies of scale enjoyed by a large corporation. A drawback is that employees who exhibit an entrepreneurial spirit can become frustrated by the bureaucracy within large corporations, especially in an environment where other employees may sabotage the intrapreneur's plans. An intrapreneur may need to be given greater freedom, even to the point of allowing the intrapreneur to function outside of the existing bureaucracy. For example, Guy Kawasaki talks about working for Steve Jobs in creating the Macintosh within Apple, Inc. Jobs placed the team building the Macintosh in a separate facility, apart from the rest of the company. Employees not

franchisee
An entrepreneur whose power is limited by a contractual relationship with a franchising organization.

social entrepreneurship
Entrepreneurial activity with the explicit purpose of addressing a social challenge or human need.

intrapreneurship
An employee within an existing corporation who assumes responsibility for taking a new idea and converting it into a profitable product, service, or process.

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Living the Dream

Don't Let Challenges Stand in Your Way

Courtney Blagrove and Zan B.R. are the sisters responsible for creating the world's first oat-milk ice cream shop, Whipped Urban Dessert Lab, on the Lower East Side of New York City. After seeing the struggles of their family and the 75 percent of African Americans who face lactose intolerance, the sisters decided to tackle this problem. "The goal was to create an indulgent frozen dessert using oat milk that even dairy lovers couldn't resist," Blagrove said. "We have developed an exceptional product that has quickly gained a following, and we are truly changing the way people think and feel about non-dairy ice cream."

The sisters, however, had their fair share of challenges with their business from the beginning. They founded Whipped Urban Dessert Lab in February of 2020, just as the COVID-19 pandemic was beginning.

> It's one thing to start a small business, there's always a risk, and you have to be flexible, but it's another thing to start a small business right before the pandemic hit. It's something even large businesses didn't know how to handle.

Strategic moves, like pairing with a national distributor to ship their ice cream nationwide, kept them afloat during such a challenging time. The sisters also attribute their determination to succeed to the experiences that they have had to overcome as African American women.

> Being Black women in America, there are a certain number of hurdles and obstacles that you're going to have to get through and get over to succeed just because of how the United States has historically treated people of color and Black people. It's tenacity and grit developed during a lifetime of not necessarily being accepted or having access to the same resources as other groups have had.

Sources: Dana Givens, "These Entrepreneurs Are Shipping Oat Milk 'Ice Creme' to Your Doorstep," *Black Enterprise*, February 17, 2021, www.blackenterprise.com/these-black-women-entrepreneurs-are-bringing-their-oat-milk-soft-serve-to-your-doorstep/, accessed March 22, 2021; and Parker Diakite, "Meet the Black Women behind the World's First Oat Milk Soft Serve Ice Cream Shop," *Travel Noire*, March 10, 2021, travelnoire.com/black-women-behind-worlds-first oat-milk-ice-cream-shop, accessed March 21, 2021.

involved with the Macintosh were not even allowed to enter the building where the work was being done.

Entrepreneurial Teams. Our discussion thus far has focused on entrepreneurs who function as individuals, and this is frequently the case. However, **entrepreneurial teams** can be extremely beneficial, particularly in ventures of any substantial size or complexity. An entrepreneurial team consists of two or more individuals who combine their efforts to function in the capacity of entrepreneurs. In short, you cannot grow a business to any significant size without a team of managers with complementary skills. (The role of entrepreneurial teams is discussed in Chapter 8.)

entrepreneurial team
Two or more people who work together as entrepreneurs on one endeavor.

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1-3 Identify how small businesses can compete against the giants.

1-3 Can a Small Company Really Compete with Big Companies?

How is it that small entrepreneurial firms can hold their own and often gain an edge over successful, more powerful businesses? The answer lies in the ability of new and smaller firms to exploit opportunities. In general, if a business can make its product or service cheaper, faster, and better, then it can be competitive. Small companies—if well managed—are just as able as larger firms to develop strategies that offer a competitive advantage.

Let's look at some ways in which small firms can gain a competitive advantage. (In Chapter 3, we'll elaborate on strategies for exploiting these potential advantages.)

1-3a Commitment to Integrity

The starting point of any competitive advantage is having a commitment to integrity. Consistently operating with integrity can set a small business apart, with a reputation of being trustworthy. Above all else, the core values of the entrepreneur, as reflected in what that person says and does, determine the culture within a business. Others will conduct business with a company only when they feel that they can trust its representatives. Trust is the foundation of all relationships, including those in business. (Chapter 2 discusses the critical importance of integrity and its role in entrepreneurship.)

1-3b Customer Focus

Small companies are particularly adept at competing when they maintain a strong customer focus. Good customer service can be provided by a business of any size. However, small businesses have greater potential to achieve this goal than larger firms do. They have the advantage of being able to serve customers directly and effectively, avoiding the layers of bureaucracy and corporate policies that tend to stifle employee initiative. In many cases, customers are personally acquainted with the entrepreneur and other key people in a small business. (We will provide further discussion of this subject in Chapter 14.)

1-3c Quality Performance

A small business does not need to take a back seat to larger firms when it comes to achieving quality in operations. We frequently observe owners of small businesses whose operations not only equal the quality performance of larger firms, but also often surpass it.

As one example, Lance and Cecilia Levine, owners of MFI International Manufacturing in El Paso, Texas, have a passion for quality. As small business owners, they are able to insist on high levels of quality without experiencing the frustration of a large-company CEO who may have to push a quality philosophy through layers of bureaucracy. In Cecilia's words, "A small business owner should have no fears about being able to compete when it comes to quality. It just needs to be part of the business culture."[8]

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Living the Dream

If You See a Problem, Fix It

In 2012, Maureen Stockton attended a business-networking event but was unable to meet as many people as she would have liked because of how uncomfortable her shoes were. After that evening, she noticed her husband putting shoe trees into his shoes so that they would fit comfortably every time he wore them. "He had the old-fashioned wooden shoe trees in his shoes, and I thought, 'Gosh, I should get some of those,' and I bought some, put them in my shoes, and they destroyed them."

This left Stockton confused as to why men had shoe trees that worked, but women did not. This problem inspired her to create the Formé shoe shaper, specifically for women's shoes. "I wanted a product that would work day in, day out. I was sick of products that you could use once and then they were done."

After four years of development, a team of women engineers was able to create a shoe shaper that worked for all shoe styles for women without destroying them. But, while Stockton has been successful in her business, it has not always been easy.

> The growth doesn't always happen as quickly as I would like. It's the hardest part of having your own business; this is why I think it's so important to surround yourself with amazing teammates.

Formé was able to pass $1 million in sales in 2019 but experienced a slight decline in sales because of COVID-19 and is now recovering. However, Stockton says one factor that will increase sales of Formé shoe shapers is that work shoes will feel more uncomfortable after so many have worked from home for such a long period of time. People are going to need some shoe shapers to fix that problem.

Sources: Barbara Haislip, "Her Shoes Were Painful. She Founded a Business to Make Them Fit Better," *The Wall Street Journal*, October 30, 2020, www.wsj.com/articles/her-shoes-were-painful-she-founded-a-business-to-make-them-fit-better-11604078460, accessed March 9, 2021; and Page Spencer, "Meet Maureen Stockton: The Founder of Formé," *Tough to Tame*, www.toughtotame.org/new-page-77, accessed March 8, 2021.

1-3d Innovation

Innovation, both in products or services and in competitive strategies, is within the reach of a small business in ways that were not thought possible a few years ago. For one thing, access to technology has helped smaller firms to compete. In many cases, it has clearly leveled the playing field with larger companies.

Research departments of big businesses tend to focus on improving existing products. Creative ideas may be sidetracked because they are not related to existing product lines or because they are unusual. In his book, *The Innovator's Dilemma*, the late Clayton Christensen, a former professor at Harvard Business School, documented how large, established companies have missed major transformations in many industries—computers (mainframes to PCs), telephones (landline to mobile), photography (film to digital), stock markets (floor trading to online trading), and many others.[9] For this reason, many large companies acquire or at least engage in a joint venture with small technological businesses.

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1-3e Niche Markets

Almost all small businesses try to shield themselves from competition by targeting a specific group of customers who have an identifiable but very narrow range of product or service interests and comprise what is called a **niche market**. The niche might consist of a specialized product or service, or it might focus on serving a geographical area. Numerous small businesses are uniquely positioned to capture these markets.

It is interesting to note that most successful entrepreneurs are not overly concerned about their ability to compete with their larger counterparts. With few exceptions, large corporations are bureaucracies, with bureaucrats as managers. Consequently, large companies often have difficulty creating effective incentives to encourage employees to think entrepreneurially. There is considerable evidence that most workers in today's huge corporations are simply not engaged in their work. The bottom line is that small companies with an entrepreneurial culture can compete and compete well.

1-4 Discuss what might motivate you to be a small business owner with all its risks and uncertainties.

1-4 Motivations for Owning a Business

Being an entrepreneur is extremely challenging. At times, you will be discouraged, maybe even terrified. Some days, you will wish you had opted for the security (or at least the perception of security) of a regular job in an established company.

So, before you decide to start a business, think carefully about the person you are and who you want to be, and how owning a business will help you become that person. Jeff Sandefer and Robert Sirico put it this way:[10]

> When you embark upon a heroic journey—a life filled with meaning and purpose—the first step is to heed the admonition inscribed over the entrance to the Oracle of Delphi in ancient Greece: "Know Thyself." Search out who you are, and then you will be equipped to discover your heroic calling.

In short, it's vitally important that you understand your personal motivations before you get into the small business world—or any calling, for that matter.

1-4a Types of Entrepreneurial Motivations

We believe there are four fundamental reasons for wanting to own your own business. The relative importance of each will vary by the person and the situation, but the following motivations will come to play in most cases:

1. Personal fulfillment
2. Personal satisfaction
3. Independence
4. Financial rewards

These motivations, along with specific examples of each, are shown in Exhibit 1.2 and discussed in the following sections.

Personal Fulfillment

Owning a business should provide significant personal fulfillment. All other motivations will not be enough in the tough times—and those times are sure to come. Apple co-founder Steve Jobs said it well:[11]

niche market
A specific group of customers with an identifiable but narrow range of product or service interests.

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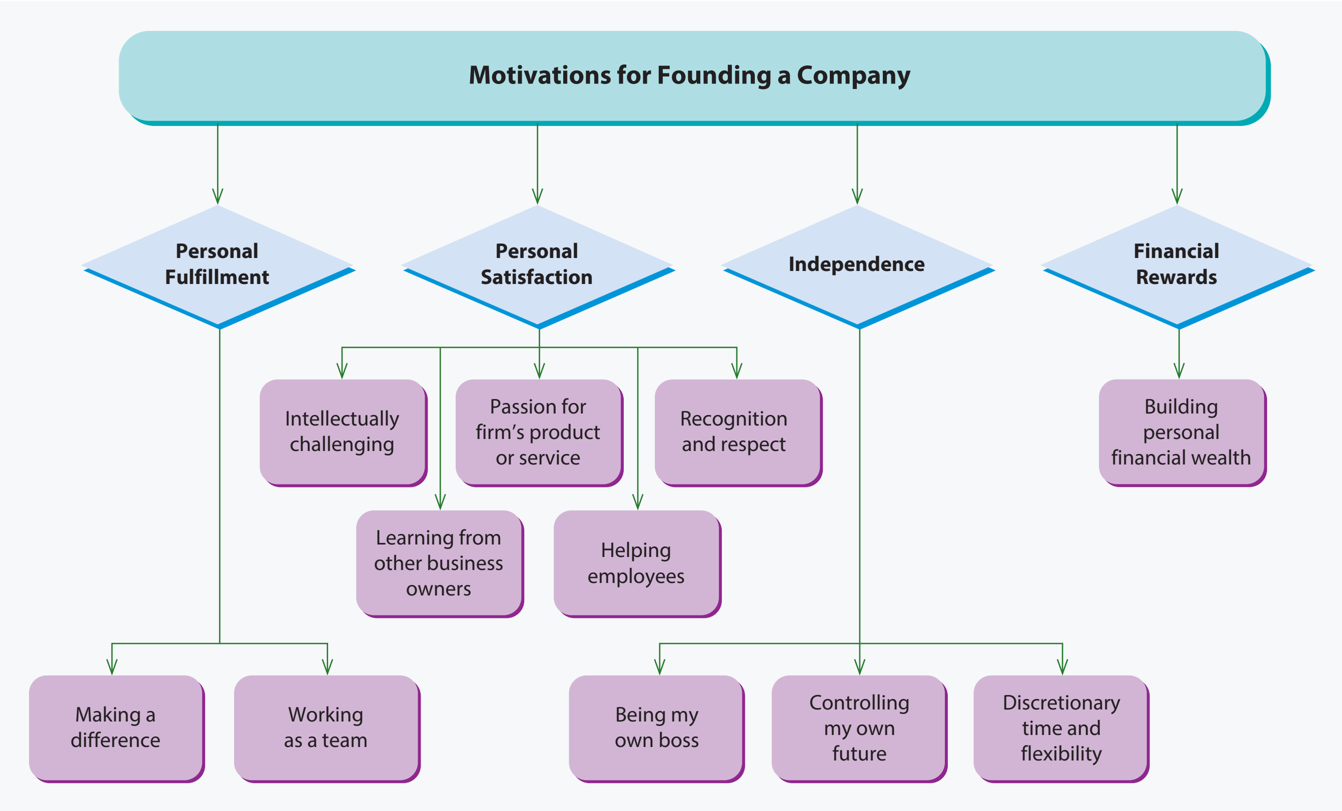
> The only way to do great work is to love what you do. If you haven't found it yet, keep looking. Don't settle. As with all matters of the heart, you'll know when you find it.

At the core, the primary reason for owning your own business should be to create a product or service that improves life for others. Only when your company is about something more significant than yourself will you have a sense that what you are doing is meaningful and well worth the effort. Bill Waugh, founder of Casa Bonita, a very successful chain of Mexican food restaurants that includes Taco Bueno, sought to make a difference by providing his company's resources to not-for-profit organizations. He commented, "My company is my base for helping others."[12]

Gallup Poll researchers examined the relationship between work and happiness for different occupational groups. They developed an overall index of contentment based on the following criteria:

- Emotional health
- Physical health
- Job satisfaction
- Healthy behavior
- Access to basic needs
- Self-reporting of overall life quality

Exhibit 1.2 Entrepreneurial Motivations



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When the findings were complete, they found that *business owners outrank all other occupational groups in terms of overall contentment*.[13]

A later Gallup poll asked employees if they were excited about their jobs. The results were interesting:[14]

- Fifty-two percent of all full-time workers were not involved in, enthusiastic about, or committed to their work.
- Eighteen percent were "actively disengaged," suggesting that they could even be undermining their company's mission and goals.

So, it seems that only 30 percent of workers feel excited about and engaged with their work. The study also found that employees at companies with 10 or fewer employees reported higher engagement levels than those in larger groups of workers.

These findings suggest that small business owners can better personalize morale-boosting efforts in more intimate groups. Richard Duncan, president of Rich Duncan Construction in Salem, Oregon, explained it this way:[15]

> Small businesses can encourage their employees to feel that they are a part of the team that not only cares for them as individuals, but also rewards them for their efforts. A small-business owner can also offer a better opportunity for employees to feel that the top decision maker has an open-door policy and readily welcomes the employee's input on business matters.

Thus, personal fulfillment is not limited to the entrepreneur but extends to the employees of small companies as well. Working as a team provides a sense of belonging for both owner-managers and employees. They come to understand that they can do nothing of significance alone. It can be a win-win for everyone if done well.

Personal Satisfaction

Closely related to personal fulfillment is the personal satisfaction that business owners frequently experience in their work. Here is what can be said about small business owners in general:

- *They feel rewarded in working with a product or providing a service and being good at it.* Rick Davis, founder of DAVACO, a Dallas-based company, said, "There is nothing else I would rather do. I love the challenges, working with others to see our dreams come true, and making a difference in the community. It is fun."[16]
- *Entrepreneurs are energized by enjoyable associations within their business.* There is a personal satisfaction that comes from helping their employees develop. Jack Griggs, president of Southwestern Bancorp, Inc., and chair of the board of Texas Heritage Bank, believes that one of his primary roles is to help his employees become better at what they do. He takes pride in the number of employees who have gone on to great careers, even if not at one of his banks.[17]
- *Entrepreneurs enjoy friendships with other business owners, frequently learning from one another.*
- *If they are visible within the community, small business owners can garner the respect of those who live there.*

As you can see, for many entrepreneurs, the personal satisfaction gained from owning and operating a business is extremely important in their lives.

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Independence

Many people have a strong desire to make their own decisions, take risks, and reap the rewards. They find it important to be free to make their own choices in their work. In other words, the more control they have over their work, the happier they are.

Business owners also have discretion in engaging in nonbusiness activities. They have more freedom to decide when to work, when to be with family, and when to join community activities than employees do.

Aimee Marnell and her husband, John, were in the same industry for several years and finally got tired of working directly under management. So, they started Carlot Solutions in Austin, Texas. When asked what she enjoys most about having her own business, Aimee replied, "I love the freedom to make choices. Whether I succeed or fail, I believe in what I do."[18]

Of course, independence does not guarantee an easy life. Most entrepreneurs work very hard and for long hours. They must remember that the customer is, ultimately, the boss. However, they do have the satisfaction of making their own decisions within the constraints required to build a successful business. Chris DeLeenheer, founding partner of Rydell Holdings, describes starting his first business and what got him through the tough times: "Three things kept me going: a drive to win, determination not to give up, and the discipline to work on the right stuff."[19]

Financial Rewards

Generally, when businesses are profitable, everyone benefits. Jobs are created, taxes are paid, and charities receive donations. Furthermore, like any other job or career, owning a business is a way to earn money and make ends meet. Of course, some entrepreneurs earn *lots* of money. In general, self-employed individuals are more likely to create greater personal wealth than persons who work for others.

While that may be true, many entrepreneurs work night and day (literally, in some cases) just to generate enough profits to survive. Others receive a modest income for their time and investment. Ideally, however, the owner should be compensated for two basic activities:

- *Payment for personal time in managing the company*, coming in the form of a salary.
- *A return for investing personal money in the business*, which should relate to the amount invested and the riskiness of the business, coming in the form of cash dividends and any increase in the value of the business as it grows.

No doubt, many entrepreneurs are highly motivated by the prospect of making money, which is totally appropriate. But it is important to understand that while some entrepreneurs do become rich quickly, the majority do not. Therefore, a more realistic goal is to "get rich slowly." Wealth will hopefully come, provided the business is economically viable and the owner has the patience and determination to make it happen.

When it comes to making money, keep in mind the adage "Money is not a problem, but money without wisdom *is* a problem." Holt Lunsford, a successful entrepreneur named to the North Dallas Real Estate Hall of Fame, once commented, "Money does not buy you happiness; it only increases your options."[20]

While we have suggested possible motivations, only you know why owning your own business is appealing *and* rewarding. Whatever the reasons, it is wise to identify what truly motivates you to be an entrepreneur. It will help you to understand what is

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important to you and give you guidance when making decisions. Clayton Christensen, a former Harvard business school professor, offered sage advice:[21]

> It is impossible to have a meaningful conversation about happiness without understanding what makes you tick. When we find ourselves stuck in unhappy careers—and even unhappy lives—it is often the result of a fundamental misunderstanding of what really motivates us.

We advise you to do a bit of self-reflection to understand your own reasons for wanting to own a business. Only then can you align your own personal mission with the first steps you take in becoming an entrepreneur.

1-4b Influencers of the Decision to Own a Business

The motivations just described represent the basic drivers of any decision to own a business, but people and circumstances affect the decision as well. Two such influencers are (1) family and friends, and (2) the desire to escape from a bad situation.

Family and Friends

You may decide to own a small business because of the influence of family members or friends who have their own businesses. Not surprisingly, many small business owners worked in their family's business before founding their own ventures. In other words, they had the opportunity to observe the "entrepreneurial life" up close.

The Desire to Leave a Difficult Situation

Starting a business may provide an escape from an undesirable job situation. Some individuals become entrepreneurs after being laid off by an employer. Those who started or acquired small businesses because of financial hardship or other negative conditions have appropriately been called **reluctant entrepreneurs**.

Individuals may also flee the bureaucratic environment of a corporation that seems stifling or oppressive to them. Entrepreneurship often provides an attractive alternative for such individuals, who are sometimes called **corporate refugees**.

Being influenced by friends and family or simply wanting to make a change in your current situation is not a sufficient reason to start your own business. You need to understand the specific motivations that will keep you going on the tough days.

1-4c Why Your Perceptions Matter

Knowing both your motivations and who or what is influencing your decision to become an entrepreneur is important to anyone interested in starting a business. But that is not enough. You also need to understand if your perceptions of what it takes to be successful in business are accurate.

In his book, *The 7 Habits of Highly Effective People*, Stephen Covey advises that to make important changes in our lives, we need to change from the *inside out*. He says that having a positive attitude or working harder is not enough. Instead, we must change how we fundamentally see a situation—that is, we must experience what he called a **paradigm shift**.[22]

Therefore, the question for someone wanting to start a business is "What will it take for you to create a successful business?" Your answer to this question will depend largely on your past experiences, which have a significant influence on your paradigm (the framework for how you see the situation).

reluctant entrepreneur
A person who becomes an entrepreneur because of some severe hardship.

corporate refugee
A person who becomes an entrepreneur to escape an undesirable job situation.

paradigm shift
A change in how we fundamentally see a situation.

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In his book, *The E-Myth Revisited: Why Most Businesses Don't Work and What to Do about It*, Michael Gerber describes three personalities that come into play when a person is starting a business:[23]

- The technician personality
- The manager personality
- The entrepreneur personality

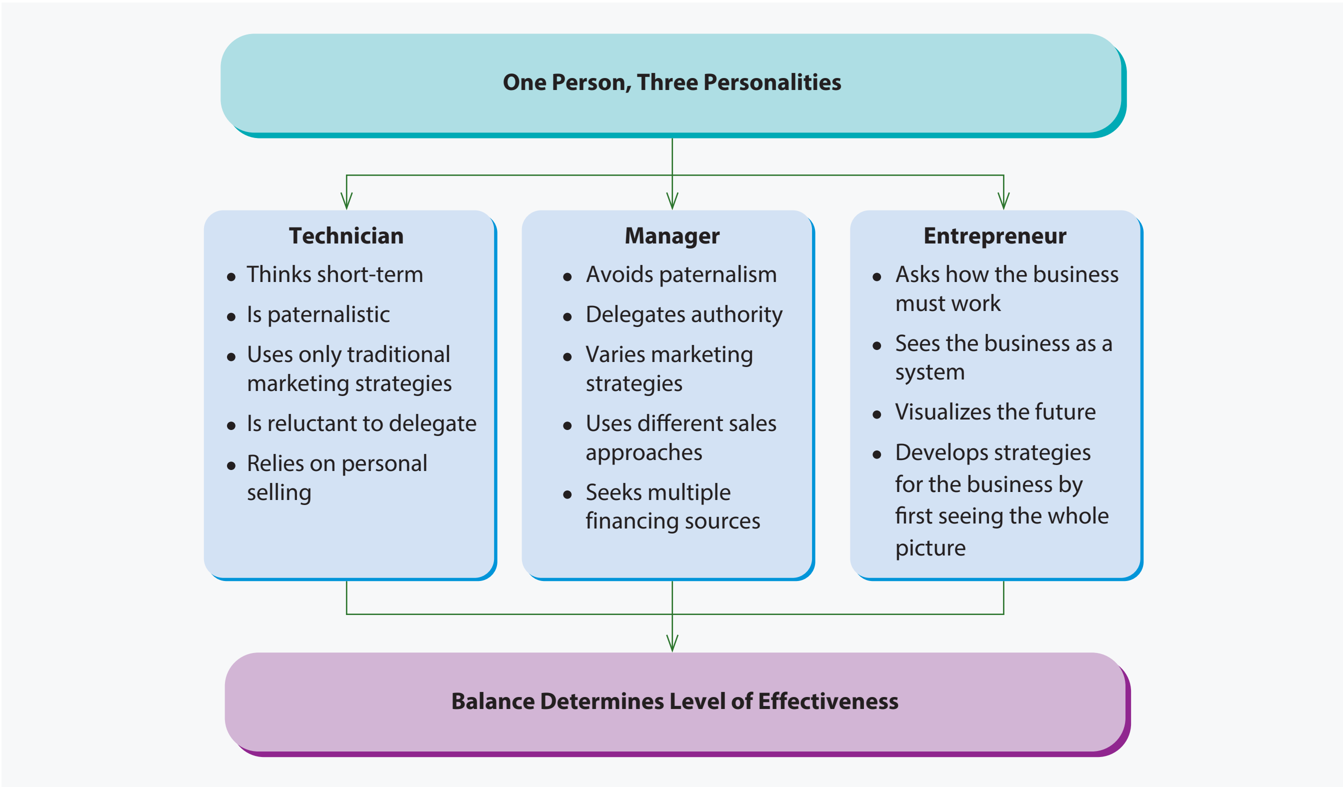
Gerber contends that everyone exhibits these personalities to some varying degree, but successful business owners need a balance of all three. Let's briefly look at the three personalities, which are shown graphically in Exhibit 1.3. As you read about these personalities, consider how you might describe yourself.

The Technician Personality

If you start an auto repair business because you love working on cars or a pie shop because your friends say you make the best pies they have ever eaten, you most likely have what Gerber calls a technician personality. The **technician personality** is usually a steady worker, experienced at *doing* what they know best. The technician dislikes managing, wanting instead to be left alone to get the job done. To the technician, starting a business may be both a dream-come-true and a nightmare at the same time. The thought of no longer being managed and having total control over what gets done is exciting, but the need to be organized and think strategically is daunting.

technician personality A personality that focuses on an already developed technical skill, wants to be left alone to get the job done, and is primarily concerned about the present.

Exhibit 1.3 **Understanding Entrepreneurial Personalities**



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A technician personality tends to do the following:

- Use short-term thinking with little planning for future growth or change.
- Be paternalistic (be a person who guides the business much as they might guide family members).
- Define marketing strategy in terms of the traditional components of price, quality, and company reputation.
- Be reluctant to delegate.
- Focus on sales efforts that are primarily personal.

The technician is prone to making a fatal assumption. According to Gerber, the technician thinks, "If you understand the technical work of a business, you understand the business that does that technical work. . . . But the technical work of a business and a business that does that technical work are two totally different things!"[24]

The Manager Personality

An individual with a **manager personality** is pragmatic, assuming responsibility for the planning, order, and predictability of the business. In Gerber's words, "The manager is the part of us that goes to Sears and buys stacking plastic boxes, takes them back to the garage, and systematically stores all the various nuts, bolts, and screws in their own carefully identified drawer."[25] A manager personality tends to do the following:

- Avoid paternalism.
- Delegate authority as necessary for growth.
- Employ diverse marketing strategies.
- Use different types of sales approaches.
- Obtain original financing from more than two sources.

In contrast to a technician, a manager's job is to prepare the business for growth through self-education, to ensure that the company's foundation and structure can carry the additional weight. The manager's boundary is defined by how many individuals they can supervise effectively or can organize into a productive effort. A small building contractor and developer who adopts a sophisticated approach to management, including detailed accounting and budgeting, precise bidding, and thorough market research has a manager personality.

The Entrepreneur Personality

The **entrepreneur personality** takes an idea and turns it into an opportunity. This personality does not look at the work that a business does. Instead, the entrepreneur examines *how* the business does what it is intended to do. In this way, the entrepreneur can see the big picture and develop strategies that will help the venture flourish. According to Gerber, this personality needs to be harnessed effectively, or it will wreak havoc by trying to pull the business in many directions at the same time.[26] The entrepreneurial personality tends to do the following:

- Ask the question, "How must the business work?"
- See the business as a system for producing outside results for the customer and, in so doing, producing profits.
- Start with a picture of a well-defined future, and then attempt to change the present to match the vision.
- Develop strategies for the business by first seeing the whole picture.

manager personality
A personality that is pragmatic and likes order and planning operations.

entrepreneur personality
A personality that focuses on the opportunity and providing results for the customer.

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The entrepreneur looks at the business as the product. In this way, the business is tailored to meet the needs of the customer and not the needs of the business owner (as is the case in a technician-founded business).

We all have a bit of each of these personalities. However, for most people, one personality dominates the others to the detriment of the business *and, possibly, the owner's personal life as well*. Thus, Gerber offers the following counsel:[27]

> Without all three of these personalities being given the opportunity, the freedom, the nourishment they each need to grow, your business cannot help but mirror your own lopsidedness. . . . And if they were equally balanced, we would be describing an incredibly competent individual.

Therefore, if you don't understand who you are as a business owner, you may think that the business is the problem when, in fact, you are the problem. By first understanding yourself, your motivations for wanting to be a business owner, your influencers, and how your past experiences affect how you see the business, you can potentially avoid a lot of disappointment and long-lasting problems.

As part of this process, seek out mentors—personal mentors *and* business mentors—as soon as you can. They will be *invaluable* when you are starting a business and during the entrepreneurial journey. Most entrepreneurs have mentors along the way, individuals who can offer guidance based on their experience. They can help you avoid mistakes and encourage you on those days when you want to throw in the towel. A good mentor can make all the difference.

1-5 What Do You Want Your Legacy to Be?

1-5 Discuss ways to build a successful business as part of your life legacy.

Building a legacy is an ongoing process that begins with the launch of the firm and continues throughout its operating life. When entrepreneurs decide to exit the business, usually by selling it or passing it on to the next generation, their business achievements become history. Reflecting on their lives and businesses, many entrepreneurs come face to face with questions such as these:

- Was it a good journey?
- Do I feel good about it?
- What are my disappointments?
- How did I make a difference?
- Was I able to hold onto the important relationships in my life?

In anticipating this time of looking back, an entrepreneur should think in terms of a legacy in two ways:

1. In a narrow sense, as material possessions bequeathed to one's heirs.
2. In a broader sense, as *everything* that one leaves behind—material items, good or bad family relationships, and a record of integrity or greed, of contribution or exploitation.

So, an **entrepreneurial legacy** includes both tangible items and intangible qualities passed on not only to heirs, but also to the broader society. You can appreciate, then, the seriousness with which the entrepreneur needs to consider the kind of legacy they are building.

entrepreneurial legacy Material assets and intangible qualities passed on to both heirs and society.

It is easy for entrepreneurs to get caught up in working harder and harder to keep up with the busy pace of life. Ultimately, such entrepreneurs may find their

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business accomplishments overshadowed by the neglect or sacrifice of something more important to them. So, before you ever start, and then repeatedly during your entrepreneurial journey, you should ask yourself, "How will I measure my life?"

Ed Bonneau revolutionized the distribution of sunglasses in the United States. But when asked how he'd like to be remembered, he downplayed his financial success:[28]

> I would hope that they knew something else besides that I once ran the biggest sunglass company in the world. That's not the number one thing that I'd want to be known for. It's okay, but I'd much rather have that final assessment made by my kids and have them say, "He was a terrific dad." I never wanted to sacrifice my family or my church for my business.

In entrepreneurial terms, what constitutes a worthy legacy? For most entrepreneurs looking back on their careers, personal fulfillment requires their businesses to have been constructive or positive in their impact. The late Bernard Rapaport, a highly successful and generous entrepreneur, stressed the importance of the means a person takes to achieve a given end. "Whatever it is you want to achieve," he said, "*how* you achieve it is more important than if you achieve it." Reflecting on his life and legacy at the age of 93, he said, "What do I want to do? I want to save the world."[29] Such idealism can guide an entrepreneur in many endeavors that are useful to both our economic system and our society.

It is our deepest hope that your journey in owning your own business and being an entrepreneur—if you choose to take that step—will be a richly rewarding experience not only financially, but also in the other important facets of your life. Above all, we hope that your legacy will bring both satisfaction *and* fulfillment for you and the important people in your life. And as you begin the journey, if you choose to do so, take the words of Ewing Marion Kauffman, founder of Marion Labs, with you:[30]

> You should not choose to be a common company. It is your right to build an uncommon company if you can—to seek the opportunity to compete, to desire to take the calculated risks, to dream, to build—yes, even to fail or succeed.

Ready to Begin?

An airplane pilot not only controls the plane during take-off, but also flies it and lands it. Similarly, entrepreneurs not only launch firms, but also manage their firm's subsequent operations. This book will help you to understand the entire entrepreneurial process.

- Part 1 offers an introduction to the entrepreneurial life and examines the fundamental values of the entrepreneur.
- Parts 2 and 3 look at the initial planning that is required for business start-ups, the various types of entrepreneurial ventures, and the new venture's business model and planning.
- Parts 4 through 6 deal with the marketing and management of a growing business, including its human resources, operations, and finances.

So, let's get started.

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1-1. Explain the importance of small business and entrepreneurship in our society.

- Entrepreneurial activity plays a vital role in the U.S. economy.
- There are 30.2 million small businesses in the United States, including 11.7 million women-owned small businesses and 9.2 million minority-owned small businesses.
- Fifty-nine million people work in small businesses, representing 47 percent of all employees and 42 percent of all salaries paid to employees.
- Many small companies have gone global, representing 97 percent of all exporters.
- Two-thirds of all small businesses survive for at least two years, while around 33 percent survive over 10 years.
- Fifty percent of the failures are due to cash flow problems, with 14 percent being the result of poor marketing strategies.

1-2. Describe what it means to be a small entrepreneurial firm.

- To distinguish between small and large businesses, we naturally consider their relative sizes, but it is also helpful to think about a small firm's potential to grow.
- There are three types of small companies, based on their growth potential: microbusinesses, attractive small firms, and high-potential ventures.
- Small companies with high-growth potential are fundamentally different from low-growth companies and must be managed differently.
- For our purposes, we focus on small firms that have the following qualities:
  - ✓ Are small compared to the largest firms in the industry (usually with fewer than 100 employees).
  - ✓ Have geographically localized operations.
  - ✓ Are financed by a small number of individuals.
  - ✓ Have growth potential.
- Entrepreneurs are willing to create value while assuming both the risks and the rewards for their efforts in either a new or an existing enterprise.
- Entrepreneurs generally think differently about resources than do employee-managers. To gain the necessary resources, they sometimes bootstrap, doing more with less in terms of resources invested in a business and, where possible, controlling the resources without owning them.
- Types of entrepreneurs include second-stage entrepreneurs, franchisees, social entrepreneurs, intrapreneurs, and entrepreneurial teams.
- Research has identified positive and negative attributes of entrepreneurs.
- There are four stages of entrepreneurship:
  - ✓ Identifying an attractive opportunity.
  - ✓ Acquiring the critical resources needed for growing the business.
  - ✓ Executing a plan to grow the firm.
  - ✓ Exiting the company to capture the value created in the business.
- Entrepreneurial success generally comes from having a clear mission, a desire to lead, and the recognition that business success requires hard work and long hours.

1-3. Identify how small businesses can compete against the giants.

- Any business that can make its product or service cheaper, faster, and better can be competitive.
- Small firms can gain a competitive advantage over larger competitors in the following ways:
  - ✓ Building an internal culture based on integrity.
  - ✓ Focusing on customers.
  - ✓ Emphasizing quality in operations.
  - ✓ Being innovative.
  - ✓ Finding a distinct market segment—a niche market.

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1-4. **Discuss what might motivate you to be a small business owner with all its risks and uncertainties.**

- Understanding clearly why you want to own a small business and what motivates you is vital to eventually achieving fulfillment through your business.
- Entrepreneurial motivations include personal fulfillment, personal satisfaction, independence, and financial rewards.
- Influencers of the decision to own a business are family and friends and wanting to leave an undesirable job situation.
- Knowing your motivations is important in starting a business. But you must also understand whether your perceptions of what it takes to be successful in business are accurate.
- The question for someone wanting to start a business is "What will it take for me to create a successful business?" Your answer will depend largely on your past experiences, which influence how you see the situation.
- According to Gerber, three personalities come into play when a person is starting a business: the technician personality, the manager personality, and the entrepreneur personality.

1-5. **Discuss ways to build a successful business as part of your life legacy.**

- Building a legacy is an ongoing process that begins with the launch of the firm and continues throughout its operating life.
- An entrepreneur's legacy includes not only money and material possessions, but also nonmaterial things, such as personal relationships and values. These are passed on to both heirs and the broader society.
- A worthy legacy brings both satisfaction and fulfillment to the entrepreneur and the important people in their life.

Key Terms

attractive small firm p. 6
bootstrap p. 7
corporate refugee p. 18
entrepreneur p. 6
entrepreneur personality p. 20
entrepreneurial legacy p. 21
entrepreneurial team p. 11
entrepreneurship p. 6
franchisee p. 10
high-potential venture (gazelle) p. 6
intrapreneurship p. 10
lifestyle business p. 4
manager personality p. 20
microbusiness p. 4
niche market p. 14
paradigm shift p. 18
reluctant entrepreneur p.18
small business p. 6
social entrepreneurship p. 10
technician personality p. 19

Discussion Questions

1. What is meant by the term *entrepreneur*?
2. Consider an entrepreneur whom you know personally. What was the most significant reason that the person decided to follow an independent business career? If you don't already know the reason, discuss it with that person.
3. What do you believe are the two most desirable and the two most undesirable qualities of an entrepreneur?
4. The motivators/rewards of profit, independence, and personal satisfaction and fulfillment are reasons that individuals enter entrepreneurial careers. What problems might be anticipated if an entrepreneur became obsessed with one of these rewards—for example, if the individual had an excessive desire to accumulate wealth, operate independently, or achieve a particular lifestyle?
5. How do different personality traits affect an entrepreneur's effectiveness in running a small business?
6. What do you believe is the advantage of having an entrepreneurial team when starting a business?
7. Explain how customer focus and innovation can be special strengths of small businesses.
8. Explain the concept of an entrepreneurial legacy.

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You Make the Call

Situation 1

In the following statement, a business owner attempts to explain and justify his preference for slow growth in his business.

> I limit my growth pace and make every effort to service my present customers in the manner they deserve. I have some peer pressure to do otherwise by following the advice of experts—that is, to take on partners and debt to facilitate rapid growth in sales and market share. When tempted by such thoughts, I think about what I might gain. Perhaps I could make more money, but I would also expect a lot more problems. Also, I think it might interfere somewhat with my family relationships, which are very important to me.

Question 1 Should this venture be regarded as entrepreneurial? Is the owner a true entrepreneur?

Question 2 Do you agree with the philosophy expressed here? Is the owner really doing what is best for his family?

Question 3 What kinds of problems is this owner trying to avoid?

Situation 2

Bear Bills, Inc. was started in 2008 by three Baylor University alumni in their early twenties as a solution to a problem every college student faces—paying utilities. The company's name originated from the university's mascot, the Baylor Bears. The business helps students pay their utility bills without all the hassles of having to collect from each roommate and getting a check to the utility company. Bear Bills pays the bills each month and splits the amount based on each student's prorated portion. The utility companies like the arrangement and are willing to give Bear Bills a commission for increasing their market share. The apartment houses where the students live like the deal because the utilities remain in the renters' names and the management receives a referral fee from Bear Bills. Of course, the students sign up because they do not have to bug a roommate to pay their share of the bill. And Bear Bills makes money.

The first year, Bear Bills signed up over 2,000 college students at the university. The second year, it incorporated as Simple Bills, Inc., and went to other college campuses, doubling its customer base to over 4,000.

At this point, the concept is proven, but the owners have a decision to make. They can raise money from investors and grow the company faster to capture market share, but that will mean they will have to give up some of their ownership in the company. Alternatively, they can continue to bootstrap the business to conserve ownership percentage but then cannot grow it as rapidly. In other words, they would limit the growth of the business to what can be financed from the cash flows currently being generated from operations.

Question 1 What do you like and not like about the Simple Bills concept?

Question 2 Would you recommend raising funds from outside investors and growing faster or continuing to bootstrap the operations to conserve ownership? Why?

Question 3 What strategy would you suggest for growing the business, assuming new investors are brought in?

Question 4 If you choose to raise funds, whom might you seek as investors?

Situation 3

Bracken Arnhart, the founder and CEO of WSR Tool Services, Inc., has immersed himself for the past 10 years in growing his business and has been unquestionably successful in doing so. When he started the company, there were only three employees. Today, he has over 100 employees, and he has achieved more than he had hoped for in terms of financial rewards.

Arnhart knows that realizing the goals he set out for the business has been at some cost to his personal and family life. He explains that he always tries to be at home when his children get up in the morning and is there to help tuck them into bed at night. The rest of the time, he is focused on the business. In discussing his work-life balance, he says,

> Living a balanced life is generally more accepted by society than sacrificing much of one's time to pursue one thing. However, I would argue that to truly do something great, one must give an inordinate amount of time and hard work to see it come to pass.
>
> There are the people that are just not ok with the fact that there are only 24 hours in a day. However, unable to alter this fact of life, they are bent on wringing the most out of those 24 hours, and doing it eight days a week, 53 weeks out of the year, only slowing down when they die (and even then, still going at about half-pace). They welcome angels such as caffeine, and curse crutches such as food and sleep. I would probably fall into this category.
>
> I would say that I have exchanged work-life balance for building a business. I am told that I'm hard to get ahold of, and even when I do have "free time," my mind is still fully engaged with my business. I am passionate about what I am doing and wouldn't want to be doing anything else. I'll admit that I may miss meals, social events, and really anything that could distract me from my goal, and I am generally ok with it.
>
> I believe that this is perfectly acceptable for entrepreneurs, possibly even necessary. Work-life balance is a great debate

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between entrepreneurs, small business owners, and even those attempting to climb the corporate ladder faster than most. Many are of the opinion that living a balanced life is essential for personal "success," whatever that may look like. However, I strongly believe that tipping the scales toward building a business is the only way to go.

Question 1 Is work-life balance for everyone?

Question 2 Is work-life balance simply a preference, or is it a necessity when growing a business?

Question 3 As an entrepreneur, would there be facets of your life that you would place at a higher priority than growing a business? Explain.

Experiential Exercises

1. Analyze your own education and experience as qualifications for entrepreneurship. Identify your greatest strengths and weaknesses.
2. Explain your own interest in each type of entrepreneurial reward. Identify which type of incentive is most significant for you personally, and explain why.
3. Interview someone who has started a business, being sure to ask for information regarding the entrepreneur's background and age at the time the business was started. In your report of the interview, indicate the entrepreneur's motivations and personality type.

Chapter 1 Case

Please see Appendix A for the Chapter 1 Case Study.

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Chapter 2

Integrity, Ethics, and Social Entrepreneurship

Looking Ahead

Learning Objectives

The purpose of the Integrity, Ethics, and Social Entrepreneurship chapter is to help you understand how to start and run a small business with integrity, taking the ethical path in all that you attempt to do. By studying this chapter, you should be able to . . .

2-1 **Describe the meaning of integrity, including its importance to small businesses.**

2-2 **Explain how integrity applies to various stakeholder groups.**

2-3 **Identify some common challenges and benefits of maintaining integrity in small businesses.**

2-4 **Determine practical approaches for building a business with integrity.**

2-5 **Describe social entrepreneurship and its influence on small companies and start-up opportunities.**

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Spotlight on Small Business

Bambino's Frozen Baby Food

https://bambinosbabyfood.com

Zoi Maroudas grew up in the food business. Her parents immigrated to the United States from Greece when she was young and settled in Anchorage, Alaska, where they opened Pizza Olympia, a Greek and Italian restaurant. They still own and operate the restaurant, and Maroudas shares in the work and learning alongside her parents both in their farms back in Greece and in their restaurant. Together with her education, medical background, and passion for a healthier tomorrow, these experiences have provided a strong foundation and inspiration for the entrepreneurial journey she is on today.

While studying business, biology, and organic chemistry at Baylor University in Waco, Texas, Maroudas interned at a local hospital where she worked with older patients. It was there that she observed the disconnect between health and wellness through food. She noticed that many patients were not eating their meals, which were bland and nutritionally inadequate. In the Greek culture, food is seen as the centerpiece of a joy-filled existence, regardless of the stage of life, so Maroudas was distressed that mealtime was about as pleasant as taking medicine. The processed baby foods fed to the older adults were neither nutritious nor visually appealing. To help patients recover and gain strength, she began creating special meals for them. With the blessing of her supervisor, she experimented with a new menu of nutritional and tasty food options. Within a month, it was evident that the patients were enjoying their meals, and they were also recovering faster.

These observations later inspired Maroudas to consider how healthy food could also benefit other age groups, which led her to launch Bambino's Frozen Baby Food in 2012. As the name implies, the start-up had a very definite purpose and mission, which is clearly expressed on the company's website:

> Our Bambino's Family Team will provide the best, most pure, fresh and nutritionally balanced organic baby food to help your little one grow strong and healthy. All of our recipes are created with love and dedicated medical research from our founder Zoi Maroudas, along with leading allergists' and pediatricians' recommendations.

The goal was to fill a gap in the marketplace that had been left by major American baby food makers, which also ignored seafood as a product option despite the obvious health benefits it provides. According to Dr. Tom Brenna, a professor at the University of Texas who specializes in both pediatrics and nutrition, seafood can be an excellent source of protein for young children. As he puts it, "The omega-3s found in seafood are to the developing retina and brain what calcium is for bones." But he also confirms that the health benefits for kids do not end there. Seafood is also rich in many important minerals, such as zinc, iron, selenium, and iodine, and these are not found in many other foods.

Aware of the benefits of seafood protein for young children, and given the absence of such alternatives on the market, Maroudas was confident that this opened up a wonderful opportunity to create a thriving business while also making an important contribution to children's health. Seeing the possibilities, she launched her new venture. From the start, she realized that her products could revolutionize the baby food industry since they would meet the lifestyle demands of busy parents who also wanted to give their children fresh foods (as if they made it themselves) and address infant development and digestive needs at the same time. Conventional baby food is processed under high heat to create a shelf-stable product that will not spoil at room temperature. But Maroudas determined that it would be far better to lock in essential nutrients by freezing the final product to maintain its freshness, and without preservatives.

Her timing was excellent, as industry research projected an increase in worldwide sales of frozen baby food. Busy parents with more disposable income prefer this option, especially when only organic ingredients are used. They recognize that these high-quality products are healthier for their infants than the usual bottled options that have been around for decades. That such demand was particularly high in fast-growth global markets like India and Indonesia was certainly a plus.

The first product that Maroudas launched was Hali-Halibut, which was soon followed by Sockeye Salmon Bisque and a number of other tasty delights. These Alaska-grown products are among those produced and stored at her company's facilities in Anchorage before being shipped to customers in all 50 states. Three-fourths of the company's sales flow through Bambino's website—which also offers subscription services—with the rest being sold through its physical store in Alaska, major retail grocery

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store chains, and even on Amazon. The range of customers has grown along with the company's sales, as 30 percent of its products are currently purchased by adults with swallowing or digestive challenges.

Maroudas's success is evident from the recognition the company has received, including being honored as Best Manufacturer of the Year in Alaska in 2019. Such recognition provides a platform from which she can advocate for health and wellness, even as she shares the good news about Bambino's products.

No matter how the future unfolds, the venture will always maintain a laser-like focus on its customers: parents and the little ones they care so much about, as well as older adults who have turned to Bambino's to meet special dietary needs. Maroudas tempers her business goal with compassion and concern. "Above all," she declares, "my greatest reward is realizing that we are feeding children and older adults delicious and highly nutritious products with the purest ingredients." And she expresses that to her customers by sending them countless handwritten notes and setting up meet-and-greet events when she travels to cities where Bambino's patrons reside. The many expressions of care and concern are not lost on those who have come to appreciate what Maroudas has done for those they love.

Sources: Allied Analytics, "Frozen Baby Food Market by Type and Distribution Channel: Global Opportunity Analysis and Industry Forecast, 2018–2025, January 4, 2021, https://www.einnews.com/pr_news/533976598/frozen-baby-food-market-by-type-and-distribution-channel-global-opportunity-analysis-and-industry-forecast-2018-2025, accessed February 3, 2021; Bambino's Baby Food, "Welcome to Bambino's Baby Food," https://bambinobabyfood.com, accessed February 3, 2021; Personal communication with Zoi Maroudas, February 9, 2021; and Laine Welsh, "Anchorage Startup Aims to Get More Seafood into the Mouths of Babies," *Anchorage Daily News*, November 24, 2020, https://www.adn.com/business-economy/2020/11/23/anchorage-startup-aims-to-get-more-seafood-into-the-mouths-of-babies, accessed February 3, 2021.

As you can see from this chapter's Spotlight feature, Bambino's Frozen Baby Food is a unique small business. While Zoi Maroudas is very interested in its financial performance, she also pays careful attention to crucial customer relationships: "What makes your business a success is the same across all industries: integrity, value, trust, and commitment. Adhering to these values will be your greatest victory."[1]

Maroudas's focus on improving children's well-being by producing healthy, organic baby food has played a key role in generating positive results. Consistent with the founding principles that have guided the enterprise, she has given serious consideration to the needs and interests of those who impact or are impacted by the firm's operations. She sees this as a matter of integrity—of being true to the character of the company and the customers who are so directly impacted by it—and it's paying off in many ways.

But what exactly is integrity? That's a very important question. In this chapter, we define and discuss this fundamental concept, recognizing integrity as the foundation for ethical behavior in small businesses. We also provide ethical and social frameworks to guide you toward principled management.

2-1 Describe the meaning of integrity, including its importance to small businesses.

2-1 What is Integrity?

The seeds of business misdeeds are sown when individuals compromise their personal *integrity*—that is, when they do not behave in a way that is consistent with the noble values, beliefs, and principles they claim to hold. A person has integrity if their character remains whole, regardless of the circumstances. In other words, **integrity** refers to a general sense of honesty and reliability that is expressed in a strong commitment to doing the right thing, regardless of the circumstances.

integrity
A general sense of honesty and reliability that is expressed in a strong commitment to doing the right thing, regardless of the circumstances.

As discussed in Chapter 1, a successful entrepreneur seeks financially rewarding opportunities while creating value, first and foremost, for prospective customers and the firm's owners. This perspective makes clear that relationships are critical and that integrity is essential to success. Financial gain is important, but it should not be

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the only goal. In fact, doing "anything" for money can quickly lead to distortions in business behavior. There are numerous motivations for misconduct in companies, but acts such as price fixing, overcharging customers, using pirated software, and a host of others are driven primarily by financial motives. Acting with integrity requires that an individual first consider the welfare of others.

Fortunately, many small business owners strive to meet the highest standards of honesty, fairness, and respect in their business relationships. Although unethical practices receive extensive attention in the news, most entrepreneurs and other business leaders are people of principle, whose integrity regulates their quest for profits.

2-2 Integrity and the Interests of Major Stakeholders

2-2 Explain how integrity applies to various stakeholder groups.

It is probably evident by now that the notion of integrity is closely tied to ethical issues, which involve questions of right and wrong.[2] Such questions go far beyond what is legal or illegal. Entrepreneurs often must make decisions regarding what is respectful and fair, and these decisions are becoming more important over time.

An honest assessment of the marketplace recognizes that ethical problems exist there. A survey conducted by the Ethics Resource Center revealed that employees witness various forms of misconduct in their workplaces, with the most frequently observed offenses involving abusive behavior and lying to employees. (Refer to Exhibit 2.1 for the percentages of workers who observed these and other forms of unethical behavior.) These are significant failures. And because a wide range of individuals may be involved and/or affected, it can be challenging for a small business owner to determine how to best address the underlying issues or resolve lingering problems related to such misconduct.

When it comes to ethical behavior, small business owners guided by integrity must consider the interests of several different groups when making decisions. These groups include owners (or stockholders), customers, employees, the community, and the government, among others. Individuals in these groups are sometimes referred to

Exhibit 2.1 Most Frequently Observed Forms of Workplace Misconduct

Source: Adapted from Ethics Resource Center, "National Business Ethics Survey of the U.S. Workforce," 2014, pp. 41–42.

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as stakeholders, indicating that they have a "stake" in the operation of the business. Although definitions vary, **stakeholders** are typically described as those individuals or groups that either can affect the performance of the company or are affected by it.

Because the interests of various stakeholder groups sometimes conflict, decisions can be very difficult to make. And because there may not be one completely right or wrong position to take, managing the process can be complicated.[3]

According to business ethics and morality scholar Archie Carroll, some responsibilities of a small business cannot be negotiated away (refer to Exhibit 2.2). For example, a firm must remain profitable to stay in business, and it must also obey the law if it wishes to keep its doors open. Societal expectations regarding a venture's ethical performance may leave a small business owner with a bit more latitude, but it is very limited. Ignoring such expectations, while legal in a strict sense, is likely to tarnish the firm's reputation and can lead to serious repercussions, including negative publicity, consumer protests, or even lawsuits—and these can easily affect financial outcomes. Finally, discretionary responsibilities, such as providing support to the community, offer greater flexibility. But even here, failing to address this responsibility is likely to have negative consequences.

The concerns of important stakeholders are fundamental to the management of a business. If neglected, any one group can use its influence to negatively affect the performance of the company. Therefore, stakeholder interests should be carefully considered and wisely balanced.[4]

2-2a The "Big Three" Stakeholders—Owners, Customers, and Employees

Some say companies must follow the golden rule—that is, those that hold the gold (owners) make the rules! Others believe that the customer is always right. And how many times have you heard someone say that a company's people are its most important resource? The truth is that all of these groups (sometimes called *primary stakeholders* because they interact very directly with the company) pack a significant punch when it comes to influence.

Promoting the Owners' Interests

In his classic book *Capitalism and Freedom*, Nobel Prize–winning economist Milton Friedman outlined the responsibilities of businesses to society in very focused terms:[5]

> There is only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.

Exhibit 2.2 Four Types of Responsibilities for Small Businesses

Type of Responsibility	Societal Expectation	General Focus
Economic	Required	Be profitable.
Legal	Required	Obey all laws, adhere to all regulations.
Ethical	Expected	Avoid questionable practices.
Discretionary	Desired/Expected	Be a good corporate citizen, and give back.

Source: Adapted with permission from Archie B. Carroll, Jill Brown, and Ann K. Buchholtz, *Business and Society: Ethics, Sustainability, and Stakeholder Management*, 11e (Mason, OH: Cengage Learning, 2022).

stakeholder
An individual or group that either can affect or is affected by the performance of the company.

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Friedman argued that businesses should be expected to earn profits honestly. Any other use of the firm's resources is justified only if it enhances the firm's value. While we believe that entrepreneurs should adopt a broad view of their social responsibilities, it is undeniable that owners have a clear and reasonable right to benefit from the financial performance of their company.

Many businesses, even small ones, have more than one owner. When this is the case, high standards of integrity require an honest attempt to promote the interests of all the owners, which include a commitment to financial performance and protection of the firm's reputation. Though entrepreneurs should be able to make their own decisions about personal matters, they have an obligation to make choices that protect the financial investment of other owners in the company.

In many small businesses, a number of people own a small part of the enterprise but have no direct involvement in its operation. When this is the case, questions concerning proper conduct can arise in a number of areas. For example, entrepreneurs sometimes face ethical issues when reporting financial information. They must decide the extent to which they will be honest and candid. Because a firm has considerable discretion when revealing performance results, financial reports can sometimes be misleading without technically being illegal. However, providing misleading financial information could easily persuade the other owners to make poor decisions regarding their investment in the company. The same could also be said for some outsiders who do not have ownership, such as bankers and suppliers who depend on the accuracy of a firm's financial reports. It is always best to make honest disclosures that do not mislead in order to protect critical relationships and the reputation of the firm.

Caring about Customers

Customers are obviously central to the purpose of any firm, and this has implications for business integrity. Owners who take customers seriously and care about them as individuals are apt to have more of them—and those customers are likely to return often.

It is easy to fall into the habit of seeing every client as merely a dollar sign, but this narrow view can lead to a wide range of questionable practices. For example, entrepreneurs are often tempted to take advantage of customers by being less than honest with them. And marketing decisions can be particularly complicated when it comes to ethical issues. Advertising content must sell the product or service but also tell the truth. Salespeople often must walk a fine line between persuasion and deception. In some businesses, a sales representative might obtain contracts more easily by offering improper incentives to buyers or by joining with competitors to rig bids. This is clearly illegal and may result in damage to the company's reputation, affecting relationships with existing and potential customers.

Companies with integrity recognize the importance of treating their customers with care, but it should be clear by now that this also just makes good sense. At its core, the formula for business success is quite simple: When a company delivers an excellent product with first-rate service, customer satisfaction and healthy sales are likely to follow.

Valuing Employees

A firm's integrity is also expressed by the value it places on employees. Through management decisions, an owner affects employees' personal and family lives. Issues of fairness, honesty, and impartiality are inherent in decisions and practices regarding hiring, promotions, salary increases, dismissals, layoffs, and work assignments. Employees are also concerned about privacy, safety, and health issues, and these should not be ignored. In fact, they have grown significantly more important since

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the COVID-19 pandemic hit in 2020, which put a spotlight on these issues as potential life-and-death concerns.

Many entrepreneurs recognize the importance of looking after the needs of their employees, creating a positive work environment, and rewarding them generously for their contributions. Indeed, research has shown that when employees feel that they are noticed and appreciated at work, they tend to be much more productive and perform tasks better.[6] It follows that employees who believe they are valued will be more loyal to the business and naturally devote themselves to their work, leading to high-quality service, very loyal customers, and ultimately, increased profits. So, the owners' interests are also well taken care of, and everyone is happy in the end. This really is no mystery—it all works beautifully when you see how the pieces fit together.

Unfortunately, there are many ways that companies can stray from the integrity track. For example, some small business owners give little thought to the standards of conduct that guide everyday behavior, thinking that an occasional shortcut can't hurt. However, lapses in integrity are passed down from superiors to subordinates, replicating like a life-threatening coronavirus that spreads throughout the organization. As this influence expands, employees of small firms may face pressure from various sources to act in ways that conflict with their own sense of what is right and wrong. For example, a salesperson may be encouraged to compromise personal ethical standards in order to make a sale, or an office employee may feel coerced to destroy documents or misrepresent production data. Such situations are guaranteed to spawn an organizational culture that erodes integrity.

Employees sometimes engage in unethical behavior at their employer's expense, like loafing on the job or taking unjustified sick leave. Some employees even feign injury and draw fraudulent workers' compensation checks, thereby inflating a company's insurance costs.

According to the FBI, employee theft (sometimes called *shrinkage*) is the fastest-growing crime in the United States, with studies finding that approximately three-fourths of employees admit to having stolen supplies, merchandise, tools, equipment, and other valuable items.[7] The American Society for Industrial Security reports that these losses cost employers as much as $100 billion each year,[8] and this figure does not include losses from embezzlement (that is, when an employee steals *money* from the firm). These problems are serious, with the U.S. Chamber of Commerce estimating that nearly one-third of all new businesses fail because of employee theft.[9]

2-2b Social Responsibility and Small Business

As we discussed in Chapter 1, an ethical business not only treats customers and employees honestly but also acts as a good citizen in its community. These broader obligations of citizenship are called **social responsibilities**.

Companies have increasingly shown commitment to the communities where they do business. Their contribution starts with creating jobs and adding to local tax revenues, but many entrepreneurs feel a duty to give back even more to the community in return for the local support they enjoy—and they usually benefit from increased goodwill as a result. It is important to recognize that opinions differ as to the extent to which businesses are obligated to engage in socially desirable activities, and the response of small businesses to that obligation also varies.

In any case, entrepreneurs should think carefully about their community commitments, because building a business on a foundation of "doing good" may add to a small company's financial burden. This is often offset by increased loyalty from customers and employees who buy into the mission, which leads to improved productivity and morale. It also sets a company apart from competitors that offer similar products or services but make no

social responsibilities
A company's ethical obligations to the community.

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charitable contributions. Perhaps most importantly, this commitment is often rewarded by customers in two ways—repeat sales and a willingness to pay a little more for what they get. These strong incentives support a firm's dedication to the community.

But how do small business owners compare with big business CEOs in their view of social responsibility? The evidence on this is mixed. Some researchers point to studies suggesting that entrepreneurs who head small, growth-oriented companies may be more narrowly focused on profits and therefore be less socially sensitive than CEOs of large corporations. With simple survival as the most pressing priority, many small firms probably see social responsibility as a luxury they simply cannot afford. Earning a profit is absolutely essential, after all, and meeting the expectations of society can be expensive. But this dim view of small businesses may not be warranted. For example, 72 percent of survey respondents indicated that they believe locally owned businesses do more to improve their communities than large corporations.[10] This evidence is consistent with countless known cases of small business philanthropy, which often take place in the form of personal contributions by business owners.

JIM WEST/ALAMY STOCK PHOTO

Many small businesses encourage their employees to contribute to their communities by volunteering to join a variety of community service projects. In this picture, Muna Haji, center, is joined by volunteers from Habitat for Humanity and Women Build as they held up the first wall of what became her new home.

Fortunately, many types of socially responsible actions can be consistent with a firm's long-term profit objective.[11] A National Federation of Independent Business study found that 91 percent of small businesses made contributions to their communities through volunteering, in-kind assistance, and/or direct cash donations. The same study reported 74 percent of all small business owners volunteered for community and charitable activities, and the average commitment was just over 12 hours per month (which translates to 18 working days per year).[12] Overall, the evidence suggests that taking social responsibilities seriously may very well be good for business.

2-2c Integrity and Governmental Regulations

Government at all levels serves a purpose, though there is much debate as to whether it has too much power or too little. It intervenes directly in the economy when it establishes laws to ensure healthy competition. But its reach extends to other business matters as well—workplace safety, equal employment opportunities, fair pay, clean air, and safe products, to name a few. Entrepreneurs must comply with governmental laws and regulations if they are to maintain integrity—and avoid spending time behind bars.

One glaring example of unethical behavior by small firm management is fraudulent reporting of income and expenses for income tax purposes. This conduct includes *skimming* (that is, concealing some income), as well as improperly claiming personal expenses to be business-related. We do not mean to imply that all or even most small companies engage in such practices. However, tax evasion does occur, and the practice is common enough to be recognized as a general problem.

Tax avoidance can be flagrant and intentional, but entrepreneurs may also come up short on their tax commitments because of casual accounting systems, a single-minded

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Living the Dream

An Entrepreneur Who Leads with Heart

Cecilia Ochoa Levine, owner of MFI International Manufacturing, was born in Mexico but moved to the United States as a young adult and attended the University of Texas. Because she spent her youth south of the border and currently has thriving business ventures there, she has always had a very deep desire to give back to the community, in both Ciudad Juárez, Mexico, as well as El Paso, Texas, where she now resides. She lives out her natural passion to serve through various charitable initiatives, including those she describes in the following excerpt from *Baylor Business Review*. As she puts it, this is just good business.

> Establishing a successful company in a community creates the opportunity to give back and demonstrate true leadership. In giving back, more success follows.
>
> MFI International Manufacturing has been known for its modern manufacturing processes and proven 35-year track record of excellence, providing a competitive advantage for the company and its global partners. Leading with your core values as a company is paramount to everything else. We showcase our values by emphasizing hands-on attention to processes and continuous improvements at our operations in El Paso, Texas, and Cuidad Juárez, Mexico, which enables us to deliver on our promise to provide premium value to our customers. In addition, a comprehensive strategy to better the lives of our employees—our internal clients and most valuable asset at the core of our company—has resulted in high rates of retention for a workforce that is continuously improving and loyal. This focus has resulted in many years of success for our family business.
>
> To me, it has been more important for MFI International to be known for its commitment to the El Paso and Cuidad Juárez communities—our family. We have always felt that our company's core values must reflect the core values of our family. As a result, our community involvement has been extensive, with a focus on family, education, and health.
>
> Creating a culture where employees view the organization as a family is important. It builds trust among the company and employees—a contagious spirit that makes both sides want to give the other their best. The loyalty and perseverance of employees can go a long way in getting through difficult situations. A company doesn't have to just be a place you go to work; it can be much more than that.
>
> Education is the backbone of a community, and companies should help employees and their families develop in this area. Companies should invest in learning opportunities, whether it is contributing to the elementary, middle, and high school education of workers, providing educational resources for families, or helping employees overcome potential language barriers.
>
> A healthy life is a happy life. Understanding the importance of community health to economic development is crucial for companies, especially those working in Latin America. Companies should identify health-related concerns in their communities that negatively impact economic success. One of the leading causes of blindness in Mexico and other developing countries is cataracts. Opening prospects for community members to seek out medical attention allows for more people to be able to work, increasing economic opportunities.
>
> Building a socially responsible company with strategic partnerships and common goals can create positive change for the economy as well as the community. Our journey to economic, social, and community success has been a challenging and rewarding one. It would not be possible to bring these opportunities to our community if it was not for the generosity of our collaborators and supporters. Everyone who participates helps to create a social ecosystem that can help the communities in which we work, live, and play.

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Good business practices start with values, and values help form true leaders. At the end of it all, true leadership is finding a worthy cause, partnering with others who also find that cause worthy and working together to do the hard work necessary to accomplish your goals.

Source: Cecilia Levine, "It Takes a Village," *Baylor Business Review*, Spring 2020, p. 20.

focus on their product or service, or both. One student entrepreneur confessed that he had a close brush with the law because he and his friends were creating clothing in his dorm room and selling it on campus. However, the company did not legally exist, and he was not keeping track of sales and expenses because he didn't take seriously the obligations and advantages of maintaining good records. After a close encounter with Internal Revenue Service (IRS) agents, this young entrepreneur learned that accurate recordkeeping and legal formalities are necessary to ethical practice. Sadly, close to one-third of self-employed Americans have admitted to not reporting some or all of their income to the IRS.[13]

When the topic of tax avoidance comes up, most people think of income taxes, but employee payroll tax—local, state, and federal obligations such as Social Security, Medicare, and unemployment—and other taxes must also be withheld. These often present the biggest tax burden on small businesses because they are owed regardless of whether the company makes a profit. And because tax authorities like the IRS do not always push hard enough to collect these taxes, small businesses can easily fall behind. In any case, it should be clear that paying all forms of required taxes is a nonnegotiable feature of integrity, especially for a small business owner who would like to stay in business.

2-3 The Challenges and Benefits of Acting with Integrity

2-3 Identify some common challenges and benefits of maintaining integrity in small businesses.

Small companies face unique challenges to integrity, especially at such critical stages as getting started and establishing a name, launching online operations, and expanding internationally. Small companies are often vulnerable because of their size and their desire to succeed. But the benefits of integrity are real, and a small business that is managed with integrity has a distinct advantage in the marketplace.

2-3a Small Companies and the Legitimacy Lie

Walking the straight and narrow may be more difficult and costly on Main Street than it is on Wall Street. That is, privately held small firms that are not part of the Wall Street corporate world may face greater pressures to act unethically than large businesses do. Indeed, because small firms usually do not have the deep pockets and superior resources of their larger competitors, their owners may find it easier to rationalize, say, inappropriate gift giving or bribery as a way of offsetting what seem to be unfair limitations in order to establish a level playing field in the marketplace. It's easy to yield to the pressure when your back is against the wall.

Because start-ups do not have a history and a reputation to lean on when trying to sell customers on their new product or service or to impress other important stakeholders, entrepreneurs often are uniquely tempted to resort to telling what some researchers call *legitimacy lies*.[14] That is, they sometimes misrepresent the facts or create false impressions to mislead others intentionally and earn their confidence. How do you feel about the following (real) situations?

- An entrepreneur who wanted to raise money for his social cloud storage platform hired three dozen people to wear T-shirts with the company logo and hang out in

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coffee shops and parks frequented by Silicon Valley investors to make these high-dollar players think his venture "was a hot property they should know about." The accomplices were instructed not to show up in the same place two days in a row so as not to blow the ruse. And it worked! The venture raised $3 million in new cash.[15]

- To launch a new platform to help companies hire developers, the founders came up with a nearly perfect but entirely fake résumé and posted it to a job board. When recruiters called to talk to "the candidate of their dreams," the crafty entrepreneurs would say, "Hey, I'm not that person, but people like this are all over the world, and you don't need a résumé to find them." The start-up landed one of its first big customers using this trick.[16]
- Partners in an auto sales start-up rented a large lot for their business but could afford only four cars for inventory—a turn-off for would-be buyers. So, the partners offered free parking in their lot to any employee of the big firm next door who would allow them to put a false price tag on their car during the day as if it were for sale. Many accepted, and soon the lot was full every morning and mostly empty by late afternoon. Passersby figured the company must be doing a booming business, and predictably, actual sales soon followed.[17]

When small business owners create false impressions to make their companies look good, are they being dishonest or simply resourceful? Pretending to be something they are not can lead small business owners into what is, at best, a gray area. The drive and ingenuity of these entrepreneurs is certainly impressive, but their behavior raises questions about ethical standards. Such moves may save companies, but how would customers feel if they knew they were being manipulated in this way?

Telling legitimacy lies threatens the reputation of the business and the trust that goes along with it. If (when) the truth is revealed, future sales or support could very well be compromised. It would be better—and much more honest—to understand the factors that move customers to have confidence in a purchase and to provide truthful information.

Research has shown that customers are less likely to decide to purchase if they have significant questions about the product or service that the new venture is offering, about those who represent and/or run the business, and about the organization itself.[18] We call these features *PRO*—*P*roducts, *R*epresentatives, and the *O*rganization—*factors* to emphasize that they can promote firm performance when customers are satisfied with them. The concerns of prospective customers include the following:

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- Will the *product* (or *service*) serve my needs better than alternatives, and will it be a hassle to change from the brand I currently buy? (Research indicates that product/service knowledge is the most important of the three factors when customers make purchase decisions.)[19]
- Do the company's *representatives* know what they are talking about, and will they (can they) live up to their assurances?
- Will the *organization* still be around to stand behind its product or service if I have a problem with it six months from now?

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These are all reasonable concerns, and it is important that the new venture find a way to address them. For example, advertising can help to get product or service information out to prospective customers. But because this can be expensive, many new ventures choose to use a well-crafted publicity program, social media tools, or other promotional strategies instead (more on these in Chapter 17).

Often, a small firm's legitimacy is staked on the reputation of its owner, but it is important to highlight and honestly bolster the credibility of anyone who represents the venture. It is best to make the credentials (educational background, expertise, industry experience, etc.) of key employees known, as well as to encourage those employees to participate in trade, business, and community organizations where they can build important relationships. The business itself can establish legitimacy by setting up a high-quality website, insisting on professional behavior from all employees, forming strategic alliances with well-respected partner firms, and taking other, similar measures. The point is that a new venture or small company may be at a legitimacy disadvantage when compared to established competitors, but there are ways to close the gap. And while the focus is primarily on the reactions of customers, many of these principles clearly apply to relationships with investors, suppliers, and other important stakeholders as well.

2-3b Integrity Online

Legitimacy and trust are important to all small businesses, but those using the online marketplace face a host of unique ethical issues. One issue of great concern is personal privacy. In fact, a poll by the Pew Research Center found that 81 percent of Internet users are now so concerned about problems with the protection of personal information that they believe potential risks from companies' data collection outweigh any benefits.[20]

Businesses and consumers often disagree about how private the identity of visitors to websites should be. For example, businesses can use cookies (digital "ID tags") to collect data on consumers' buying habits related to a particular Internet address. In this way, a business can create a detailed profile of customers, which it may then sell to media-buying companies and other interested groups. While the collection of personal information may allow a business to create a more personalized shopping experience and offer convenience to the buyer, it also opens the door to potential misuse of data. To minimize customer concerns, a company must be honest and transparent with customers about its practices and draft a privacy policy that conforms to the guidelines provided by organizations like the Better Business Bureau or through consultation with an attorney.

Privacy issues concern more than just online companies. The extent to which an employer may monitor an employee's Internet activity is also hotly debated. Many workers believe it is inappropriate for employers to monitor their email, a practice they consider to be an invasion of privacy. Employers, on the other hand, are concerned that employees may be engaging in "cyberslacking" at the office—that is, wasting company time dealing with personal email, shopping online, and surfing the Internet. And it appears there is reason for concern. According to a survey conducted by Salary.com, 89 percent of employees admitted to wasting at least some time every day while on the job.[21] Here is a list of some of the top "time-wasters" at work:[22]

- Seventy-seven percent spent time on Facebook, but also on other social media websites.
- Sixty-four percent visited websites unrelated to their job every day during work hours.

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- Forty-six percent spent time looking for a different job on company time.
- Forty-five percent surfed the Internet for personal reasons.
- Twenty-three percent spent significant time socializing with co-workers.

Many employers are convinced such activity hinders workplace productivity and are taking steps to do something about it. An increasing number of small businesses are installing software to monitor Internet use, which is consistent with the trend for all companies. To see how these systems can impact employee productivity, consider the following case:[23]

> Sagar Gupta, executive vice president at Dallas-based Biorev, a 3D-visualization company, introduced ActivTrak monitoring software [after becoming] fed up with low work output. The software quickly revealed employees typically worked just three hours out of each eight-hour day. Since employees became aware that their [online] activities were being tracked, he says, statistics have dramatically improved.

Seven of Biorev's 150 employees were offended by the "enhanced oversight" and left the company, but most were able to adjust to being monitored and now have the benefit of seeing just how they are spending their time.

Beyond productivity, companies are increasingly worried about leaks of sensitive information and system exposure to risky viruses and malware. These concerns are warranted but must be balanced against respect for employee privacy.

While there are legal limits to how companies can monitor their employees, the courts have granted firms significant freedom to check up on their workers—often without telling them what they are tracking. With the rise of new technologies, the available tools continue to grow in number and sophistication. As well as scrutinizing employee email messages, companies now can sift through calendar appointments, texts, chats—even record and transcribe calls on mobile devices. But this is just the beginning. They can also use software to gauge team chemistry and morale, require employees to wear badges that record their voices to sense and study changes in their stress levels, track their movements around offices to measure and manage collaboration and productivity, and so much more.[24]

Small business owners who decide to monitor their employees should be guided by policies that have sound legal footing in order to avoid problems later. For example, when it comes to screening emails, legal experts have pointed out that "virtually every court to consider the issue has found that an employer may read emails employees send using the employer's company email system, even if the employee labels or considers these messages to be private."[25] Still, to be safe, it is wise to spell out in an employee handbook that the firm has a legal right to monitor personal email.[26]

Beyond checking email messages, many small companies choose not to monitor workers' Internet use. But even those taking a cautious approach should require employees to sign a monitoring consent form when they are first hired.[27] Taking such measures is very practical—it helps head off costly legal challenges—and it also communicates the firm's respect for its employees and its sound commitment to high standards of integrity.

intellectual property
Original intellectual creations, including inventions, literary works, and works of art, that are protected by patents, copyrights, trademarks, design rights, and trade secrets.

Widespread use of the Internet has also focused attention on the issue of protecting **intellectual property**. Traditionally, protection has been granted to original intellectual creations—inventions, literary works, and artistic products such as music—in the form of patents, copyrights, trademarks, design rights, and trade secrets. The law allows originators of such intellectual property to require compensation for its use. However, the Internet has made it easy for millions of users to copy intellectual property free of charge. In fact, when the U.S. Government and Accounting Office purchased a variety

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of name-brand goods from third-party sellers offered on popular consumer websites, it determined that 43 percent of them were counterfeit.[28] Ending up with phony goods can lead to disappointment for those who are tricked into buying them, erode their trust in the legitimate brands they had hoped to get, and even create health and safety risks.

2-3c Integrity and Doing Business Abroad

Sooner or later, small business owners operating abroad will confront challenging ethical questions, and they could relate to any part of the company's operations. For example, what would you do if you were confronted with the following situations?

- Should your firm agree to provide consulting services to a foreign government if it refuses to support basic human rights or represses its citizens politically?
- China's environmental protections are relatively weak, so would it be acceptable to use toxic chemicals in production processes there, as long as the local authorities approve it?
- If giving a gift to a business partner in Bolivia is the local custom but is considered a bribe by U.S. standards, is there any harm in following such a practice?

Such quandaries are bound to come up time and again when doing business abroad.

Frequently, entrepreneurs simply apply U.S. standards to the situation. But this approach may be criticized as **ethical imperialism**, an arrogant attempt to impose American values on other societies. Some guidance is provided by restrictions specified in the Foreign Corrupt Practices Act, which makes it illegal for U.S. businesses to use bribery in their dealings anywhere in the world. Regardless of local practices, American firms must comply with these laws, even though "gray areas" exist in which there are no definitive answers.

Another viewpoint, sometimes called **ethical relativism**, is troublesome because it implies that anything goes if the local culture accepts it. To define its ethical landscape and work out its position on difficult issues, a small business must consider the nuances of the particular international environment. Training is also needed to ensure that each employee understands the firm's commitment to integrity. In such cases, consulting an attorney in the United States with appropriate expertise is highly recommended.

Bear in mind that an intended one-time practice may set a pattern for future behavior. Some business owners have observed that offering a bribe to make a business deal possible often creates expectations for more of the same in the future. Owners who refuse to pay these "fees" may have to deal with frustrating inconveniences in the short term (for example, shipped products being held up by customs), but they are likely to discourage such demands in the future. This is one of the ways in which integrity in business may offer unanticipated rewards.

2-3d The Integrity Edge

When it comes to establishing the legitimacy of a start-up, taking operations online, expanding internationally, and so many other features of managing a small business, it is not always easy to stay on the high road of proper conduct. Indeed, the price of integrity is high, but the potential payoff is incalculable. The entrepreneur who makes honorable decisions, even when it comes to the smallest of details, can take satisfaction in knowing that they did what was right, even if things do not turn out as planned.

But integrity yields other important benefits as well. A growing body of research supports the simple notion that ethical practices are good for business. Citing specific

ethical imperialism
The belief that the ethical standards of one's own country can be applied universally.

ethical relativism
The belief that ethical standards are subject to local interpretation.

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studies, the advocacy group Business for Social Responsibility contends that there are numerous long-term benefits of adopting ethical and responsible business practices:[29]

- Improved financial performance
- Enhanced brand image and reputation
- Increased sales and customer loyalty
- Improved productivity and quality
- Better recruitment and reduced employee turnover
- Fewer regulatory inspections and less paperwork
- Improved access to capital

This is consistent with research conducted by the Institute of Business Ethics, which found that firms operating with a "clear commitment to ethical conduct" consistently outperform companies that do not.[30] These findings prompted Philippa Foster Back, former director of the institute, to declare, "Not only is ethical behavior in business life the right thing to do in principle, but we have also shown that it pays off in financial returns."[31]

Perhaps the greatest benefit of integrity in business is the *trust* it generates. Trust results only when there's a match between the stated values of a company and its behavior in the marketplace. When a small business owner considers the needs of others and follows through on their promises, stakeholders notice. Customers buy more of what a firm sells when they realize that the company is doing its best to make sure that its products are of high quality and its customer service is excellent. Employees are much more likely to "go the extra mile" for a small company when the company clearly considers them to be more than simply replaceable parts in an impersonal machine.

2-4 Determine practical approaches for building a business with integrity.

2-4 Building a Business with Integrity

The goal of a small business owner with integrity should be to operate honorably in all areas of practice, setting the entrepreneur on a path toward crafting the worthy legacy discussed in Chapter 1. Those at the top must provide the leadership, culture, and training that support appropriate ethical perspectives and proper behavior.

2-4a The Foundations of Integrity

The business practices that a firm's leaders and employees view as right or wrong reflect their **underlying values**. An individual's beliefs affect what that person does on the job and how they act toward customers and others. Business behavior, then, reflects a person's commitment to honesty, respect, truthfulness, and more—in other words, to integrity in all of its dimensions. Such values are often evident in the company's mission statement.

Values that serve as a foundation for integrity in business are based on personal views of the role of humankind in the universe and, naturally, are part of basic philosophical and/or religious convictions.[32] Since these principles are reflected in the business practices of firms of all sizes, a leader's personal commitment to certain basic values is an important determinant of their firm's commitment to business integrity. A long-time observer of high-tech start-ups commented on the significance of an entrepreneur's personal standards to investment decisions:[33]

underlying values
Beliefs that provide a foundation for ethical behavior in an individual or a firm.

> I can tell you, even with the smallest high-technology companies, the product had to be good, the market had to be good, the people had to be good. But the one

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thing that was checked out most extensively by venture capitalists was the integrity of the management team. And if integrity wasn't there, it didn't matter how good the product was, how good the market was—they weren't funded.

A deep commitment to basic values clearly affects behavior in the marketplace and gives rise to business practices that are widely appreciated and admired. Ethical standards can easily be compromised without a strong commitment to integrity on the part of a firm's leadership.

2-4b Leading with Integrity

In a small organization, the influence of a leader is more pronounced than it is in a large corporation where leadership can become diffused. This fact is recognized by J. C. Huizenga, the founder of National Heritage Academies, which was started in 1995 and today operates more than 90 public charter schools, serving more than 60,000 students in nine U.S. states:[34]

> The executive of a small company must often face moral challenges more directly, because [they have] more direct contact with customers, suppliers, and employees than an executive in a large corporation who may have a management team to deliberate with. The consequences of [their] choices often affect the business more significantly because of the size of the issue relative to the size of the company.

In these contexts, actions speak louder than words. That is, a leader's behavior has much greater influence on employees than their stated philosophy does. Everyone watches how the leader behaves, and this conduct establishes the culture of the company, underscoring what is allowed or encouraged and what is prohibited. The dominant role of this one person (or the leadership team) shapes the ethical performance of the small company, for good or for ill.

2-4c An Ethical Organizational Culture

Integrity in a business requires a supportive organizational culture, one that communicates to employees at every level that the firm is fully committed to honorable conduct. To a considerable degree, strong leadership helps build this understanding. As a small business grows, however, personal interactions between the owner and employees occur less often, creating the need to articulate and reinforce principles of integrity in ways that supplement the personal example of the entrepreneur. A good place to start is to establish an ethics policy for the company.

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In their highly influential book *The Power of Ethical Management,* Kenneth Blanchard and Norman Vincent Peale offered insights to guide the development of an ethics policy. They suggested that the policy be based on the following five fundamental principles:[35]

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1. *Purpose.* The vision for the company and your core values will guide business conduct.
2. *Pride.* When employees take pride in their work and their company, they are much more likely to be ethical in their dealings.
3. *Patience.* If you push too hard for short-term results, sooner or later acting unethically will seem to be the only way to achieve the outcomes you seek.
4. *Persistence.* Stand by your word, which is the foundation of trust. If you are not committed to an ethical framework, your integrity is at risk, as is the reputation of the company.
5. *Perspective.* Stop from time to time to reflect on where your business is going, why it is going that way, and your plans to achieve your goals. This will allow you to be more confident that you are on the right track now and will continue to be in the future.

To define ethical behavior in a company, the owner-manager of a small firm should formulate a **code of ethics** similar to that of most large corporations but adapted to the specific needs of the business. A survey of MBA students employed by small and medium-size companies revealed that codes of ethics shape and improve conduct in their organizations in a number of ways:[36]

- By defining behavioral expectations.
- By communicating that those expectations apply to employees at all levels in the business.
- By helping employees convey the company's standards of conduct to suppliers and customers.
- By serving as a guide for handling peer pressure.
- By providing a formal channel for communicating with superiors without fear of reprisal.

In other words, a code of ethics identifies conduct that is ethical and appropriate, but it is also a practical tool that can encourage and protect ethical behavior.

A well-written code expresses the principles to be followed by employees of the firm and gives examples of these principles in action. A code of ethics might, for example, prohibit acceptance of gifts or favors from suppliers but point out standard business courtesies, such as a lunch or a couple of movie tickets, that might be accepted without violating the policy. If a code of ethics is to be effective, employees must be aware of its nature and convinced of its importance. At the very least, each employee should read and sign it. As a company grows larger, employees will need training to ensure that the code is well understood and taken seriously.

Entrepreneurs further reinforce an ethical business culture when they hire and promote ethical people, recognize and correct behavior that is unethical, and lead by example in business dealings, while encouraging all employees to do the same. With training and consistent management, employees can develop the level of understanding needed to act in the spirit of the code when faced with situations not covered by specific rules. A code of ethics, however, will be effective only to the degree that the entrepreneur's personal behavior is consistent with their own stated principles. Employees can easily spot hypocrisy, and double standards quickly dull the ethical sensibilities of the organization.

code of ethics
Formally established standards of employee behavior communicated by a business owner.

2-4d Better Business Bureaus

Sometimes, the business conduct of small companies is shaped by external forces. Because unethical operations reflect adversely on honest members of the business

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community, privately owned companies in many cities have joined together to form Better Business Bureaus (BBBs). The purpose of such organizations is to promote ethical conduct on the part of all businesses in a region in the following ways:

- By providing consumers with free information to help them make informed decisions when dealing with a company.
- By creating an incentive for businesses to adhere to proper business practices and earnestly address customer complaints.
- By resolving questions or disputes concerning purchases through mediation or arbitration.

As a result, unethical business practices often decline in a community served by a Better Business Bureau.

Though BBBs report relevant information to law enforcement agencies, they are not government entities, and they cannot collect money or impose penalties on companies that engage in unethical business practices. However, a BBB can provide information on a company's operating track record, which will affect the firm's reputation and, in turn, its success in the marketplace. This creates an incentive for companies to adopt fair and proper business practices and address customer complaints appropriately in order to avoid losing business.

2-4e The Ethical Decision-Making Process

Ethical decision making often is not a clear-cut process. In fact, even after much thought and soul searching, the appropriate course of action still may not be apparent in some business situations. The Ethics Resource Center offers a decision-making process that may help with challenging dilemmas. We have adapted this simple six-step process to help small business owners see the issues more clearly and make better, more ethical decisions.[37]

Step 1: Define the Problem

How you define the problem is important because this will guide where you look for solutions. For example, if a customer is frequently late in paying invoices, is this a problem because they don't manage their books well, are they trying to conserve working capital by forcing you to carry this debt for as long as possible, or are their own customers often slow in paying them for the goods they sell? If your customer is careless with their books or is just trying to stretch out their accounts payable, a penalty for the delay may correct the problem. However, penalizing your customer is not likely to solve the problem if the delays are actually the result of their cash-strapped customers' struggle to find a way to pay. In fact, penalizing your customer in this case may only make matters worse. Looking for the root of the problem is the best place to start in your search for a solution to a challenging ethical problem.

Step 2: Identify Alternative Solutions to the Problem

It is tempting to go with an "obvious" solution or one that has been used in the past, but often this is not the best answer—even if it is ethical. Be open-minded, and consider creative alternatives. Often, an innovative solution is available that is consistent with your personal ethics, protects the interests of other affected parties, and offers superior outcomes. Seeking advice from trusted friends and advisers who have faced similar situations can spur your thinking and lead to options that you might otherwise overlook.

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Step 3: Evaluate the Identified Alternatives

Rotary Club International, a worldwide organization of business and professional leaders, has set a high standard for business conduct. It calls on its members to ask the following four questions when they prepare to make a decision about the things they think, say, or do:[38]

1. Is it the *truth*?
2. Is it *fair* to all concerned?
3. Will it build *goodwill* and *better friendships*?
4. Will it be *beneficial* to all concerned?

Taking a similar approach, you might ask yourself, "How would I feel if my decision were reported in the daily news?" Or, the question can be even more personal: "How well could I explain this decision to my mother or children?" The answer could help to steer you away from unethical behavior.

Perhaps the most widely recommended principle for ethical behavior is simply to follow the Golden Rule: "Treat others as you would want to be treated." This simple rule is embraced, in one form or another, by most of the world's religions and philosophies,[39] and its influence is very far reaching. For example, the philosopher Immanuel Kant introduced the so-called categorical imperative, a sophisticated way of asking, "How would it be if everyone decided to do what you intend to do?"[40] Raising such questions can be a very practical way for an entrepreneur to evaluate ethical decisions and guard their integrity.

No matter what approach you take, evaluating alternatives requires time and patience. In addition, personal perceptions and biases are likely to cloud the way you see solutions. Therefore, it is important to separate what you *think* is the case from what you *know* to be true. It often helps to write down your thoughts about alternatives so that you can keep track of your concerns as well as important facts and details. You might list the ethical pros and cons of each alternative or identify the impact of each option on every person or company that will be affected. Another possibility is to rank all potential options based on their overall merits and then narrow the list to the two or three best solutions to consider further. This will allow you to organize your thoughts and make a better selection.

HOLMES GARDEN PHOTOS/ALAMY STOCK PHOTO

Step 4: Make the Decision

The next step is to choose the "best" ethical response, based on your evaluation of all possible alternatives. On the surface, this sounds easy enough, but unfortunately no single option will completely solve the problem in most cases. In fact, you may not even be able to identify an obvious winner. No matter how you go about making the decision, keep your vision and core values firmly in mind—this is essential to making solid decisions that do not compromise your ethical standards.

Step 5: Implement the Decision

Entrepreneurs sometimes put off responding to ethical challenges because

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any response will be bad news for someone involved. But avoiding action on the decision may allow a small problem to grow into a major crisis, and it may cause you to spend more time thinking about the problem when other important matters deserve your attention.

Step 6: Evaluate the Decision

The goal of making a decision is to resolve an ethical dilemma. So, has the situation improved, gotten worse, or stayed about the same? Has the solution created ethical issues of its own? Has information come to light indicating that your decision was not the most ethical course of action? Everyone makes mistakes. You may very well need to reopen the matter to make things right. But remember, if your decision was based on the best of intentions and information available at the time, you can wade back into the waters of ethical turmoil with a clear conscience, and there is no substitute for that.

2-5 Social Entrepreneurship: A Continuing Trend

2-5 Describe social entrepreneurship and its influence on small companies and start-up opportunities.

The social issues affecting businesses are numerous and diverse. Businesses are expected—at different times and by various groups—to help solve social problems related to education, crime, poverty, and the environment. In fact, these expectations converge in a form of venturing called **social entrepreneurship**. Although the term has been defined in different ways, Harvard researchers suggest that *social entrepreneurship* refers to "entrepreneurial activity with an embedded social purpose."[41] It has been described more poetically as having "a vision of a greater good and working to make it real."[42] In other words, a social entrepreneur is one who comes up with innovative solutions to society's most pressing needs, problems, and opportunities and then makes them happen.

2-5a Social Entrepreneurship and the Triple Bottom Line

Becoming a social entrepreneur usually does not mean that a business owner is no longer concerned with making money—financial gain is just one of an expanded set of goals. In fact, the outcomes of interest are sometimes referred to as the "triple bottom line" because they focus on people, profits, and the planet. Clearly, no enterprise can exist for long without making a profit. But social entrepreneurs believe that ventures should also be concerned with people and the environment. To get a feel for the wide range of enterprises that fall under the social entrepreneurship umbrella, consider the following cases:

- While the world is ditching plastic straws, Craig Gonsenhauser is putting his years of experience in the optical industry to good use in saving the planet. He and his wife, Stacey Gorlick, launched Just Human, a start-up that uses recycled glass and biomaterials (wherever possible) to produce a new generation of chic, functional sunglasses that are eco-friendly.[43]
- Homeboy Industries grew out of a jobs program launched by Father Greg Boyle to create an alternative to gang violence. Today, it helps thousands of previously incarcerated individuals re-enter the workforce each year through its bakery, café and catering operation, farmers market, and other small enterprises.[44]
- Bart Weetjens trains amazingly odor-sensitive rats to sniff out and locate deadly unexploded land mines that litter the countryside in many war-torn nations, so that they can be cleared and children can play without fear of being killed or maimed.[45]

social entrepreneurship Entrepreneurial activity that provides innovative solutions for social issues.

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These entrepreneurs clearly do not fit the money-obsessed stereotype that some associate with business owners. They are hoping to solve a social issue, but they are doing well financially, too. And this is not surprising. According to a recent Nielsen survey, 55 percent of global consumers said "they're willing to pay more for products and services from companies that are committed to positive and social-environmental impact."[46]

2-5b Small Business and the Natural Environment

Society's fast-rising concern for the environment has spawned a rapid shift toward **sustainable small businesses**. This trend recognizes that a company must be profitable to stay in business, but it also promotes the use of eco-friendly practices (careful use of resources, energy conservation, recycling, etc.) through all facets of a company's operations. In short, a sustainable enterprise must respond to customer needs while showing reasonable concern for the environment. This is consistent with the concept of integrity outlined in this chapter.

Sustainability Matters

Many small business owners are committed to the cause of **environmentalism**, and in many cases, this emphasis makes sound financial sense. For example, companies can actually save money by buying or leasing LEED-certified buildings, a stamp of approval granted only to those facilities that have been built to strict standards promoting energy and water conservation, reduced CO_2 emissions, improved indoor air quality, and other resource sensitivities. Though typically more expensive to construct, such buildings yield a 7 percent increase in asset value while decreasing average operating costs by 14 percent. And healthier workplace environments improve employee productivity, reduce illness and absences, enhance recruitment and morale, and raise retention—all of which can create a net savings for the company.[47] One company with a LEED-certified facility estimated a nearly 20-to-1 return on its investment.[48]

We need to emphasize, however, that the sustainability news for small business is not all good. In fact, some firms are very adversely affected by new environmental protection laws. Businesses such as fast lube and oil change centers, medical waste disposal operations, and self-service car washes have been especially hard hit by these expanding regulations. The costs can be punishing, forcing many struggling firms to close, especially those with limited resources and older equipment that may need to be upgraded.

Regardless of the financial impact, it is critical to obey the law, following all environmental regulations that apply to your business. While GreenBiz.com cautions businesses to comply with governmental rules at all levels, it also emphasizes that there are "dozens of ways companies of all sizes can reduce their environmental footprints, save money, earn consumer trust and stakeholder confidence, comply with government regulations, be ready to snag new market opportunities, and boost efficiency and productivity."[49]

Win-win solutions are possible. For example, firms whose products leave minimal environmental impact are generally preferred by customers over competitors whose products pollute. And in some cases, compliance with environmental regulations may actually lead to unexpected benefits, such as a reduction in paperwork for companies that can show they are in line with regulations.

In any case, resources are available to help you avoid the potentially disastrous consequences of noncompliance. The Small Business Administration is prepared to

sustainable small business
A profitable company that responds to customers' needs while showing reasonable concern for the environment.

environmentalism
The effort to protect and preserve the environment.

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Living the Dream

Don't Let Your Landscaper Get Your Goat!

Entrepreneurs are increasingly launching start-ups that reflect their concern for the environment and the impact their businesses will have on the planet. One such founder is Jennifer Zeitler, who established Let's Goat Buffalo in 2018. Located in Buffalo, New York, the venture offers a service known as "goatscaping," which uses goats to gobble up unwanted vegetation and minimize environmental harm. Because goats think of weeds as fine dining, they are very effective as "live lawnmowers"—especially on neglected land that has become overgrown. It's a win-win situation. As one goatscaper explained, "It's like mowing your lawn, but with four-legged weed whackers."

The company's approach is very straightforward. When a customer requests the service, Zeitler first assesses the land where the job will take place to ensure the setting will not be hazardous for the goats. Next, the company sets up low-voltage electric-net fencing around the area to keep the goats within the area to be manicured and to keep outside predators away. Let's Goat Buffalo then transports the goats to the site, where they will chomp to their heart's content until the job is complete. While they go about their work, the goats are supervised and are provided with water and nutritional supplements. At night, the goats are housed in a bus or trailer to ensure their safety and comfort. At the end of the job, Let's Goat Buffalo goes the extra mile, providing maintenance tips that can help landowners preserve any gains made by the goats.

This natural service offers several benefits. For example, a goat's digestive processes sterilize the seeds of weeds and other plant reproductive material, which helps break regrowth cycles. The practice also cuts down or eliminates the use of pollutants that are unkind to the earth, including herbicides and exhaust emissions from landscaping equipment that would otherwise be necessary for weed control. On top of that, the service is very cost-effective. Jan Gerstel, president of a local homeowners' association, estimates that goatscaping costs about half as much as hiring people to mow and trim. The goats obviously need better union representation!

These days, companies are becoming very aware of their carbon footprints, and goatscaping can help with that, too. Goats produce much less methane than larger livestock, and they leave behind a nearly odorless fertilizer that helps plants and grasses thrive. They also outperform standard landscaping methods when it comes to environmental preservation. While mowing equipment damages ecosystems, goats do not disturb natural habitats. As if the news on goatscaping wasn't positive enough, experts note that goats can eat vegetation down to the dirt, which creates a natural firebreak, leaving nothing to burn if a wildfire should sweep through an area.

Despite the upsides of a goatscaping business, there also are challenges. One is the risk of animal injury. Goats sometimes get hurt or can even break a leg when they go about their grazing. To reduce this threat, Let's Goat Buffalo carefully assesses plots to be managed before turning the goats loose. And then there is the possibility of goats getting away. Though the grazing area is always carefully fenced in, goats sometimes manage to escape and then make a run for it. They can end up damaging plants in the neighborhood while "on the run." Even if they remain within the fence and dutifully go about their grazing business, well-meaning passersby will sometimes feed them things that are unhealthy if consumed. This means the herd requires some supervision.

To increase revenues, Let's Goat Buffalo has started to provide goat-sponsorship opportunities, listing the names of the goats and their stories on the company website. Anyone can choose to sponsor a goat, with options ranging from \$79.50 to \$500. Website visitors are also invited to purchase t-shirts or goatscaper certificates—even goat soap, which makes a fine souvenir.

Let's Goat Buffalo maintains a herd of about 15 goats. Most of these are acquired from a local organic dairy farm called Alpine Made, which passes along those animals deemed unsuitable for farm life due to age, disability, illness, gender, or temperament. So, the goatscaping venture offers its goats a new lease on life. Perhaps it is more like semi-retirement.

Zeitler plans to grow the business and expand outside of the Buffalo area. This will require a bigger bus to transport the goats and house them while working a job. Some space inside the bus will be carved out for the herder, complete with a bed and a bathroom. This next step is going to set the venture back around \$20,000.

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But if it enables Let's Goat Buffalo to double the size of its herd to keep up with local demand, it will be a good move for Zeitler's pocketbook—and the planet!

Sources: GoFundMe, "Let's Goat Buffalo!" https://www.gofundme.com/f/let039s-goat-buffalo-quotgoatquot-fund-me, accessed February 3, 2021; Brenna Fuss, "Let's Goat Buffalo Warms Up for Season 2," March 10, 2020, https://spectrumlocalnews.com/nys/buffalo/news/2020/03/10/let-s-goat-buffalo-warms-up-for-season-two, accessed February 3, 2021; Let's Goat Buffalo, "Our Goats Are Clearing Land the Way Nature Intended," https://www.letsgoatbuffalo.com, accessed February 3, 2021; and Konrad Putzier, "Well-Employed in Pandemic Times: Landscaping Goats," *The Wall Street Journal*, December 15, 2020, https://www.wsj.com/articles/well-employed-in-pandemic-times-landscaping-goats-11608044907, accessed February 3, 2021.

lead you through the sometimes choppy waters of environmental law, and the U.S. Environmental Protection Agency (EPA) offers the EPA Small Business Gateway, a website that will connect you to information, technical assistance, and solutions to challenges related to the environment.[50] The EPA also provides online access to "Managing Your Hazardous Waste: A Guide for Small Businesses," which helps make compliance much easier to manage.[51]

Green Opportunities for Small Businesses

Although they add to the cost of doing business for some small companies, environmental concerns open up great opportunities for others. In fact, many start-ups have come to life precisely because of the "greening" of business and the potential opportunities that this has created.

Some green businesses are based on sophisticated technologies that are well beyond the reach of the typical small business. However, many opportunities in this category are very accessible to small companies and start-ups. The following green start-up story perhaps will inspire you to think about new venture possibilities that could be right for you. As owner of Boo Bicycles, Nick Frey builds and sells high-performance bikes with frames that are made out of fast-growing and sustainable bamboo—and business is good. With prices ranging from $1,800 for a basic bike to more than $10,000 for a tricked-out racer, though, many consider the company's handmade products to be more like fine works of art! Beyond aesthetics, the company's website points out, "With a stiff, lively ride that is also supple and compliant, bamboo allows [riders] to have their cake and eat it too."[52] But the product definitely turns heads—and opens wallets as well.

Interest in the sustainability trend can take many forms. For a growing number of small business owners, the ultimate goal is to save the planet. Others recognize that sustainable business practices can hold down costs, attract customers, and generate value for shareholders. The movement provides huge opportunities for companies with determination and creativity, as long as they can execute the plan. This is prime territory for small entrepreneurial companies, given their flexibility and innovative thinking. Entrepreneurs may be able to do well financially *and* do good, by guarding the environment and their integrity at the same time.

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2-1. **Describe the meaning of integrity including its importance to small businesses.**

- Integrity refers to a general sense of honesty and reliability that is expressed in a strong commitment to doing the right thing, regardless of the circumstances. Doing "anything" for money can quickly lead to distortions in business behavior.
- Many small business owners strive to achieve the highest standards of honesty, fairness, and respect in their business relationships.

2-2. **Explain how integrity applies to various stakeholder groups.**

- Closely tied to integrity are ethical issues, which go beyond what is legal or illegal to include more general questions of right and wrong.
- When they make business decisions, entrepreneurs must consider the interests of all stakeholder groups, in particular those of the owners, customers, employees, the community, and the government.
- A company's owners have a clear and reasonable right to benefit from the financial performance of the business.
- Companies that take customers seriously and serve them well are likely to have more of them—and those customers are likely to return often.
- Showing proper appreciation for employees as human beings and as valuable members of the team is an essential ingredient of managerial integrity.
- Most people consider an ethical small business to be one that treats customers and employees honestly and acts as a good citizen in its community.
- Research suggests that most small business owners exercise great integrity, but some tend to cut corners when it comes to social responsibilities if profits will be affected.
- Entrepreneurs must obey governmental laws and follow applicable regulations if they want to maintain their integrity and avoid jail time.

2-3. **Identify some common challenges and benefits of maintaining integrity in small businesses.**

- Small firms' limited resources and desire to succeed make them especially vulnerable to allowing or engaging in unethical practices.
- Start-ups and small companies sometimes resort to telling legitimacy lies, but they can win customers and attract other important stakeholders by paying close attention to *PRO factors* (those related to the firm's products, its representatives, and the organization itself).
- Use of the online marketplace has highlighted such ethical issues as invasion of privacy and threats to intellectual property rights.
- Cultural differences may complicate ethical decision making for small firms operating abroad. The concept of ethical relativism is particularly troublesome because it implies that ethical standards are subject to local interpretation.
- Research supports the notion that ethical business practices are good for business. When customers and employees trust a small company to act with integrity, their support can help keep the company going.

2-4. **Determine practical approaches for building a business with integrity.**

- The underlying values and the behavior of business leaders are powerful forces that affect ethical performance.
- An organizational culture that supports integrity is key to achieving appropriate behavior among a firm's employees. Small firms should develop codes of ethics to provide guidance for their employees.
- Many small companies join Better Business Bureaus to promote ethical conduct throughout the business community.
- Following an ethical decision-making process can help entrepreneurs protect their integrity and that of their business.

2-5. **Describe social entrepreneurship and its influence on small companies and start-up opportunities.**

- Researchers have defined *social entrepreneurship* as "entrepreneurial activity with an embedded social purpose."
- Social entrepreneurship continues to gain momentum and leads to innovative solutions to society's most pressing needs, problems, and opportunities.

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- Social entrepreneurs focus on an expanded set of priorities—a triple bottom line, which takes into account a venture's impact on people, profits, and the planet.
- A sustainable small business is a profitable company that responds to customer needs while showing reasonable concern for the natural environment.
- Environmental regulations may adversely affect some small firms, such as dry cleaners.
- Win-win outcomes are possible in many cases—the cost of eco-friendly business practices can often be more than offset by increased customer interest and reduced paperwork, for example.
- The SBA, the EPA, and other public and private resources stand ready to help small businesses comply with environmental regulations.
- Small companies are sometimes launched precisely to take advantage of opportunities created by environmental concerns. Creating environmentally friendly products and services requires creativity and flexibility, areas in which small businesses tend to excel.

Key Terms

code of ethics p. 44
environmentalism p. 48
ethical imperialism p. 41
ethical relativism p. 41
integrity p. 30
intellectual property p. 40
social entrepreneurship p. 47
social responsibilities p. 34
stakeholder p. 32
sustainable small business p. 48
underlying values p. 42

Discussion Questions

1. Define the concept of integrity. What are the major features of integrity?
2. What are the major stakeholder groups that influence and are influenced by small companies? What are the primary interests of each of these groups? How can a small business owner manage potential conflicts that may arise, given the demands of these groups?
3. Why might small business CEOs focus more attention on profit and less on social goals than large business CEOs do?
4. How do small business owners sometimes end up avoiding paying taxes? If it is intentional, how do you think owners of small firms might attempt to rationalize such a practice?
5. What is a legitimacy lie? In the case of a start-up, how can an entrepreneur use *PRO factors* to win the confidence of potential customers and investors and avoid telling legitimacy lies?
6. What privacy issues are most important to small businesses? What should a company do to guard against violations of the privacy rights of customers, employees, and others?
7. What are some of the advantages of conducting business with integrity? Some people say they have no responsibility beyond maximizing the value of the firm in financial terms. Can this position be defended? If so, how?
8. Explain the connection between underlying values and integrity in business behavior.
9. What are the six steps in the ethical decision-making process presented in this chapter? What is the practical value of this process to a small business?
10. Give some examples of expenditures required on the part of small business firms to protect the environment. In your opinion, do rising concerns for the environment create more costs or more business opportunities for small companies?

You Make the Call

Situation 1

Rachel's online advertising business had only been operating for a year, but already she was happy with the growing client list. In fact, business had been going so well that she finally concluded that it would be wise to hire some help to stay ahead of the surge of work that was coming in. Using an online job board called ZipRecruiter, Rachel was able to identify a handful of high-potential prospects. From that list, she set up in-person

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interviews and settled on the candidate she concluded was the best of the group, Madeline. She called Madeline to give her the good news, and together they decided that the job would begin the following Monday.

A few days later, a friend called to tell Rachel that she had found someone who would be the ideal employee for her company. Rachel explained that the position had been filled, but her friend was unrelenting. “Her name is Jenna, and you absolutely have to meet her,” the friend insisted. “You never know when you will need to hire even more help, so it would be good to make this connection—I mean, just for future reference.”

After nearly 20 minutes of nonstop coaxing, Rachel finally gave in. “Alright,” she consented, “I’ll visit with her, but that’s all it’s going to be—a visit.”

“I’m so happy that you will meet her,” Rachel’s friend insisted. “You won’t regret it!”

Rachel’s friend was absolutely right. A few days later, Rachel met with Jenna and was absolutely blown away by the potential she saw in her. In fact, Rachel concluded that her friend had more than likely *underestimated* Jenna’s full capability. Her résumé was far stronger than any of the candidates Rachel had considered, including Madeline’s. Perhaps more impressive was the fact that she had lots of business contacts and could no doubt bring plenty of new clients to Rachel’s venture. There was no way Rachel could lose if she brought Jenna on board. But then what about Madeline? She had already given her word to Madeline that she could start her new position that following week.

Question 1 What decision on Rachel’s part would contribute most to the success of her business?

Question 2 What ethical reasoning would support hiring Madeline?

Question 3 What ethical reasoning would support hiring Jenna?

Situation 2

Darryl Wilson owns Darryl’s Deals on Wheels, a small used-car dealership in Humble, Texas. Wilson started the company three years ago, but he is still struggling to get a solid footing in the industry. The slow economy isn’t helping—no one seems to have money to buy cars right now—and there is plenty of competition. The business provides the main source of income for his family, which includes his wife and two teenage daughters. Wilson has to make this business work to keep food on the table and to pay the typical expenses involved in raising a family.

Finding customers is essential to success in the car sales business, but so is holding down costs. This means Wilson has to find “rolling stock” that is in demand and inexpensive. That is not easy to do because all the other dealers in his area are also trying to snap up the best deals, and this is driving up the cost of inventory. So, controlling costs means looking at other features of the business, and Wilson thinks he has found something that just may help. The state of Texas requires dealers to report the purchase of all vehicles they acquire for resale, which means the dealer will have to pay a 2.5 percent inventory tax (based on the purchase price) when it sells the car later. But when Wilson buys a car from a private seller, he can usually convince that seller to sign over the title without designating a specific buyer. This allows Wilson to fill in that part of the title and the transfer form with the name of the person who buys the car from him, when that time comes. In the end, the state has no evidence of Wilson’s involvement in the transaction, which allows him to avoid paying administrative fees and the inventory tax—a savings of about $250 on a typical sale. The state doesn’t catch on, and his customers never seem to notice because they have to pay administrative fees and sales tax anyway when they buy the car and transfer the title into their own names.

So far, Wilson has not run into any problems with this practice. In his mind, this is nothing more than “heads-up business.” Furthermore, his profits are so slim right now that playing by the book would probably mean that he would have to go out of business. Even the state would lose money then, because a company that is out of business pays no income taxes and Wilson would have to start collecting unemployment.

Question 1 What are the advantages and possible drawbacks to Wilson’s title-transfer scheme?

Question 2 Which stakeholders are affected by this approach, either positively or negatively? How great are their gains/losses?

Question 3 Wilson finds it hard to identify a downside to his approach. What risks might he be overlooking?

Question 4 What would you do if you were in Wilson’s shoes? If his competitors are following the same practice (and some of them surely are), would that make any difference to you?

Situation 3

Ben London owns and operates Fantastic Footage, a film-editing company in Los Angeles that does contract work mostly for production companies in Hollywood. Not long ago, a local landscaping business completed nearly $5,500 worth of work around London’s offices. While the initial bid now seems a little high for the amount of work that was actually done, there is no question that the work completed was of high quality, and London finally feels comfortable inviting potential clients to meet him at his office to discuss possible deals. However, because of an apparent oversight, the landscaping contractor never submitted a bill. It’s been more than 15 months since the completion of the project, and London has come to conclude that the contractor somehow lost track of the project. He is thinking about calling the company to ask for a final invoice so that he can settle up, but business has been really slow over the last year, and it hasn’t been easy to pay all of the bills as it is. Forking over $5,500 for the landscaping would not be impossible,

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but it would be pretty challenging to scrape up that kind of money right now. So, he is trying to figure out what he should do.

Question 1 In your opinion, whose responsibility is it to initiate the payment of this debt?

Question 2 What if London is unable to come up with the money to pay the bill when (if) it is finally submitted? What should he do then?

Question 3 What are the options available to London in this case? Assess these using each of the following tests: (1) the Rotary Club's four-question test, (2) the "news report" test, (3) the "explain it to your mother" test, and (4) the Golden Rule. Do you arrive at the same conclusion when applying each of these? If not, which one should London use to decide what he should do?

Experiential Exercises

1. Report briefly on some lapse in integrity that has been recounted in the news. Could this type of problem occur in a small business? Explain.
2. Employees sometimes take sick leave when they are merely tired, and some students have been known to miss class for the same reason. Separate into groups of four or five, and prepare a statement on the nature of the ethical issues (if any) in this practice.
3. Based on your experience as an employee, customer, or observer of a particular small business, rate its ethical performance. Outline the evidence or clues you used as a basis for your opinion. How typical are the issues in this case of small businesses in general? Be prepared to offer a summary of your assessment and conclusions.
4. With a current or previous employer in mind, write a simple code of ethics that would show due regard for the interests of all of the company's primary stakeholders (most notably the owners, customers, employees, the community, and the government). How difficult was it to protect and balance the concerns of these groups in the code that you came up with? Report briefly on your findings.
5. Search online for "top environmental concerns," and select five concerns that seem to be most relevant to small businesses. Analyze these concerns to determine how they will shape business practice in small firms over the next decade. Then, identify five new venture opportunities that could be created based on the environmental concerns you selected. Explain your findings and recommendations.

Chapter 2 Case

Please see Appendix A for the Chapter 2 Case Study.

Endnotes

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Chapter 3

Starting a Small Business

Learning Objectives

The purpose of the Starting a Small Business chapter is to help you to identify a business opportunity that is best suited to you and has higher odds for success than other possible options. By studying this chapter, you should be able to . . .

3-1 Distinguish among the different types and sources of start-up ideas.

3-2 Use innovative thinking to generate ideas for high-potential start-ups.

3-3 Describe external and internal analyses that can shape the selection of venture opportunities.

3-4 Explain broad-based strategy options and focus strategies.

3-5 Screen business ideas to identify those with the greatest potential.

3-6 Assess the feasibility of a start-up idea.

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Spotlight on Small Business

HARA Clean Beauty

www.haracleanbeauty.com

Starting a business takes passion and desire, to be sure, but the biggest hurdle often is simply being willing to accept the risk of striking out on your own. This was certainly true for Pooja Goel when she decided to turn away from her medical career to launch a business selling clean and safe beauty products.

From a very young age, Goel had dreamed of working as a medical doctor, and her family was very supportive of her life's plan. After completing her bachelor's degree in biological sciences at Lehigh University in Bethlehem, Pennsylvania, she went on to earn an MD degree from Ross University School of Medicine in the Caribbean.

Goel's first job was in an urgent care clinic in Maryland. She was employed there for some time, working routine 14-hour shifts and getting home late. Once she decided that this was not the vision she had for her life, she left to join the student health services medical staff at New York University, where she was able to work normal hours and even enjoy an hour-long lunch break! But something was still missing. That's when a new vision came into focus for Goel: the thought of starting her own business. She first explored the possibility of an interior design start-up. She found the concept intriguing and knew it was something that she would love to do. But the COVID-19 pandemic had already begun to spiral out of control, leading her to conclude that the time wasn't right to start such a business.

At her husband's suggestion, Goel started looking into clean and natural beauty products. This seemed like a good fit because she had been studying the harmful effects of everyday chemicals on human health for years and had begun exploring new and innovative ways to promote wellness. After giving the idea some thought, she decided that the time was right to launch a new clean-beauty products venture. Goel started her online shop in July 2020, calling it HARA, which means "green" in Hindi.

HARA Clean Beauty is a marketplace of more than 40 top-performing clean-beauty brands and products that strongly appeal to people who are looking to improve their sense of wellness. To get the business off the ground, Goel reached out to 50 companies that sell healthy products and introduced herself to them. Her pitch to these firms was as uncomplicated as it was appealing: She simply asked if she could help market their products and boost their sales. More than 30 of the businesses decided to sign on with HARA. Most of the brands that declined Goel's offer did so because they were set up to sell only through brick-and-mortar stores or sites that could afford to purchase large quantities of stock. Next, she signed up with Shopify, which handles the payment processing and shipping logistics for countless e-commerce enterprises. Dipping into her savings, Goel was able to find the $50,000 needed to buy inventory, which was her greatest expense. To hold costs down and add a personal touch to every order, she packs all shipments herself in a white box with tissue paper that she sprays with perfume, which she also sells.

Goel is working hard to make her venture a success, but that will depend on how well she can attract customers to the products she has to offer. How has she been doing so far? "[I'm] not at the point where I've cracked the sales thing," she confesses. "But I'm sure it's going to happen. It just takes time."

On a more personal note, Goel expresses great delight and relief that her family is proud of her new life's work and is not disappointed at her move away from medicine. HARA has started to grow and has received a lot of support from customers who trust Goel's rigorous product-vetting process and wish to support a small business run by a woman. They are also drawn to the products sold through HARA because they are not available on mega-sites like Amazon. That makes shopping at the start-up all the more special.

Sources: "HARA's Story," https://www.haracleanbeauty.com/pages/haras-story, accessed February 9, 2021; Lauren Mechling, "A Doctor Launches Her Passion Project: Selling 'Green' Beauty Products," *The Wall Street Journal*, January 10, 2021, https://www.wsj.com/articles/a-doctor-launches-her-passion-project-selling-green-beauty-products-11610283658, accessed February 9, 2021; and "Pooja Goel, MD," https://www.linkedin.com/in/pooja-goel-md-24005022/, accessed February 9, 2021.

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One of the undeniable facts of life is that entrepreneurs keep coming up with innovative ways of doing things, and the new businesses they create from these concepts change the way we live. But to get the ball rolling in the right direction, someone must be able to recognize high-potential start-up ideas that others have overlooked. This is precisely what Pooja Goel was able to do when she came up with the concept for HARA Clean Beauty, which is profiled in the opening Spotlight feature. We should emphasize that identifying imaginative new products or services that may lead to promising business ventures is so central to the entrepreneurial process that it has its own name: **opportunity recognition**.

Business opportunities are like air—they are always around, even though you may not realize it. What sets entrepreneurs apart from everyone else is their ability to see the potential that others overlook and then take the bold steps necessary to get new businesses up and running. How do they do it? Most entrepreneurs have uncommon observation skills and the motivation to act on what they see. In some cases, the identification of a new business opportunity may be the result of an active search for possibilities or insights derived from personal experience or work background. In other cases, the search for opportunities may be a less deliberate and more automatic process.[1]

Economist Israel Kirzner proposed that entrepreneurs have a unique capability, which he called **entrepreneurial alertness**. According to this view, entrepreneurs are not actually the source of innovative ideas; rather, they are simply "alert to the opportunities that exist *already* and are waiting to be noticed."[2] When these opportunities are aligned with an entrepreneur's knowledge, experience, and aspirations, they are even more likely to be spotted.

A discussion of the finer points of entrepreneurial alertness is beyond the scope of this book, but it is important to understand that being watchful for conditions that might lead to new business opportunities can really pay off.[3] Try it for yourself to see if new possibilities for a business become apparent: Over the next week or so, take note of trends, changes, and situations that might support a new business. You will probably be surprised at how many potential opportunities you can identify. If you continue this rather deliberate search, over time you may find that it becomes a habit.[4]

Perhaps you already have a business idea in mind that you would like to pursue. With good planning and the right strategy, you may soon be on your way to success as an entrepreneur. On the other hand, you may have a passionate desire to start your own company but are not sure that you have chosen the right business idea to get you there. Or maybe you have an *idea* in mind but are not sure if it is a good *business opportunity*. No matter which group you fall into, we will help to get you started on the right foot, with the right idea and the right strategy.

In this chapter, we focus mostly on opportunity recognition and strategy options as these apply to **start-ups**—that is, businesses that did not exist before entrepreneurs created them. However, the chapters that follow will go beyond a discussion of start-ups and consider business opportunities that already exist, such as purchasing a franchise or buying an existing business (Chapter 4) or joining a family business (Chapter 5). These can all be high-potential options. As you read this chapter, keep in mind that many of the insights and strategies described here also apply to ongoing small businesses, not just to start-ups.

opportunity recognition
Identification of potential new products or services that may lead to promising businesses.

entrepreneurial alertness
Readiness to act on existing, but previously unnoticed, business opportunities.

start-up
A new business venture created "from scratch."

3-1 Developing Start-Up Ideas

3-1 Distinguish among the different types and sources of start-up ideas.

So how do you get started? It all begins with a promising business idea. But new venture concepts are not all equal, and they can come from many different sources. By recognizing the nature and origin of start-up ideas, an entrepreneur can broaden the range of new ideas available for their consideration.

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Exhibit 3.1 Types of Ideas That Develop into Start-Ups

New Market Ideas	New Technology Ideas	New Benefit Ideas
New Market	New Technology	New Benefit
↓	↓	↓
Offering a new prepaid laundry service to college students that is available on other campuses	Developing an app that allows pet owners to see openings in the schedules of all veterinarians in a city and set up emergency appointments by pushing "1" on their cellphones	Using remote-controlled drones equipped with digital video cameras to detect and map evidence of irrigation failure in arid countries

3-1a Types of Start-Up Ideas

Exhibit 3.1 shows the three basic types of ideas from which most start-ups are launched: ideas to enter new markets, ideas based on new technologies, and ideas that offer new benefits. Each type of idea has its own unique features.

Numerous start-ups develop from **new market ideas**—that is, those concerned with providing customers with a product or service that does not exist in a particular market but does exist somewhere else. Indeed, many of the largest companies in existence today were initially launched with a vision of applying existing ideas in new contexts. Because it has so much potential, taking this perspective on new venture ideas should be given careful consideration.

Other start-ups are based on **new technology ideas**, which involve new or relatively new knowledge breakthroughs. This type of business can be high risk because there is usually no definitive model of success to follow, but it can also offer tremendous promise. You should pay close attention to the fundamental features of a well-conceived new venture of this type. For starters, the technology involved needs to be unique, better than others currently available, feasible to implement, and focused on a market need that is deep enough to generate sufficient sales. Also, the founders should have the knowledge, skills, resources, and connections necessary to build a profitable company around the new technology.

Because of the complexities involved with new technology businesses, it often becomes necessary for entrepreneurs to **pivot** at some point after start-up. This refers to refocusing the start-up as it unfolds or completely recreating it if the initial concept turns out to be seriously flawed. According to Kevin Systrom, co-founder of Instagram, the idea behind the pivot is to "try out new ideas, shed them quickly if they don't catch on, and move on to the next new thing."[5] In other words, if the initial idea turns out to be unsound, it is best to fail fast and fail cheap. While pivoting is sometimes helpful for other types of start-ups, it is common and frequently necessary (often more than once) for those based on new technologies.

New benefit ideas—those based on offering customers benefits from new or improved products or services or better ways of performing old functions—account for a significant number of start-ups. Consider Nicky Bronner, who co-founded Unreal Brands in 2012 when he was only 15 years old. To satisfy his sweet tooth without wrecking his health, he set out to "unjunk" snacks by creating and selling his own version of M&Ms, Snickers, Reese's, and other popular candies that are still as tasty

new market idea
A start-up idea centered around providing customers with an existing product or service not available in their market.

new technology idea
A start-up idea involving new or relatively new technology, centered around providing customers with a new product or service.

pivot
To refocus or recreate a start-up if the initial concept turns out to be flawed.

new benefit idea
A start-up idea centered around providing customers with a new or improved product or service or a better way of performing old functions.

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but made of far more wholesome ingredients. Today, Unreal Brands employs 17 people, and its products can be found on the shelves of natural food stores and many grocery chains nationwide, including Kroger, Sprouts, Shaw's, and Whole Foods. You might say Bronner has proved that focusing on new benefits can sometimes lead to really sweet business ideas.[6]

3-1b Common Sources of Start-Up Ideas

Several studies have identified sources of ideas for small business start-ups. Exhibit 3.2 shows the results of one such study by the National Federation of Independent Business (NFIB), which found that prior work experience accounts for 45 percent of new ideas. However, there are other important sources. As indicated in the exhibit, the NFIB study determined that personal interests and hobbies represent 16 percent of the total, and chance happenings account for 11 percent.

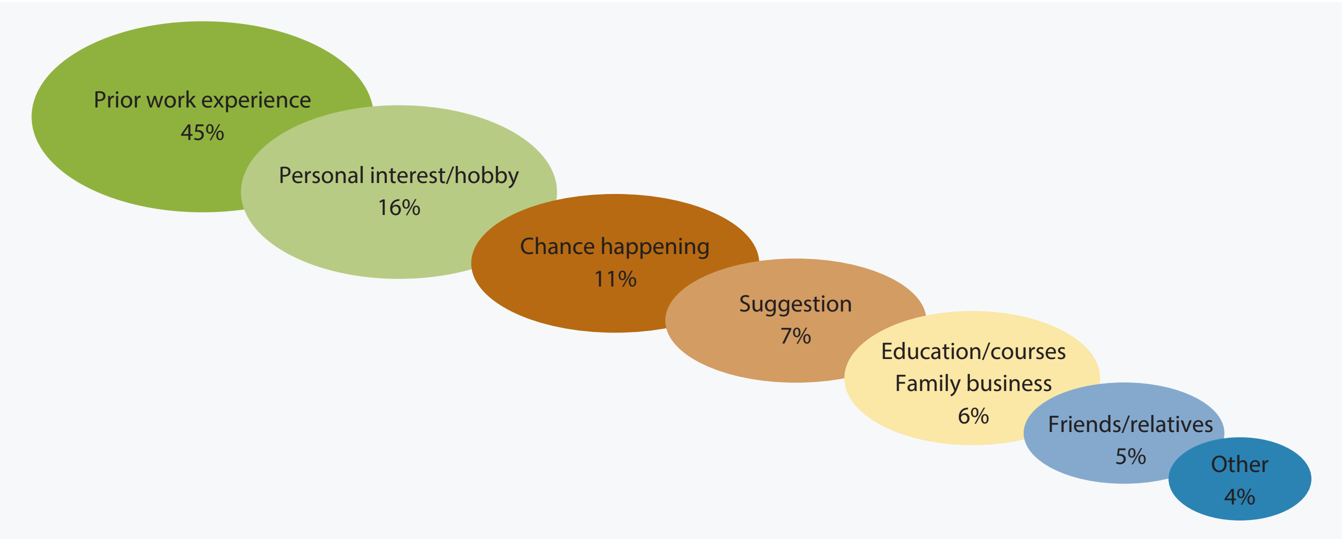
Ideas for a start-up can come from anywhere, but for now we will focus on three possible sources: personal/work experience, hobbies and personal interests, and accidental discovery.

Personal/Work Experience

One of the primary sources of start-up ideas is personal experience. Often, knowledge gleaned from a present or former job allows a person to see possibilities for modifying an existing product, improving a service, becoming a supplier that meets an employer's needs better than current vendors, or duplicating a business concept in a different location. Perhaps your personal contacts (your network) include suppliers that are interested in working with you or customers whose needs are not currently being met. Start-up concepts may even result from trying personal circumstances or misfortunes, especially when the entrepreneur can use work experience or technical skills to address the challenge at hand. Regardless of the situation, these insights may lead you to an opportunity with tremendous potential.[7]

That's how it worked for Adrienne Kallweit, whose attempts to find a suitable babysitter for her young child proved to be more challenging than she had expected.

Exhibit 3.2 **Common Sources of Start-Up Ideas**



Source: Data developed and provided by the National Federation of Independent Business and sponsored by the American Express Travel Related Services Company, Inc.

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From this experience—which reflects a very real need for so many young couples who need safe and reliable child care—Kallweit decided to launch SeekingSitters, which provides an on-demand babysitter referral service. Apparently, Kallweit's experience was a great predictor of opportunity, because the company has been expanding rapidly since it was launched. As evidence of its growth, it recently added additional services for full-time nannies, church nursery care support, professional care for weddings and other special events—even pet and home sitting.[8]

Hobbies and Personal Interests

Sometimes, hobbies grow beyond being leisure activities to become businesses, and they can add surprising energy to the start-up process. For instance, skiing enthusiasts might start a ski equipment rental operation as a way to make income from an activity that they enjoy. Also consider that Mark Zuckerberg didn't intend for Facebook to grow into the massive company that it is today; rather, he says it started out in his dorm room as a fun hobby. "I was just trying to help people connect at a few colleges and a few schools," he recalls now.[9] While we don't expect all or even most small businesses to grow into life-changing technology giants, Zuckerberg's story proves that fun side projects can sometimes grow into significant new companies with serious profit potential. In fact, research has revealed that start-ups based on a personal pastime are more likely than others to generate early sales and reach profitability, and the entrepreneurs who launch these businesses tend to be more deeply committed to them.[10]

Accidental Discovery

Another source of new start-up ideas—accidental discovery—involves something called **serendipity**, a facility for making desirable discoveries by accident. Awareness obviously plays a role here, but anyone may stumble across a useful idea in the course of day-to-day living. That's what happened to Sara Blakely, founder of shapewear superstar Spanx. As a 27-year-old selling fax machines door to door in 1998, she always wanted to look her best. But she was bothered by a nagging problem: visible panty lines, which are unsightly and uncomfortable. She decided to solve the problem by cutting the feet off her pantyhose, which she then wore under a pair of white pants. The experiment worked beautifully, and the look was very fashionable! From that unplanned discovery, her business was born. Investing $5,000 from her savings, Blakely launched the company and went on from there to become a self-made billionaire.[11]

Other Idea Leads

If the sources of start-up ideas just discussed do not reveal a specific entrepreneurial opportunity that is right for you, examine the following methods, which have been useful to many entrepreneurs:

- Tap personal contacts with potential customers and suppliers, professors, patent attorneys, former or current employees and co-workers, venture capitalists, and chambers of commerce.
- Visit trade shows, production facilities, and universities and research institutes, and reach out to successful entrepreneurs (in other markets) who are doing what you want to do.
- Observe trends, such as those related to material limitations and energy shortages, emerging technologies, recreational practices, fads, pollution problems, personal security needs, and social movements.

serendipity
A facility for making desirable discoveries by accident.

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- Pay close attention to all forms of change, including shifts in specific industries and markets, demographic swings, and emerging discoveries or scientific breakthroughs.
- Read trade publications, bankruptcy announcements, and profiles of entrepreneurs and various business opportunities in *Inc., Fast Company*, and similar periodicals.
- Search the Internet, where you can find an unlimited supply of information on the start-up process and even specific opportunities. For example, *Entrepreneur* magazine offers the Business Idea Center (www.entrepreneur.com/businessideas) for free, a website that profiles business ideas that can be browsed by industry, interest, and profession.

3-2 Using Innovative Thinking to Identify Business Ideas

3-2 Use innovative thinking to generate ideas for high-potential start-ups.

If you haven't come up with a start-up idea from the common sources just identified, you may need to dig deeper. This is where creative thinking becomes the name of the game.

To help you see how various possibilities can come together to provide inspiration, we believe it is helpful to think about this as an "opportunity kaleidoscope." If you have ever looked through a kaleidoscope, you know that these tube-shaped optical instruments reveal changing patterns of colors and designs as they are rotated. The following suggestions are similarly designed to help you see things from different angles and pick up on new combinations of possibilities that can guide your search for that one great idea for a start-up—or find ways to keep an existing business fresh, alive, and moving forward. We have organized these alternatives into four general groupings: identifying "pain points" that may lead to new possibilities, taking a cue from existing products or services, finding new ways to deliver products or services, and tapping into the potential of emerging possibilities.

3-2a Identify "Pain Points" That Open the Door to New Possibilities

High-potential business ideas often address problems that people have or a "pain" that a new venture idea could relieve. So, begin with a problem in mind. Think about a significant problem or hassle that people have to deal with, dissect it, chart it out, and then roll it over and over in your mind while considering possible solutions. Lots of smart business ideas are likely to come to mind. If the pain you are trying to address is your own, the results can be especially good, since you are an expert on the problem and will feel passionate about finding a solution. This notion is validated by Faith Popcorn, a best-selling author, futurist, and founder of marketing consultancy BrainReserve. She provides a starting point for new ventures when she suggests, "Look at your day and say, 'What's missing?' Then build a product around that."[12]

3-2b Take a Cue from Existing Products or Services

Recall the opportunity kaleidoscope, and consider an existing product or service from a new angle. Often, high-potential possibilities emerge from creatively improving or adapting business concepts that already exist.

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Borrow from Existing Product and Service Ideas or Other Industries

"Good artists borrow; great artists steal," said Pablo Picasso or T.S. Eliot or Salvador Dalí—no one seems to know for sure. This principle launched Apple Computer on the road to greatness when one of its co-founders, Steve Jobs, identified technologies that Xerox had developed but was not using. It can work for you, too, within the limits of the law and ethical conduct.

In some cases, it's a matter of bringing to one country a business that has proved successful in another. For example, Scott Gable took notice of the compact parking towers that use sensors and lifts to stack cars. These facilities are very popular in Europe and Asia and are much cheaper to build than traditional garages. Seeing the potential, Gable started CityLift Parking to bring these automated and highly efficient parking systems to crowded cities in the United States where they did not exist but were badly needed.[13]

Thinking deeply about how you might put ideas and practices to work can be a powerful starting place to launch a new venture or accelerate the growth of an existing business.

Combine Two Businesses to Create a Market Opening

Putting two businesses together can sometimes lead to unique products, services, or experiences that customers can't get elsewhere. Examples include theaters that combine dinner and a movie, and bookstores that add a sandwich shop.

Bike shops have also been following this trend. This includes Road Crew Coffee & Cycles, which has shifted into high gear using this strategy. Customers turn to this shop in St. Louis, Missouri, when they need to pick up cycling accessories. But they also drop by to get a flat fixed, have a bike looked over and tuned, or request a build from the ground up. Many also stop in to enjoy a cortado espresso or seasonal latte in the café, grab a donut or some gourmet baked goods, and even converse with other hardcore cycling enthusiasts. The shop's loyal customers shrug off the somewhat-higher repair charges because the overall experience is so good. "It's just a friendly environment for everyone in the cycling community and anyone in general who wants to enjoy good coffee in a welcoming, open place," says co-owner Patrick Woodling.[14]

At some point, it may make sense to start (or buy) more than one business without merging the operations, a strategy known as *diversification*. This is especially true when the businesses can share some kind of synergy that will boost the "launch-ability" and performance of the ventures involved.

When Glenn Boyette feared that he might lose his 150-acre family farm in Clayton, North Carolina, he decided to go into the business of scaring others! He still produces fruits and vegetables during the growing season. But once Halloween season arrives, Boyette Family Farms transforms into Clayton Fear Farm, offering hayrides and games for young kids during the day and less-tame "haunted attractions" for teenagers and adults when night falls—all for a price. The success of his calendar-driven venture was extended more recently by the addition of a dazzling display of lights at Christmas time, the backdrop for a tractor-pulled hayride complemented with Yuletide music and holiday magic for paying customers. These new product and service extensions saved the day, doubling the revenues Boyette was getting from farming alone. You might say it's just a different cash crop.[15]

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Improve the Function of an Existing Product or Service

Almost all suitcases have wheels these days, but that wasn't always the case. The innovation was perfected by Robert Plath, who created the Rollaboard design in 1987. The product was so popular that Plath decided to quit his job as a commercial pilot to start Travelpro International, now a major luggage company.[16] Luggage without wheels is still functional, but adding this feature opened the door to new sales and a new venture.

Adapt a Product or Service to Meet Customer Needs in a Different Way

Many new ventures get their start by borrowing a product or service that was already working well somewhere else and modifying it to address a different need or situation. For example, eBay's online model has been adapted with great success by many start-ups, such as Etsy.com (to sell handmade goods, vintage products, and art supplies) and Newegg.com (an online marketplace for sellers of electronics).

Consider, too, Michelle Brooke-Marciniak and Susan Walvius's launch of a company called Sheex. This entrepreneurial team decided to use the moisture-wicking fabrics found in workout clothes to manufacture and sell super-comfortable bedsheets, weighted blankets, and sleepwear.[17] This successful business provides another illustration of the endless possibilities when adapting a product or service.

Creatively Expand the Market for a Product or Service

Annie Haven's family ranch in Southern California had few takers for the "fertilizer" that its cattle produced, so she decided to package the growth-stimulating stuff in three-by five-inch pouches and sell it to gardening enthusiasts (a box of nine "tea bags" sells for $32.95 on Etsy). Customers simply steep each bag in one to five gallons of water and use that "tea" to water their plants. Haven found a way to create a new business by expanding the market for her product, along with the profits she can earn.[18]

3-2c Find New Ways to Deliver Products and Services

Convenience sells. Countless new businesses are created every year by entrepreneurs who figure out how to provide ready access to products and services that consumers need or want—especially if it will save them time, hassle, *and* money.

Streamline a Customer's Activities

Many people are busy, so they look to firms that can bear some of life's burdens for them. That's what keeps businesses like grocery-delivery services going. Take some time to ponder the day-to-day experiences of people in the market segment you would like to serve. What activities would they gladly offload?

COURTESY OF AUTHENTIC HAVEN BRAND

Cash in on the Sharing Economy

You know about high-profile start-ups like Airbnb and Uber that give consumers low-cost access to apartment and home rentals and car rides, respectively. But the sharing economy apparently is far from tapped out. An analysis published in 2017 by the Brookings Institution

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had projected that the sharing economy would grow to $335 billion worldwide by the year 2025.[19] However, the global pandemic dealt a crushing setback to many businesses in this economy, including ride-sharing operators and home-sharing marketplaces like Airbnb. But during the same period of time, food delivery services, short-term workspace providers, and other sharing ventures actually gained ground. This resilience has prompted government analysts to conclude that these services may be positioned to endure such shocks better than their competitors in traditional industries and to predict plenty of growth in the future.[20] There are other potential potholes on the road to shared-economy riches, and plenty of start-ups have fallen into them, including BlackJet (the "Uber for jet travel") and carpooling start-up Ridejoy, among many others. Even so, success stories like Rent the Runway and Bag Borrow or Steal show that making high-end products like designer dresses and luxury handbags available to average consumers on an as-needed rental basis can provide a platform for success.

Offer Products through a Subscription Service

In recent years, countless item-of-the-month and quarterly offer start-ups have sprung up around the idea of shipping a different set of niche items to subscribers on a set schedule. The products being sold this way range from pet toys to healthy snacks to cosmetics. These companies combat the "choice fatigue" that frustrates many buyers trying to choose from the dizzying array of products available for sale. Subscription services solve this problem by eliminating the selection process altogether. They send out packages of carefully curated items to members for fees that range from around $10 a month (beauty and grooming products at BirchBox.com) to $100 a quarter (name brand fashion, beauty, and home essentials at Curateur.com) for most services.

This type of business is not without its challenges—dealing with packaging and shipping crunches, for instance, and offering selections that are fresh and interesting enough to bring customers back for more. But many entrepreneurs are managing to keep their subscribers happy and are earning handsome returns for their efforts.

Meet Common Customer Needs through a Mobile Business

Everyone is used to going to places of business to get the products and services they need. But imagine how many customers would prefer to deal with a company that would come to them instead. This is not exactly new. Pet groomers, auto detailers, photographers, and other service providers have been doing this for years. But there is still plenty of opportunity for mobile businesses, which could leave an open door for you.

Justin Joffe is certainly trying to get in on the act. He founded HENRY the Dentist, a New Providence, New Jersey–based mobile dentistry start-up. Joffe will pull up to your home or office to do everything from taking X-rays to filling a nagging cavity to transforming your smile with Invisalign treatments.[21]

Cut Out Intermediaries and Sell Directly to the Consumer

Entrepreneurs have a knack for finding clever ways to unlock opportunities that others just seem to overlook—or that their rivals wish would remain unnoticed. For example, direct-to-consumer (DTC) start-ups have been stripping market share away from major chains by daring to sell products directly to those who use them. In a traditional supply chain, manufacturers push their products out through wholesalers, distributors, retailers, and other intermediaries. This requires time-consuming negotiations at each stage as the product is handed off from production to final delivery. Because contact with the end user is indirect, the customer feedback loop is often delayed—and some signals never make it back at all.

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DTC start-ups streamline the standard approach by cutting out intermediaries and tapping the power of the Internet to sell products to final consumers. Some of these ventures use the subscription model mentioned above, but many (for example, Casper for mattresses and Warby Parker for glasses) sell their products on an as-needed basis and still others (such as Dollar Shave Club) do both. DTC businesses have grown dramatically in number and size, swelling greatly during the COVID-19 pandemic when customers chose to shop from home, but future scalability may be more challenging.[22]

3-2d Tap into the Potential of Emerging Possibilities

Solving customers' problems, adapting existing business concepts to better serve their needs, and offering them convenience can all provide a footing for successful new business ideas. In other cases, though, it can pay to anticipate new developments and address them with untried alternatives.

Recognize a Popular Trend, and Ride the Wave

Fads can lead to serious, though sometimes short-lived, money-making opportunities (to check out one example, search for "Pet Rocks"), but *trends* provide a much stronger foundation for businesses because they are connected to a larger change in society. Even more powerful is the product or service that builds on three or four trends as they come together. For example, the outrageous success of Apple's iPad is the result of multiple merging trends: consumer desires for increased mobility, instant gratification, and no hassles, all tied together with the product's slick design and "coolness" factor.

Also look for countertrends. For example, some hotels, resorts, and travel companies have started offering "tech escape" or "digital detox" packages to guests if they surrender their digital devices at check-in. Such offers appeal to guests who need an excuse to take a *complete* break from their work.[23] To identify a countertrend, make it a habit to ask those who resist a trend (such as the coffee drinker who refuses to go to Starbucks) what products or services would appeal to them and then see what possibilities come to mind. Set aside your preconceived notions of what "ought to be," and get into the minds of those who resist the flow. If you use the trend as your starting point, you will know better where to look for the countertrend, and that's when you can get ahead of the game.

Offer a "Green" Product or Service Alternative

A great surge of effort and investment has been flowing toward ventures that focus on protecting the environment. Green start-ups include an upscale paper-saving electronic invitation service for weddings and other formal events (Greenvelope)[24] and an "upcycler" that transforms waste into high-quality products (LooptWorks).[25] Given the success that many of these companies are having, it clearly can pay to think "green."

Keep an Eye on New Technologies

New technologies often open up potential opportunities for start-ups, but only those who take note of the possibilities can reap the rewards. Read widely, consult industry experts and government offices that promote new technologies, drop by the technology transfer office of a nearby university, or visit with faculty who work at the cutting edge of their fields. Regardless of where you look, be sure to research innovations that have potential commercial value, particularly for new ventures.

These options represent only a few of the many possibilities. We encourage you to seek and assess new venture ideas in whatever circumstances you find yourself. By considering a number of internal and external factors, you should be able to fit together the pieces of the opportunity puzzle.

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Living the Dream

More and More Entrepreneurs Are Joining the Club

You have probably heard about the remarkable young business known as Dollar Shave Club. Launched by Mark Levine and Michael Dubin in 2011, the company seemed to come out of nowhere to become a significant player in an industry that has been around forever: razors and other personal grooming products. How did Levine and Dubin pull off such an amazing accomplishment?

Dollar Shave Club's secret rests on the simplicity and ease with which the business can get everyday shaving products into the hands of customers. By clicking on a few boxes on the company's website, creating an account, and then checking out, buyers can be assured that the items they have ordered will soon be on their way to the shipping address they provided. It really is that convenient.

The company is one of countless new direct-to-consumer (DTC) start-ups—that is, ventures that sell products directly to the end user, allowing them to bypass the high costs that go along with selling through intermediaries. Leaning on an ever-expanding universe of digital tools and platforms, these creative new businesses have been able to radically transform the way customers buy things. And, as you might guess, established brands are not at all happy about this new trend.

It seems there is no end to the "must-have" products being sold by DTC players these days, including machine-washable wool sneakers (Allbirds), modern and functionally designed suitcases and travel accessories (Away), beauty and skincare product samples (Birchbox), bed-in-a-box mattresses (Casper), cosmetics (Glossier), bright and whimsically patterned socks (Happy Socks), natural deodorants (Native Deodorant), women's activewear (Outdoor Voices), oral-care products (Quip), nutrient-rich meal-replacement drinks (Soylent), eyeglasses (Warby Parker), and the list goes on. There was even a DTC competitor to Dollar Shave Club called Harry's that pried its way into the market by promising that for every razor purchased they would donate a razor to someone in need. But Harry's ditched the model at some point along the way and now sells its products through large retailers like Target and Walmart. If you can't beat 'em, get a bigger partner!

The advantages of the DTC approach go far beyond simple cost savings. As detailed in a recent report by the consulting firm Deloitte, these ventures enjoy a number of noteworthy financial, operational, and market advantages that can lead to benefits like revenue growth, improved margins, expanded market reach, reduced capital expenditures, more complete end-user data, improved customer relationships, and comprehensive product assortments. The same report also outlined the many and very serious drawbacks of taking the traditional approach—that is, launching a product through a network of retailers and other, more standard distribution channels:

> Brands have limited control over prices, which are negotiated with and ultimately set by retailers. Furthermore, they don't own their customer data. At best, they can buy aggregated point-of-sale customer data and analyze [them] post-purchase, but this provides little insight into who their customers really are. Retailer relationships must be continually managed, and brands must work with retailers' timing and pricing, margin and trade spend demands. Operating costs are high thanks to trade spend and retailer margins—and yet retail sales are stagnating.

But this does not mean that implementing the DTC model is easy. These ventures have to be exceedingly alert and nimble if they are to succeed. Among other conditions, they must be ready and willing to embrace the latest tech tools and platforms that make it possible to draw new consumers to the company and hold them there. And since user satisfaction along all points of contact is a key differentiating factor for DTC businesses, it is crucial that they create a superior total customer experience to become brands with staying power. For example, experts say these start-ups need to pay especially close attention to vital factors like "ease of purchase, speed of delivery, seamless returns, [and] responsiveness to complaints."

Looking forward, businesses following the DTC model are going to have to find ways to perfect the formula in order to adjust to shifting competitive conditions and come out on top. A *Harvard Business Review* analysis summarized the challenge as follows:

> Given how much things have changed, what has worked in the past almost certainly won't work in the future. The path forward must include both a return to management fundamentals and a move beyond the existing DTC playbook in order to incorporate the lessons of the last decade. Success today requires an understanding of both enduring business basics and also the ways in which the DTC model has permanently reshaped the industry.

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That's a tall order, and perhaps it explains why the founders of Dollar Shave Club sold the company a few years back to the consumer goods giant Unilever for a reported $1 billion. But the company's remarkable success is sure to inspire plenty of imitators in the years to come.

Sources: "Going Digital, Going Direct (Digital Strategies to Help Brands Connect with Today's Consumer)," https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consumer-business/ca-en-consumer-business-going-digital-going-direct.pdf, accessed February 15, 2021; "How Does a Dollar Shave Club Membership Work?" https://ask.dollarshaveclub.com/hc/en-us/articles/115012584047-How-does-a-Dollar-Shave-Club-Membership-work-, accessed February 15, 2021; Lawrence Ingrassia, "Inside the Success of Dollar Shave Club and Why DTC Changed the Retail Landscape," March 26, 2020, https://www.inc.com/magazine/202004/lawrence-ingrassia/billion-dollar-brand-club-direct-consumer-dtc-book.html, accessed February 15, 2021; and Len Schlesinger, Matt Higgins, and Shaye Roseman, "Reinventing the Direct-to-Consumer Business Model," *Harvard Business Review*, March 31, 2020, https://hbr.org/2020/03/reinventing-the-direct-to-consumer-business-model, accessed February 15, 2021.

3-3 Using Internal and External Analyses to Assess New Business Ideas

3-3 Describe external and internal analyses that can shape the selection of venture opportunities.

Two general approaches can help to identify business ideas—outside-in and inside-out analyses. In other words, entrepreneurs can look for needs in the marketplace and then determine how to use their own capabilities to pursue those opportunities (outside-in), or they can first evaluate their capabilities and then identify new products or services they might be able to offer to the market (inside-out).[26] It is important to understand the finer points of the two methods because they can reveal business ideas that may otherwise be overlooked.

3-3a Outside-In Analysis

Entrepreneurs are usually more successful when they study a business context in order to identify potential start-up opportunities and determine which are most likely to accomplish their goals. This outside-in analysis should consider the general environment, or big picture, and the industry setting in which the venture might do business. It should also factor in the competitive environment that is likely to have an impact.

The **general environment** is made up of very broad factors that influence most businesses in a society, while the **industry environment** is defined more narrowly as the context for factors that directly impact a given firm and all of its competitors. The **competitive environment** is even more specific, focusing on the strength, position, and likely moves and countermoves of competitors in an industry.

general environment
The broad environment, encompassing factors that influence most businesses in a society.

industry environment
The environment that includes factors that directly impact a given firm and all of its competitors.

competitive environment
The environment that focuses on the strength, position, and likely moves and countermoves of competitors in an industry.

The General Environment

The general environment encompasses a number of important trends, as shown in Exhibit 3.3. *Economic trends* include changes in the rate of inflation, interest rates, and even currency exchange rates, all of which promote or discourage business growth. *Sociocultural trends* refer to societal currents that may affect consumer demand, opening up new markets and forcing others into decline. *Political/legal trends* include changes in tax law and government regulations (for example, safety rules) that may pose a threat to existing companies or devastate an inventive business concept. *Sustainability*

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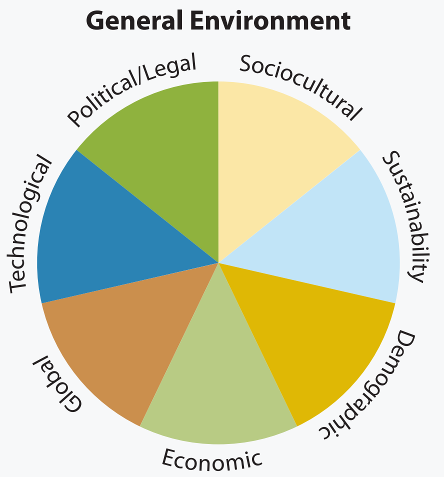
Exhibit 3.3 Trends in the General Environment



trends represent developments in the physical environment to which companies should or must respond, including ecological concerns like water pollution or suspected causes of climate change. *Global trends* reflect international developments that create new opportunities to expand markets, outsource, invest abroad, and so on. As people and markets around the world become increasingly connected, the impact of the global segment on small business opportunities will increase.

Developments that grow out of *technological trends* spawn—or wipe out—many new ventures. And given the rapid rate of change in this segment of the general environment, it is very important that small business owners stay current on these trends and understand the impact that they may have. Some technological developments to keep an eye on include the following:

- High-quality, affordable virtual-reality and augmented-reality technologies are transforming entertainment, communications, and business.
- The Internet of Things connects and combines the limited computing power embedded in devices in the home and office to make advanced automation possible.
- Robotics and industrial automation continue to fill gaps left by labor shortages, replacing humans on assembly lines and elsewhere with highly efficient and tireless machines.
- 5G communication applications are driving demand for higher-speed Internet connections and a shift to super-connected homes, smart cities, and far greater personal mobility.
- Autonomous driving innovations could reduce motor vehicle deaths by as much as 90 percent, even as it eliminates jobs for drivers and crushes the need for auto insurance.
- Artificial intelligence and machine learning can boost workplace efficiency and take over repetitive or dangerous tasks, but it can also threaten to displace employees.

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Finally, *demographic trends* also play an important role in shaping opportunities for start-ups. These trends include population size, age structure, ethnic mix, and wage distribution. For instance, a focus on aging baby boomers (the 70 million Americans born between 1946 and 1964) can really pay off, given their $2.6 trillion in spending power and willful self-indulgence. And there is no limit to the products and services that can be targeted to this age group. Cell phones with larger keys that can easily be seen in dim lighting and magazines that focus on health issues in the retirement years are business ideas that have already emerged with this demographic trend in mind.

Some people believe that evaluation of the general environment is appropriate only for large firms that have corporate staffs to manage the process, but small businesses can also benefit from such analysis. For example, in America today people with obesity comprise one-third of the population (not including those who are medically considered overweight), and that number is projected to increase to around 50 percent by the year 2030, if current trends persist.[27] Entrepreneurs have realized that a multitude of business opportunities can be launched based on this rising tide, from weight-loss services to products that help people with obesity live more comfortably. Among the many businesses launched by those reading the trend are start-ups offering airline seatbelt extenders, high-capacity bathroom scales, and extended-size apparel.

The Industry Environment

An entrepreneur will be even more directly affected by the start-up's industry than by the general environment. The impact can be substantial, with studies reporting that industry influences can explain anywhere from 8 to 30 percent of firm profitability.[28] To outline these dynamics, Michael Porter lists five factors that determine the nature and degree of competition in an industry:[29]

- *New competitors.* How easy is it for new competitors to enter the industry?
- *Substitute products/services.* Can customers turn to other products or services to replace those that the industry offers?
- *Rivalry.* How intense is the rivalry among existing competitors in the industry?
- *Suppliers.* Are industry suppliers so powerful that they will demand high prices for inputs, thereby increasing the company's costs and reducing its profits?
- *Buyers.* Are industry customers so powerful that they will force companies to charge low prices, thereby reducing profits?

Exhibit 3.4 shows these five factors as weights that offset the potential attractiveness and profitability of a target industry. Profits in an industry tend to be inversely related to the strength of these factors—that is, strong factors yield weak profits, whereas weak factors yield strong profits.

Entrepreneurs who understand industry influences can better identify high-potential start-up opportunities—situations where, say, rivalry is weak and neither buyers nor suppliers have enough power to drive hard bargains on price. But these insights can also help entrepreneurs to anticipate threats they are likely to encounter and to begin thinking about ways to defend their start-ups from any downside risk. Entrepreneurs who recognize and understand Porter's five industry factors can position their ventures in a way that makes the most of what the industry offers.

The Competitive Environment

Determining the strength, position, and likely responses of rival businesses to newcomers is critical for the assessment of any business idea. William A. Sahlman of

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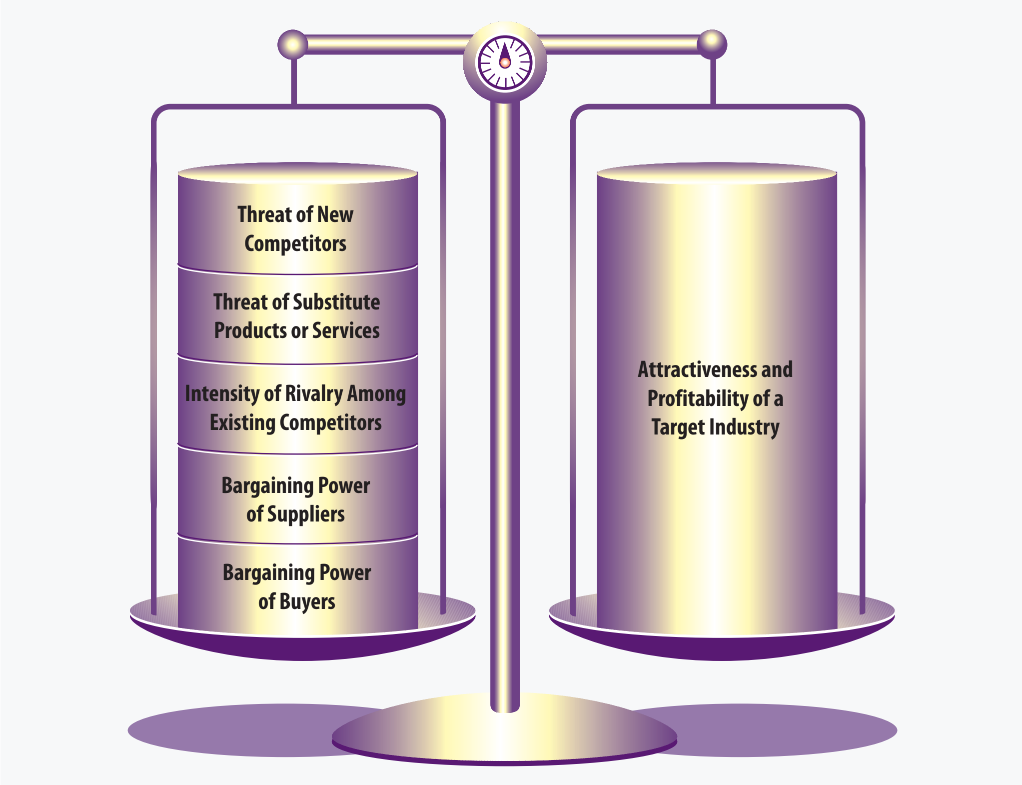
Exhibit 3.4 Major Factors Offsetting Industry Attractiveness



Harvard Business School contends that every aspiring entrepreneur should answer several questions about the competitors they are likely to encounter in the marketplace:[30]

- Who would be the new venture's current competitors?
- What unique resources do they control?
- What are their strengths and weaknesses?
- How will they respond to the new venture's decision to enter the industry?
- How can the new venture respond?
- Who else might see and exploit the same opportunity?
- Are there ways to co-opt potential or actual competitors by forming alliances?

This analysis helps an entrepreneur to evaluate the nature and extent of existing competition and to fine-tune future plans. It can also help to identify high-potential business opportunities based on the competitive situation.

When analyzing the competition, entrepreneurs should take one more step: They should identify the thinking that shapes their rivals' moves, which often is based on the assumption that businesses must operate in a certain way because they always have. But this clearly is not the case. For example, it wasn't all that long ago that teenagers had to do their shopping at the mall, realtors had to use cameras to take pictures of investment properties for out-of-state buyers, and customers had to use cash or credit cards to pay for purchases. Today, these can all be done by cell phone, and forward-thinking businesses can gain an advantage by changing their model to reflect these new realities. In other words, innovative entrepreneurs often can overtake established rivals by using their competitors' commitment to time-honored approaches against them.

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Living the Dream

Delivering on Promises during a Pandemic

One of the keys to building a successful small business is tuning in to existing conditions in the general environment so that the venture is matched to emerging opportunities. This is true when trying to launch a start-up or grow an existing venture. In either case, it pays to be aware of changes in the environment, even those that create hardship for many. For example, countless ventures were launched after the 9/11 terrorist attacks in 2001 (indeed, statistics showed a surge in entrepreneurship across the country at that time), and existing small businesses had to make significant adjustments to stay afloat.

The same was true in the wake of the crushing recession that started in late 2007 due to the subprime mortgage crisis. Such cycles of destruction drive some small companies out of business, force others to change course to hold on to what they have or search for ways to boost their growth prospects, and create openings for start-ups that meet needs that did not exist before. This is one of the reasons it is so important for entrepreneurs to pay close attention to developments in the general environment.

The business world has been affected more recently by COVID-19, the super-infectious virus that started sweeping the globe in 2020. As with previous crises, the fallout from the pandemic and related government restrictions led to the closure of countless small businesses, and many others were very adversely impacted. A Federal Reserve report released on February 3, 2021, revealed that 95 percent of the 10,000 small businesses it surveyed were significantly and negatively affected by the pandemic. Nearly 78 percent experienced a decline in revenues, and 46 percent had to lay off staff. These clearly were difficult times.

While operating a business in the middle of a crisis like a pandemic can be challenging, those that survive the ordeal prove that it can be done. Beyond that, as with the start-up trend that followed the 9/11 attacks, the large increase in the number of new business applications in the United States (which reached a 13-year high during the pandemic) shows how devastating environmental shocks can stimulate start-up activity. To increase the chances of new venture success during or following demanding times, an analysis in *Forbes* magazine offers some tips that prospective business owners should consider when starting their businesses.

1. *Determine the reason for starting a business.* You may have spotted a great opportunity in the market or hit upon a wonderful idea to solve an important problem. Or perhaps you have grown tired of working for other people and are now interested in being your own boss. Whatever the reason, it is important to know exactly why you want to start a business, as this can help keep you going when things get tough.
2. *Be sure you can fill a market need.* When launching a business in the middle of a crisis, you must position the start-up to fill a clear market need. During periods of extreme change, some industries become more relevant than others. For example, new ventures created to offer delivery services, home improvement supplies, and fitness equipment did very well during the COVID-19 pandemic.
3. *Focus on digital marketing.* Environmental jolts can limit opportunities to meet with people face-to-face, underscoring the importance of building digital marketing capabilities. Maintaining direct communication with customers, and listening with empathy through these channels will cause them to remember you and return later to buy the solution you provide.
4. *Leverage your network when starting a business*. Using social media tools like Facebook, Twitter, and LinkedIn can help to get the word out. Your network is likely to comprise the first users of your product or service, and they will be able to give you initial feedback. This feedback can guide fixes to any problems with the start-up's offerings as more customers begin to try them out. It is also a good idea to use surveys to solicit feedback that can guide further improvements.
5. *Create a recession-proof business plan*. When the economy stumbles, it is important to have a business that is able to withstand the effects of a recession. If possible, have enough savings to live on for up to one year before starting a business so that you can survive even if you do not see immediate sales. You should also turn to government assistance programs for small businesses, which can ease the financial burdens of new ventures. That's why they exist.

(*continued*)

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To see how to "read the tea leaves of opportunity" during a time of crisis, consider Jeremy Shoykhet, who graduated in 2015 from Northwestern University with a degree in economics. Building on his understanding of supply and demand conditions, Shoykhet recognized great potential in starting a business in the middle of the 2020 pandemic. He figured the situation was ripe for opportunity—at least for what he had in mind. His business, called SuperFastNYC, provides fast, free delivery of snacks and household essentials to residents of New York City. The service obviously filled what was a great need during the pandemic, as the risk of infection and government restrictions deterred people from going out to buy many items they craved or absolutely needed. Shoykhet was able to leverage social media tools, such as Facebook and Instagram, to inform people about the business. This was crucial to his success. But had Shoykhet decided to start his business at just about any other time, he would have been up against a crowded field of established competitors. The pandemic offered him an opening to start a successful business, and that is exactly what he did.

Sources: Caroline Castrillon, "Tips to Starting a Business during Covid," January 17, 2021, https://www.forbes.com/sites/carolinecastrillon/2021/01/17/5-tips-to-start-a-business-during-covid, accessed February 18, 2021; Jonnelle Marte, "Fed Survey Shows Most Small Businesses Lost Sales Due to Pandemic," February 4, 2021, https://www.insurancejournal.com/news/national/2021/02/04/599923.htm, accessed February 17, 2021; "Jeremy Shoykhet," https://www.linkedin.com/in/jeremy-shoykhet-a79a2381/, accessed February 18, 2021; and "SuperFastNYC," https://www.facebook.com/superfastnyc, accessed February 18, 2021.

3-3b Inside-Out Analysis

Identifying opportunities in the external environment is definitely worth the effort, but business concepts make sense only if they fit well with the resources, capabilities, and competencies that an entrepreneur can bring to the world of business. The search for a start-up opportunity can actually *begin* with an inside-out analysis, one that catalogs the start-up's sources of potential strengths (including those that can reasonably be obtained or created) and the unique competencies that can be formed from them. These can provide a platform from which the fruit of new business opportunities can be reached and harvested.

Building on Internal Resources and Capabilities

Entrepreneurs who want to start or build a business based on inside-out analysis will first need to have a solid grasp of the resources and capabilities that are available to them. The term **resources** refers to those inputs that an entrepreneur can use to start and/or operate a business, such as cash for investment, knowledge of critical technologies, access to essential equipment, and capable business partners, to name just a few.

resources
The basic inputs that an entrepreneur can use to start and/or operate a business.

tangible resource
An organizational resource that is visible and easy to measure.

intangible resource
An organizational resource that is invisible and difficult to assess.

capabilities
A company's routines and processes that coordinate the use of its productive assets in order to achieve desired outcomes.

A start-up or small business can have both tangible and intangible resources. **Tangible resources** are visible and easy to measure. An office building, manufacturing equipment, and cash reserves are all examples of tangible resources. But these are very different from **intangible resources**, which are invisible and difficult to assess. Intangible assets can include intellectual property rights such as patents and copyrights, an established brand, a favorable reputation, and an entrepreneur's personal network of contacts and relationships.

Although the terms are often used interchangeably, *resources* technically are not the same as *capabilities*. Whereas resources are inputs to the work of a business, **capabilities** are best viewed as the company's routines and processes that coordinate the use of these productive assets to achieve desired outcomes. Resources can do nothing on their own. Rather, entrepreneurs who figure out how to work with and integrate resources in ways that create value for customers are those most likely to create and build successful ventures.

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Identifying Core Competencies and Achieving a Competitive Advantage

Once entrepreneurs have an accurate view of their resources and capabilities, they will be in a better position to identify core competencies that can be created and used to compete. **Core competencies** are those crucial capabilities that distinguish a company competitively and reflect its general focus and personality. In most cases, these strengths make it possible to achieve a **competitive advantage**, which gives a start-up or small business the upper hand by helping it to provide products or services that customers will choose over available alternatives.

An illustration of how all of this works is provided by Starbucks, which offers a nice selection of gourmet coffees. But that is not its only edge in the marketplace. In fact, many of its competitors, large and small, also provide high-quality coffee products. So why has the company been so successful? Most observers believe that it is the premium product, combined with the special "Starbucks experience," that has allowed the coffee icon to grow from a single store in the mid-1980s to more than 30,000 retail locations in 80 countries today.[31] In a way, Starbucks isn't really in the business of selling coffee; it's more like a great place to hang out that just happens to sell coffee.

Though the success of Starbucks is undeniable, the company's growth has actually unleashed a torrent of new rivals by whetting the market's appetite for both the product and the experience. But how do small firms compete in a Starbucks-saturated market? By focusing on their own unique core competencies and the advantages they can support. Many small shops thrive in this environment by providing free refills, paying meticulous attention to product quality, emphasizing connections with the local community, or taking other steps to showcase their own unique character and individuality. In other words, they establish core competencies by using resources and capabilities in unique ways that reflect the "personality" of their own enterprises.

3-3c Integrating Internal and External Analyses

A solid foundation for competitive advantage requires a reasonable match between the strengths and weaknesses of a given business and the opportunities and threats present in its relevant environment. This integration is best revealed through a **SWOT analysis** (standing for *S*trengths, *W*eaknesses, *O*pportunities, and *T*hreats), which provides a simple overview of a venture's strategic situation. Exhibit 3.5 lists a number of factors that can be classified by this framework. However, these are merely representative of the countless possibilities that may exist.

In practice, a SWOT analysis provides a snapshot view of current conditions. Outside-in and inside-out approaches come together in the SWOT analysis to help identify potential business opportunities that match the entrepreneur and their planned venture. However, because a SWOT analysis focuses on the present, the entrepreneur also needs to consider whether the targeted opportunity will lead to other opportunities in the future (for example, through skill building or an expanded network) and whether pursuit of the opportunity is likely to set off a competitive response by potential rivals. Obviously, the most promising opportunities are those that lead to others (which may offer value and profitability over the long run), promote the development of additional skills that equip the venture to pursue new prospects, and yet do not provoke competitors to strike back.

When potentials in the external environment (revealed through analysis of the general, industry, and competitive environments) fit with the unique resources, capabilities, and core competencies of the entrepreneur (highlighted by internal assessment), and threats outside the start-up or weaknesses within it are manageable, the odds of success are greatly improved. As shown in Exhibit 3.6, this is what we call

core competencies
The capabilities that distinguish a firm competitively and reflect its focus and personality.

competitive advantage
A benefit that exists when a firm is able to offer a product or service that is seen by its target market as better than those of competitors.

SWOT analysis
An assessment that provides a concise overview of a firm's strategic situation.

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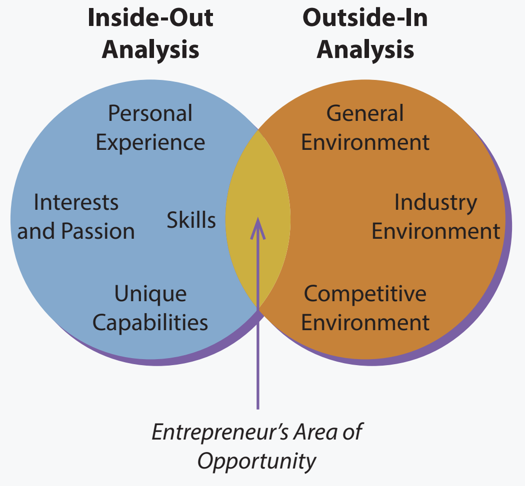
Exhibit 3.5 Examples of SWOT Factors

	Positive Factors	Negative Factors
Inside the Company	***Strengths***	***Weaknesses***
	• Important core competencies • Financial strengths • Innovative capacity • Skilled or experienced management • Well-planned strategy • Effective entry wedge • Strong network of personal contacts • Positive reputation in the marketplace • Proprietary technology	• Inadequate financial resources • Poorly planned strategy • Lack of management skills or experience • Limited innovation capacity • Negative reputation in the marketplace • Inadequate facilities • Distribution problems • Insufficient marketing skills • Production inefficiencies
Outside the Company	***Opportunities***	***Threats***
	• An untapped market potential • New product or geographic market • Favorable shift in industry dynamics • High potential for market growth • Emerging technologies • Changes allowing overseas expansion • Favorable government deregulation • Increasing market fragmentation	• New competitors • Rising demands of buyers or suppliers • Sales shifting to substitute products • Increased government regulation • Adverse shifts in the business cycle • Slowed market growth • Changing customer preferences • Adverse demographic shifts

the entrepreneur's "opportunity sweet spot," an area that typically offers the greatest potential for superior business results. With this in mind, we encourage you to be observant and systematic in your search for opportunities and to think carefully about how these opportunities fit your background and skills, as well as your interests and passions. If you do so, you are much more likely to enjoy the adventure.

Clearly, conducting outside-in and inside-out analyses and integrating the results can help you identify potential business opportunities and then build a solid foundation for competitive advantage. With that foundation, an entrepreneur can begin to position the new venture concept or established company with a well-defined strategy that will be more likely to generate superior financial results.

Exhibit 3.6 The Entrepreneur's "Opportunity Sweet Spot"



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3-4 Selecting Strategies That Capture Opportunities

3-4 Explain broad-based strategy options and focus strategies.

A **strategy** is, in essence, a set of coordinated actions that are carried out to move a business toward a competitive advantage, which can be used to increase its performance. Choosing a strategy that makes sense for a particular entrepreneur and start-up is a critical early step toward superior performance. But keeping an eye on strategy options—both broad-based and focus strategies—can also guide established companies toward success.

3-4a Broad-Based Strategy Options

Firms competing in the same industry can adopt very different strategies. Broadly speaking, companies can choose to build their strategies around an emphasis on either low cost or differentiation as they consider how to position themselves relative to their competitors.

Cost-Based Strategy

To follow a **cost-based strategy**, a firm must hold down its costs so that it can compete by charging lower prices for its products or services and still make a profit. The sources of cost advantages are varied, ranging from low-cost labor to efficiency in operations. Many people assume that cost-based strategies will not work for small companies, and often this is true. However, cost-advantage factors are so numerous and diverse that, in some cases, small businesses may be able to use them with great success. Think about the thousands of small operators who sell used cars on eBay as a primary occupation. Although they lack the scale advantages of the large dealerships against which they compete, they operate with very little overhead by selling exclusively online and handling all features of the transactions involved in order to limit costs. It appears that motivated entrepreneurs can almost always find ways to compete on cost and undercut their much larger competitors.

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To be sure, taking the low-cost path is not without its risks, especially if doing so sparks a price war with established competitors that have deeper pockets and are inclined to take shots at upstarts that want to steal their customers. But perhaps the most enduring downside of this strategy is that it attracts customers who are always searching for the best deal. As a result, it can be a great challenge to develop customer loyalty and generate long-term success.

strategy
A plan of action followed to create a competitive advantage and help an organization achieve superior performance.

cost-based strategy
A plan of action that requires a firm to hold down its costs so that it can compete by charging lower prices and still make a profit.

differentiation-based strategy
A plan of action designed to provide a product or service with unique attributes that are valued by consumers.

Differentiation-Based Strategy

The second general option for building a competitive advantage is following a **differentiation-based strategy**, an approach that emphasizes the uniqueness of a firm's product or service (in terms of some feature other than cost). A firm that can create and sustain an attractive differentiation-based strategy is likely to be a successful performer in the marketplace. For the strategy to be effective, the consumer must be convinced of the uniqueness and value of the product or service, whether real or perceived. A wide variety of operational and marketing tactics, ranging from design to promotion, can lead to product or service differentiation.

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3-4b Focus Strategies

Focus strategies represent a strategic approach in which entrepreneurs try to shield themselves from market forces by targeting a specific group of customers who have an identifiable but very narrow range of product or service interests (often called a *market niche*). By focusing on a specialized market, some small businesses develop unique expertise that leads to higher levels of value and service for customers, which is great for business. In fact, this advantage prompted marketing guru Philip Kotler to declare, "There are riches in niches."[32]

The two broad options discussed earlier—cost-based and differentiation-based strategies—can also be used when focusing on a market niche. Although few entrepreneurs adopt a cost-based focus strategy, it does happen. SturdiSteel, a bleacher manufacturer, decided years ago to focus mostly on bids to install bleachers at event facilities within a one-day's drive of the company headquarters. This decision allows SturdiSteel to save on transportation and other travel-related costs, as well as to sell to dollar-sensitive customers at prices that are significantly lower than those charged by competitors.[33] Clearly, this approach requires a geographically limited market.

Contrast this approach with the differentiation-based focus strategy that Tina Nguyen adopted for her small business, Jax & Bones. Taking inspiration from her pet beagle, Jax, Nguyen came up with the idea of selling high-end pet beds to style-sensitive affluent homeowners who are willing to pay more than $100 for what she calls "nappers" or for her line of luxury pet toys. The target market is quite narrow, but that hasn't stopped her from cashing in. In fact, Nguyen's strategy of offering top-line products in what is largely a commodity marketplace allowed her to generate sales of more than $3 million after only a few years in business,[34] and the venture has continued to grow.

Entrepreneurs can usually select and implement a focus strategy that will allow them to target a market niche within a sizeable industry, thereby avoiding direct competition with larger competitors. This can be accomplished in a number of ways, as discussed in the following section.

Focus Strategy Selection and Implementation

By selecting a particular focus strategy, an entrepreneur decides on the basic direction of a business, which determines the venture's very nature. A firm's overall strategy is formulated, therefore, as its leader decides how the firm will relate to its environment—particularly to the customers and competitors in that environment. This can involve a delicate balancing act, one that keeps the venture out of the crosshairs of industry heavyweights and yet offers enough market promise to provide the start-up with a reasonable shot at getting off the ground.

Focus strategies are very popular because they allow a small firm to operate in the gaps that exist between larger competitors. They also leave entrepreneurs with plenty of room to maneuver as they come up with creative new venture ideas. For starters, focus strategies can be set up in the following ways:

- By restricting the target market to a single subset of customers.
- By emphasizing a single product or service.
- By limiting the market to a single geographical region.
- By concentrating on the superiority of the product or service.

focus strategy
A plan of action that isolates an enterprise from competitors and other market forces by targeting a restricted market segment.

If you want to succeed as a focus player, it's wise to pinpoint a profitable niche and develop great depth of competence in it so that you can *own* it. For example, a repair company may choose to work only on Sub-Zero appliances so as to become the best service option available for that brand. This is very different from offering to repair

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any brand of appliance, which is liable to put the company in direct competition with a major rival like Mr. Appliance. That is, by focusing, repair personnel will be more likely to have the right parts on hand and have greater familiarity with the brand and its quirks, all of which can lead to better and faster repairs that naturally generate positive word of mouth and increased referrals from customers.

Because powerful focus strategies also offer great flexibility, entrepreneurs often find ways to start a number of different specialization strategies within the same industry, with hope of success for each of them. At the same time, however, they must consider problems stemming from overspecialization and competition, which can threaten to erode the profits of such strategies.

Drawbacks of Focus Strategies

A word of caution about selecting a market niche is definitely in order. If a small business becomes too specialized, it may end up with too few customers to be viable. For example, Caroline Weaver has had success selling nothing but pencils at her store, CW Pencil Enterprise in New York City,[35] but such ventures obviously must find enough customers to pay the bills and keep their doors open.

In addition to the dangers of becoming too specialized, firms that adopt a focus strategy often must tread a narrow path between maintaining a protected market and attracting competition. If their ventures are profitable, these entrepreneurs are likely to face an influx of new competitors that will pursue the same niche, thereby luring away customers and driving down returns for all rivals until the segment is no longer profitable. Although it can apply to any type of competitive strategy, this **paradox of attraction** illustrates that the very feature of a market that makes it attractive to one small company (that is, the lack of competition) also makes it attractive to others. Recognizing this and other common pitfalls, strategy guru Michael Porter cautions that a segmented market can erode under any of the following four conditions:[36]

1. The focus strategy is imitated.
2. The target segment becomes structurally unattractive because the structure erodes or because demand simply disappears.
3. The target segment loses its uniqueness.
4. New firms subsegment the industry.

Stated another way, it should be clear that focus strategies do not guarantee a sustainable competitive advantage. Small firms can boost their success, however, by developing and extending their competitive strengths. Good strategic planning can help point the way through these challenging situations, as well as shape the feasibility of the venture.

3-5 Screening New Business Ideas

3-5 Screen business ideas to identify those with the greatest potential.

With all of the approaches to business idea generation described in this chapter, your problem may not be coming up with an idea for a start-up, but coming up with too many. After narrowing your focus to the one that seems most promising, you should complete an in-depth feasibility analysis (discussed later in the chapter) to determine whether the idea you have selected is viable and merits the investment of time and money that will be necessary to launch it. If your new business idea still seems to be a winner, we will then lead you through the steps required to establish a business model that is sustainable and even to write a full business plan (discussed

paradox of attraction
The self-contradictory idea that an attractive market opportunity is likely to draw multiple competitors, thereby diminishing its attractiveness.

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in Chapter 6). At this point, however, you really need to decide on the business idea that you want to consider further. The business idea screening process can help you do this.

It is important to understand that the quality of the final evaluation will be only as good as the information used to generate it. For that reason, screening business ideas requires adequate background research and informed estimates so that the analysis and conclusions will be based on trustworthy facts and reasonable judgments. The process must be more than a dart-throwing exercise. But it also doesn't need to be time consuming. In most cases, one hour will be enough time to complete the screening for each business idea assessed.

Because the business idea screening process is designed to provide a quick assessment, it is by no means comprehensive. Rather, it only takes into account the merits of an idea relative to five very important factors:

1. *Strength of the business idea.* The best business ideas will meet a definite market need, create value for end users, and offer products or services that customers favor and find easy to use. They also will have no fatal flaws (discussed later in the chapter).
2. *Targeted market and customers.* Businesses are more likely to thrive if they focus on a sizeable market that is easy to identify, growing rapidly, and composed of customers with high levels of purchasing power that they are very willing to use. Further, the best customers will be easily reachable through clear channels of promotion.
3. *Industry and competitive advantage.* The most favorable industries for start-ups have few or no competitors, are growing quickly (to allow room for new entrants), and feature high operating margins. They also present few or no barriers to keep new businesses out and would allow a start-up to establish and sustain its specific competitive advantage.
4. *Capabilities of founder(s).* In a best-case scenario, the founder(s) will have industry-related experience, skills, and networks, as well as a great passion for and a good fit with the new business.
5. *Capital requirements and venture performance.* An entrepreneur will fare best when the venture needs little capital to launch, its anticipated profit potential is great, and similar enterprises perform very well. Low levels of liability and other risks are ideal, as is the ability to start the new business incrementally or test it cheaply before full launch.

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The last factor deserves further explanation. If your start-up budget is tight (as is so often the case), a business idea's promise is likely to be determined by your ability to launch a limited version of that idea or to test market reactions to gauge its odds for success. This may be more manageable than you realize through the use of free or cheap tools available online or low-tech methods that can get the job done.

Many entrepreneurs have tested their ideas on a very limited budget, sometimes for $100 or less. Examples of cost-effective methods include using SurveyMonkey.com to contact potential customers and estimate the size of the market, as well as conducting market research at no

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cost by joining online support groups to probe the depth of interest in a planned service offering (if this is permitted and appropriate). You can set up a website for the business using a free template, but be sure it is one that is approved for commercial use. Securing and registering a domain name can be inexpensive if it is original, and limited Web-hosting services can be found for well under $5 a month (though a service upgrade will be needed once website traffic picks up). Google Analytics can be installed for free to track website traffic. Then, you are ready to advertise using Google AdWords, or to try any of a number of other online or social media marketing platforms (Facebook, Instagram, Twitter, Snapchat, etc.) to start promoting your site.

Of course, these are just a few of the options that will be available to you. But testing an idea before launching a business is almost always an advantage, and it fits with the spirit of the *lean start-up method*, which is a very powerful approach that will be described more fully in Chapter 6.

Finally, you should remember that an idea can be assessed more than once to allow for adjustments that would improve the start-up's projected viability. For example, shifting to a narrower market niche might lead to a smaller venture, but it can also reduce the number and strength of competitors, increase the willingness of customers to pay for the product, lower start-up costs, boost profitability, and so on.

The screening process just presented cannot provide a *perfect* estimate of the potential of a given business idea. One reason is that all items are weighted equally for the sake of simplicity, even though some may have more impact on an idea's potential than others. Nonetheless, this practical method for assessing multiple ideas will let you efficiently decide which one would be best to pursue. Then, after you have narrowed your focus to the one concept that you want to consider further, you should analyze the feasibility of your idea to determine its potential in more depth.

3-6 Is Your Start-Up Idea Feasible?

3-6 Assess the feasibility of a start-up idea.

We will show you in Part 3 of this book how to develop a business model and then write a business plan that will spell out the details of your planned enterprise and its start-up considerations. But it is very important that you take an intermediate step first, one that tells you how *feasible* your business idea may be. A **feasibility analysis** is a preliminary assessment of a business idea that gauges whether or not the venture envisioned is likely to succeed. Of course, it may also indicate that the concept has merit, but only if it is modified in some important way.

Developing a solid feasibility analysis before jumping ahead to the business plan can help ensure that the planned venture will not be doomed by a **fatal flaw**—that is, a circumstance or development that, in and of itself, could render a new business unsuccessful. It is estimated that nine out of ten entrepreneurs fail because their business concept is deficient. Because they are so motivated to strike out on their own, aspiring small business owners often don't do their homework ahead of time to be sure their ideas actually have a chance to succeed. Talent alone can only take you so far; you also need to have a well-conceived business concept if you are to stand up against the rough-and-tumble of a competitive marketplace.

With an awareness of the risks of jumping in prematurely, entrepreneurs must look deeply and honestly for potential weaknesses in their own start-up ideas.

feasibility analysis
A preliminary assessment of a business idea that gauges whether the venture envisioned is likely to succeed.

fatal flaw
A circumstance or development that alone could render a new business unsuccessful.

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No matter how remarkable the business concept may seem to be, moving forward is pointless if it must use a manufacturing process that is patent protected, requires start-up capital that cannot be raised, ignores market limitations, or is unsound in some other way.

John W. Mullins is a serial entrepreneur and an associate professor at the prestigious London Business School. He is also the author of *The New Business Road Test*, a book that underscores the importance of identifying the fatal flaws of a business idea before it is too late:[37]

> If [entrepreneurs] can find the fatal flaw *before* they write their business plan or *before* it engulfs their new start-up . . . they can deal with it in many ways. They can modify their idea—and pivot to a better version—thereby shaping the opportunity to better fit the hotly competitive world in which it seeks to bear fruit. If the flaw they find appears to be a fatal one, they can even abandon the idea before it's too late.
>
> Better yet, if, after [questioning] and probing, testing and especially experimenting for answers, the signs remain positive, they can embrace their opportunity with renewed passion and conviction, armed with a new-found confidence that the evidence—not just their intuition—confirms their [insight]. Their idea really is an opportunity worth pursuing.

Deciding to complete a feasibility analysis before proceeding to the business plan stage can save a lot of time, money, and heartache. Or, as Mullins points out, it may reaffirm the power of a business idea and strengthen the resolve to move forward, providing a reserve of energy and commitment that will come in handy when the going gets tough—and it definitely *will* get tough as the venture unfolds.

Keep in mind that success in entrepreneurship is generally the result of three elements that come together in such a way that the new enterprise gets the thrust it needs to launch and the sustained power to keep it going. These three elements are a market with potential, an attractive industry, and a competent individual or team with the skills and capabilities to pull it all together. (These elements, as well as the micro-level market niche and industry competition, are shown in Exhibit 3.7). A feasibility analysis investigates each of these elements.

3-6a Market Potential

It is important to make clear the distinction between a market and an industry, as the two are very different. A market consists of *buyers*, current or potential customers who are interested in purchasing a particular class of products or services to satisfy wants or needs—and they must also have the ability to pay for them. An industry, on the other hand, is composed of *sellers* who compete with one another by offering identical or similar products or services for sale to the same general group of buyers.

When assessing the pool of potential buyers that a business might serve, it is important to think of that market on two levels—the broad macro-market and the fragments or niches (micro-markets) that can be identified within the broader market. Entrepreneurs with limited business aspirations may find attractive niche opportunities acceptable. However, Mullins points out that "it is also important to know which way

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Exhibit 3.7 A Feasibility Analysis Framework

Source: Adapted from John W. Mullins, The New Business Road Test: What Entrepreneurs and Investors Should Do before Launching a Lean Start-up. (London: Pearson Education Limited, 2018).

the tides are flowing."[38] That is, a desirable niche today is likely to lose its luster over time if the broad market from which it is derived is trending toward the negative. In most cases, the health of the macro-market can be a very useful predictor of the future potential of the micro-markets within it.

An entrepreneur with lofty ambitions may be satisfied with an attractive niche only if it can serve as a point of entry into a macro-market with prospects for fast growth and ample long-term potential. The attractiveness of that niche is limited if the fundamental features of the macro-market that support it are not promising. In any case, assessments of the market should be completed on both levels, and each level will be driven by a very different set of questions.

As part of a feasibility analysis, an evaluation of the general environment will help to identify a potential-laden trend that can support promising start-up ideas, one of which you will likely select for more thorough consideration. This sets the framework for a macro-market analysis, establishing the boundaries for research regarding the number of customers targeted and their overall purchasing power and habits.

The micro-level assessment, however, goes in a very different direction. A start-up idea will most likely be tied to a market niche that seems to offer acceptable prospects for growth and, perhaps more important, a path to market entry that is somewhat protected from existing competition. (These dynamics are explained in some detail in our earlier discussion of focus strategies.) Your evaluation of the micro-market should clarify the unique value that the start-up idea would offer customers, but it should also provide estimates of the size of the niche, its rate of growth, and its long-term prospects.

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3-6b Industry Attractiveness

Like markets, industries should be considered from both a "big-picture" and a more focused point of view. A macro-level analysis assesses the overall attractiveness of the industry in which the start-up will be established, perhaps summarized best by Michael Porter's model of industry forces. Ultimately, these insights will tell you whether industry conditions would be favorable for the start-up you hope to pursue. The more favorable the conditions, the more attractive the industry. Keep in mind, however, that a single unfavorable force can be enough to tip the balance toward unattractiveness, so it is important to consider these conditions with great care. Foreknowledge of adverse conditions helps an entrepreneur make the necessary adjustments to compensate, or it may suggest that it is time to pull the plug on that particular concept. Either way, the feasibility analysis will have served its purpose by highlighting problems in a particular industry setting.

A micro-level industry assessment is focused less on whether industry conditions overall are suitable to launching a new business and more on the probability of a start-up's success over the long run. The aspiring entrepreneur must then think carefully about the proposed venture to determine whether the advantage it holds can be protected from competitive pressures once rivals realize that they have a new challenger. This will be determined mostly by the start-up's potential to generate adequate sales and the strength of protective barriers that will shield it from competitors' efforts to replicate its strengths.

3-6c New Venture Leadership

Finally, a new business will only be as strong as its leader, so it is important to assess whether the entrepreneur, or entrepreneurial team, is up to the task. Mullins suggests that three dimensions of capability are important here: (1) the fit of the venture with its leader's mission, aspirations, and level of comfort with the risk involved, (2) the leader's grasp of factors that are critical to the success of the enterprise and their ability to execute on these, and (3) the leader's connections to suppliers, customers, investors, and others in the industry who will be essential in making the venture work.[39]

These factors will have direct and indirect effects on the venture's odds of success. For example, the intensity and consistency of an entrepreneur's mission focus, personal aspirations, and tolerance for the risks involved fuel the drive and commitment required to get a business off the ground and keep it moving forward. And the capabilities that come from a deep knowledge and understanding of the new venture, as well as a strong network of professional connections, allow a leader to sense new product and market trends before others see them coming and make wise decisions when positioning products or services in competitive spaces.[40] In the end, these qualities determine whether a leader has what it takes to start a new business—and whether they will prevail.

Conducting a feasibility analysis takes time and effort, but it serves the very important purpose of identifying flaws in a business concept that may be fatal to the proposed start-up. While many of these flaws can be corrected by a course adjustment, the analysis might expose major flaws that cannot be addressed or corrected. If it does, you would be wise to abandon the concept and shift your energies to a more attractive alternative. Regardless of the final outcome, completing a feasibility analysis will let you know what needs to be done before you commit time, money, and energy to complete a full-scale business plan.

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3-1. Distinguish among the different types and sources of start-up ideas.

- New market ideas are concerned with products or services that exist but are not present in all markets.
- New technology ideas involve new or relatively new knowledge breakthroughs.
- New benefit ideas are based on new and improved products or services or better ways of performing old functions.
- Research shows that entrepreneurs claim prior work experience is the leading source of inspiration for start-up ideas.
- Personal experience leads many aspiring entrepreneurs to make the decision to start a business.
- Some entrepreneurs start their new ventures based on their hobbies and personal interests, which can add passion and energy to the enterprise.
- Accidental discoveries may also provide useful ideas for start-ups.
- Personal contacts, trade shows, current trends, and trade publications are among other idea leads for start-ups.

3-2. Use innovative thinking to generate ideas for high-potential start-ups.

- A commitment to creative thinking can generate many ideas for new businesses and also help to keep an existing business fresh and moving forward.
- Business ideas can be spurred by addressing existing problems, taking a cue from existing products and services, finding new ways to deliver products and services, and tapping into the potential of emerging possibilities.
- More specifically, ideas for new businesses include combining businesses to create a market opening, responding to a trend, improving the function of an existing product or service, expanding the market for a product or service, making a product or service "green," offering products through a subscription service, meeting common customer needs through a mobile business, and selling directly to the consumer.

3-3. Describe external and internal analyses that can shape the selection of venture opportunities.

- Outside-in analysis considers the external environment, including the general, industry, and competitive environments.
- Opportunities arise for small businesses that are alert to changes or openings in the external environment.
- Major trends in the general environment are economic, sociocultural, political/legal, sustainability, global, technological, and demographic in nature.
- The major forces that determine the potential attractiveness and profitability of a target industry include the threat of new competitors, the threat of substitute products or services, the intensity of rivalry among existing competitors, and the bargaining power of suppliers and buyers.
- It is extremely important to determine the strength, position, and likely reactions of competitors to industry newcomers.
- Inside-out analysis helps the entrepreneur to understand a start-up's sources of potential strengths and the unique competencies that can be formed from them.
- Resources are the basic inputs used to start and/or operate a business. Tangible resources are visible and easy to measure, whereas intangible resources are invisible and difficult to quantify.
- Capabilities refer to a firm's routines and processes that coordinate the use of its productive assets to achieve desired outcomes.
- Core competencies are those capabilities that can be leveraged to enable a firm to do more than its competitors, thereby leading to a competitive advantage. They also reflect a venture's general focus and personality.
- A SWOT analysis provides an overview of a firm's strengths and weaknesses, as well as opportunities for and threats to the organization.
- An entrepreneur's "opportunity sweet spot" is found at the point of overlap of emerging potentials in the

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external environment and the unique strengths and capabilities of the entrepreneur and the venture.

3-4. Explain broad-based strategy options and focus strategies.

- Broad-based strategy options include both cost-based and differentiation-based strategies.
- A cost-based strategy requires the firm to become a low-cost provider within the market while still making a profit.
- A differentiation-based strategy emphasizes the uniqueness of a firm's product or service.
- Focusing on a specific market niche is a strategy that small firms often use successfully.
- Entrepreneurs can exploit very different market niches within the same general industry.
- In selecting a particular focus strategy, an entrepreneur determines the basic direction of the business, and this affects its very nature.
- A focus strategy may involve restricting focus to a single subset of customers, emphasizing a single product or service, limiting the market to a single geographical region, or concentrating on product or service superiority.
- The benefits of a focus strategy can diminish when the firm becomes too specialized, the strategy is imitated, the target segment becomes unattractive or demand dwindles, the segment loses its uniqueness, or new firms subsegment the industry.

3-5. Screen business ideas to identify those with the greatest potential.

- If too many new business ideas are generated, it will be necessary to use a screening process to determine which idea deserves more focused attention.
- The screening of ideas can be performed quickly (usually in an hour) and should precede the decision to complete a feasibility analysis of the idea selected.
- The five main factors considered in the screening process include the strength of the idea, the targeted market and customers, industry and competitive advantage issues, the founder's capabilities and fit with the new business, and capital requirements and venture performance.
- There are ways to test many new business ideas in part or "on the cheap," and the practicality of doing this is an important consideration in the screening process.
- An idea can be revised and screened again if doing so will improve its projected viability.

3-6. Assess the feasibility of a start-up idea.

- A feasibility analysis investigates three elements of an entrepreneurial venture: a market with potential, an attractive industry, and a capable leadership team.
- A feasibility analysis should be conducted to identify potential fatal flaws prior to making the decision to invest the substantial time, energy, and other resources required to put together a full-scale business plan.
- It's important to distinguish between a market and an industry. A market consists of all buyers of a product or service; an industry is made up of all sellers who compete for the same market.
- The potential of a market should be assessed on two levels—the broad macro-market and the micro-market—because the long-run potential of a market niche is determined largely by the outlook for the overall market.
- The industry should be assessed for its overall attractiveness (potential for profits) and the specific context of direct competition, which can greatly impact a start-up's prospects for success.
- Entrepreneurs are likely to be successful in a start-up situation to the degree that the planned venture fits with their mission, aspirations, and tolerance for risk.
- Successful entrepreneurs understand and are able to manage the factors that are critical to the operation of the enterprise, and they are able to connect with suppliers, customers, investors, and others whose involvement is crucial to the future performance of the planned venture.

Key Terms

capabilities p. 74
competitive advantage p. 75
competitive environment p. 69
core competencies p. 75
cost-based strategy p. 77
differentiation-based strategy p. 77
entrepreneurial alertness p. 59
fatal flaw p. 81
feasibility analysis p. 81
focus strategy p. 78
general environment p. 69
industry environment p. 69
intangible resource p. 74
new benefit idea p. 60
new market idea p. 60
new technology idea p. 60
opportunity recognition p.59
paradox of attraction p. 79
pivot p. 60
resources p. 74
serendipity p. 62
start-up p. 59
strategy p. 77
SWOT analysis p. 75
tangible resource p. 74

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Discussion Questions

1. What are the three basic types of start-up ideas? What are the most common sources of inspiration for start-up ideas?
2. Describe the approaches outlined in this chapter that can be used to generate creative new business ideas. What are the most important features of each of these?
3. List the most important trends of the general environment. What are some ways in which each trend might affect a small business?
4. What are the primary factors that shape competition in an industry, according to Porter's model? In your opinion, which of these factors will have the greatest impact on industry prices and profits?
5. How are tangible and intangible resources related to a venture's capabilities? How are capabilities linked to core competencies? What is the connection between core competencies and competitive advantage?
6. What is a SWOT analysis? How can a SWOT analysis help an entrepreneur to match opportunities in the external environment with organizational capabilities?
7. What are the two basic strategy options for creating a competitive advantage?
8. What is meant by the term *focus strategy*? What are the advantages and disadvantages of a focus strategy? What must an entrepreneur know and do to maintain the potential of a focus strategy?
9. Under what circumstances is a new business idea screening process useful? Why? What are the major factors that should be considered when screening new business ideas?
10. Name and describe the major features of feasibility analysis. Why is conducting a feasibility analysis important?

You Make the Call

Situation 1

Jonathan Lugar, 17, had just finished helping his mom with a garage sale when it occurred to him that he might create a business to do the same for others and make a little money for college. The idea was to offer a service that would take the headache out of running a garage sale. Lugar would handle all advertising and sale setup, and his experience with other garage sales in the area would allow him to coach sellers on pricing so that items would actually be purchased. He figured he could charge $200 per job for sales that bring in $400 or less, but he and the seller would split sales above $400 on a 50-50 basis. Lugar believes the greatest value added from his services would be from his pricing insights, since most people rarely have a garage sale and thus have little idea about how much to ask for items. Careful pricing would make his customers happy, since they could maximize their sales and minimize the risk that they would be left with the very items they were trying to get rid of. In fact, Lugar planned to keep track of how much things sold for to fine-tune his pricing advice. He estimates that his start-up costs would be minimal and would come mostly from the use of his truck and some fuel.

Question 1 How would you classify Lugar's start-up idea? Is it a new market idea, a new technology idea, or a new benefit idea?

Question 2 What was the source of Lugar's start-up idea?

Question 3 Would you recommend that he give this start-up concept a try? Explain your reasoning.

Situation 2

Willy Whitlock loves to restore classic cars, but run-of-the-mill classics are not what he goes for. His fascination is with rolling stock from the 1950s and 1960s rebuilt to be fast, fun, and true works of art. And that is the focus of his restoration garage start-up, Smokin' Wheels by Willy, a company name so good that it immediately gives away the essence of the business. Since the launch of his Tucson, Arizona–based company in 2018, Whitlock has driven his new venture to $2 million in sales by offering classic beauties (at $45,000 to $150,000 each) that are "tricked out" to the specific tastes of very picky collectors and classic car enthusiasts.

Uniqueness is key to the company's strategy, but it goes further than that. Whitlock uses stunning paint work, creative pinstriping, and lots and lots of chrome to create breathtaking cars that are guaranteed to turn heads—but painted and accessorized in each case to suit the precise tastes of the car lover who orders them. These are true works of art that balance high performance and functionality with breathtaking aesthetics. Whitlock's work allows clients to add time-honored classic car models to their

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collections, but with super-high-performance drivetrains and one-of-a-kind paint applications and design details.

Question 1 Based on the frameworks introduced in this chapter, what kind of strategy is Whitlock following in his new venture?

Question 2 Identify the strengths upon which this business is built. Do you see any weaknesses that may be of concern to the company?

Question 3 Are there any particular threats that will put Smokin' Wheels by Willy at risk as time goes on? Can you see any opportunities that may allow the company to expand in the future?

Question 4 What resources and capabilities form the foundation for the business? Do you think these will be sufficient to create a *sustainable* competitive advantage for the company? Why or why not?

Situation 3

Overcoming jet lag on international trips is crucial to making good decisions when working with overseas counterparts, especially when difficult negotiations are involved. If an executive wants to be refreshed and on top of their game, Phillip Sanderson has a solution. Perfect Illuminations, his five-year-old company, has been offering sleep-recovery services through business-class hotels in major cities around the world. So far, he has worked out deals with eight partner hotels in four cities: New York, Tokyo, London, and Paris. His system provides booths in which guests can bask in 30 minutes of simulated sunshine generated from electronic light boxes. Science has shown that this form of light therapy can help to restore the body's natural sleep rhythms well ahead of the recovery time that it normally takes to reset one's internal clock. The price of the service varies, depending on the city and the specific deal worked out with each partner hotel, but the client response so far has been encouraging. Now Sanderson is trying to identify other cities where he can help weary travelers avoid jet lag.

Question 1 Will the market for Sanderson's product continue to grow in the years ahead?

Question 2 Given the company's success so far, what sources of competition should he expect?

Question 3 What steps would you recommend that Sanderson take to protect his company from the onslaught of competition that is likely to come?

Experiential Exercises

1. The U.S. Census Bureau provides massive amounts of data that can be used to shape business ideas so that they are compelling and more likely to succeed. Check out its profiles through the QuickFacts feature to get a feel for how useful these data can be (learn more at https://www.census.gov/quickfacts/fact/table/US/PST045219).

   On the QuickFacts website, enter a specific city and state into the search window, and then review the data provided. Next, propose three businesses that would be supported by the demographics of your selected city. Prepare a brief report on your findings, outlining the three proposed businesses and rank-ordering them according to your assessment of their potential based on the data. Be prepared to justify each proposed business and the thinking behind ordering them as you have.
2. Select a product that is manufactured by a successful small business and try to determine which features of the general and/or industry environments are the foundation for its creation and success.
3. Visit the website of a business publication, such as *Entrepreneur*, *Inc.*, or *The Wall Street Journal*, and describe the type of target market strategy you believe the newspaper or magazine uses.
4. The next time you visit a local small retailer, ask the manager to describe the firm's customer service policies. Do you think these policies are consistent with what you know about the company's primary strategy? Be prepared to present a case defending your conclusions.
5. Working in small groups, write a brief but specific description of the best target market for a new product that is familiar to most of the class. Designate a member of each group to read the group's market profile to the class.
6. Visit the website of a small business to identify the external factors (such as those in the general, industry, and/or competitive environments) as well as the internal factors around which the business has been created. Does the firm seem to be more sensitive to internal or external dynamics? Given your knowledge of the business, is that good or bad?
7. A company called Brompton manufactures and sells folding bicycles. Take a look at the information found on the company's website (https://us.brompton.com). Using the terminology introduced in this chapter, identify the specific type of strategy Brompton Bikes is using to expand its business.

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Chapter 3 Case

Please see Appendix A for the Chapter 3 Case Study.

Endnotes

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Chapter

4

Franchises and Independent Contracting in the Gig and Sharing Economies

Learning Objectives

The primary purpose of the Franchises and Independent Contracting in the Gig and Sharing Economies chapter is to introduce you to two additional methods of starting a business by using other models. By studying this chapter, you should be able to . . .

4-1 Define *franchise* and other key terms related to franchising.

4-2 Distinguish the pros and cons of franchising.

4-3 Outline the process for evaluating a franchise opportunity.

4-4 Explain the meanings of the terms *independent contractor, gig economy*, and *sharing economy* and their importance to entrepreneurs.

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Spotlight on Small Business

Duck Donuts

https://www.duckdonuts.com/location/woodbury-mn/

During the COVID-19 pandemic, hundreds of businesses closed daily. Duck Donuts franchisees Desirea and Justin Butler saw their revenues decline by 48 percent in 2020, but they were determined that they would not be one of those closures.

After graduating from the University of Delaware with a degree in accounting, Desirea served as a finance officer with the U.S. Air Force. When her active duty service ended, she joined Deloitte as a senior auditor. Justin had grown up in a family of entrepreneurs and surprised himself and his family by joining a corporation out of college rather than starting his own business. Like Desirea, he has a degree in accounting (from Saint Louis University) and took a job as a senior auditor with Bank of America. Desirea and Justin married while both were working in Charlotte, North Carolina. When opportunities opened for both of them with Synchrony Financial (formerly GE Capital Retail Finance), they found themselves living in Minnesota.

Not long after arriving in Minnesota, the Butlers made the decision to try something on their own. They were hunting for a location for a Rita's Italian Ice franchise, a brand they had come to love, when an existing franchisee put his business up for sale. After becoming franchisees with Rita's, Desirea and Justin recognized that franchising worked for them. They looked for another concept and added a Duck Donuts franchise to their company. Their operations were doing so well, they were negotiating to open a second location in the Mall of America, the nation's largest shopping mall. And then the pandemic hit. Suddenly, the focus turned from growth to survival. As Justin said, "We're in it for the smiles and making people happy, but ultimately we're in it to make a profit."

The Duck Donuts franchisor was helpful and encouraging in cost control and diversification for the Butlers and other franchisees. Justin discovered that getting to know other franchisees was valuable, especially learning from those who had found ways to expand the brand. Although he anticipated that walk-in traffic along with catering and special orders would eventually return, he also began evaluating drive-thru and delivery-only formats as he rethought the second location that they still wanted to open.

The Butlers did not rely exclusively on their franchise network. As independent business owners, they knew they bore the responsibility for keeping the company going. In 2020, Comcast launched Comcast RISE, a multi-year program of consulting, media, and creative production services targeting Black, Indigenous and People of Color (BIPOC)-owned small businesses. The Butlers' franchise, Duck Donuts of Woodbury, was one of thirteen award recipients in the Twin City region of Minnesota and one of approximately 700 nationwide.

GRANDBROTHERS/SHUTTERSTOCK.COM

Justin was also highlighted in *Franchise Times* magazine when Duck Donuts was selected as the national winner of the *Franchise Times* Zor Awards, recognizing the best franchises to buy in 2021. Both franchisors and franchisees struggled to survive during the pandemic, but many, like the Butlers, worked hard, collaborated, and innovated toward brighter futures as the economy improved.

Sources: Jason Puckett and Naswa Bawab, "VERIFY: Are 800 Small Businesses Closing Each Day in the US?" https://www.king5.com/article/news/verify/verify-800-small-businesses-closing-a-day/507-1d1f6f90-c558-4307-b5eb-c02b420505f2, accessed March 2, 2021; "Duck Donuts to Open Its Second Minnesota Location, at the Mall of America," https://bringmethenews.com/minnesota-lifestyle/duck-donuts-to-open-its-second-minnesota-location-at-the-mall-of-america, accessed March 3, 2021; Dwight Hobbes, "Black Business Spotlight: Corporate Backgrounds Inform Couple's Franchise Venture," https://spokesman-recorder.com/2018/05/26/corporate-backgrounds-inform-couples-franchise-venture/, accessed March 3, 2021; "Comcast RISE Awards 13 Black-Owned, Small Businesses in Twin Cities with Marketing and Technology Resources and Makeovers," https://twincities.comcast.com/2020/12/01/multiyear-program-opens-eligibility-to-small-businesses-owned-by-black-indigenous-people-of-color/, accessed March 3, 2021; and Laura Michaels, "Get In on the Action," *Franchise Times*, March 2021, pp. 14–17.

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In this chapter, we examine methods by which entrepreneurs can become business owners in collaboration with others. Franchisees and independent contractors are independent in the ownership of their companies, but they agree to some constraints through contracts with various business partners. Why would you agree to a contract that obligates you to act in certain ways and restricts you from other actions? The key is the expected benefit of something valuable, like more security, greater revenues, or supply chain support. The Spotlight feature highlighted how the Butlers chose to become franchisees with two different franchisors. So, let's begin by looking at the franchise model.

4-1 What Is a Franchise?

4-1 Define *franchise* and other key terms related to franchising.

The franchise model has been around for a long time in various forms. Some consider the model for modern franchising to be the early Roman Catholic Church, when a pope authorized tax collectors to retain a portion of the money they collected and turn the rest over to the church.[1] Others point to the British government's granting of property in the Middle Ages to feudal lords who would, in turn, raise armies, collect taxes, and establish toll roads. In some cases, the noblemen would give a portion of the land to tenant farmers in exchange for some of their crops.[2]

The Singer Company is credited with being the first franchisor in the United States.[3] In 1851, Isaac Merritt Singer entered into agreements with local retailers to give them exclusive rights to sell Singer sewing machines. His contract became the basis for those used by franchisors to this day. Some historians, however, contend that Benjamin Franklin was actually the first U.S. franchisor.[4] They describe the arrangement he made with a printer in South Carolina to reproduce *Poor Richard's Almanac* columns. (An interesting side note is that the widow of the South Carolina printer eventually took over her late husband's business, making her the first female franchisee in North America.)

4-1a Franchising Terminology

Knowledge of the language used in franchising is essential if you are considering purchasing this type of business. Definitions for some of the most common terms follow:[5]

- A **franchise** is a method of distributing products or services in a particular geographic area. It involves a franchisor, which establishes the brand's trademark or trade name and business system, and a franchisee, which pays royalties to the franchisor and often an initial fee for the right to do business under the franchisor's name and system.
- **Franchising** is a process for expanding a business and distributing goods and services through a licensing arrangement.
- A **franchisor** is the party in a franchise contract that specifies the methods to be followed and the terms to be met by the other party.
- A **franchisee** is the party in a franchise contract that is granted a license to do business under a particular trademark and trade name by the franchisor.

Franchising is based on mutual trust between the franchisor and franchisee. The franchisor provides business expertise (marketing plans, management guidance, financing assistance, site location, training, etc.) that otherwise would not be available to the franchisee. The franchisee brings the entrepreneurial spirit and drive necessary to make the franchise a success.

franchise
A method of distributing products or services in a particular geographic area.

franchising
A process for expanding a business and distributing goods and services through a licensing arrangement.

franchisor
The party in a franchise contract that specifies the methods to be followed and the terms to be met by the other party.

franchisee
The party in a franchise contract that is granted a license to do business under a particular trademark and trade name by the franchisor.

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There are two primary forms of franchising:

- **Product and trade name franchising**—A franchisor owns the right to a product or trademark and sells that right to a franchisee. Ford automobile dealers, Pepsi-Cola soft drink bottlers, and Chevron convenience stores and service stations are examples of companies engaged in this type of franchising
- **Business format franchising**—The franchisor often provides a full range of services, including site selection, training, product supply, marketing plans, and even assistance in obtaining financing. Quick-service restaurants (such as Carl's Jr.), hotels and motels (such as Choice Hotels), and business services (such as Jani-King) typically engage in this type of franchising.

product and trade name franchising
A process whereby a franchisee is granted the right to use a widely recognized product or trademark.

business format franchising
A process whereby a franchisee is provided with an entire marketing, management, and supply system geared to entrepreneurs.

In order to become a franchisee, you need to enter into a legal contract with a franchisor, spelling out your relationship and obligations to each other. This is known as a **franchise contract**. Before you sign this agreement, the franchisor must provide you with a Franchise Disclosure Document, which will be described later in this chapter. Franchisors establish organizational structures and designate employees or partners to expand the number of franchised outlets and to monitor their performance. The most frequent means for carrying out these growth strategies are through use of the following:

franchise contract
The legal agreement between a franchisor and franchisee.

- A **master licensee**, a firm or individual having a continuing contractual relationship with a franchisor to sell its franchises. This independent company or businessperson acts as an intermediary or sales agent and is responsible for finding new franchisees within a specified territory. Master licensees may provide support services such as training and warehousing, which are more traditionally provided by the franchisor. U.S.-based franchisors often use master licensing arrangements to expand into other countries, selecting successful foreign business companies and leaders to open units of their own and then "sub-franchise" to others.
- **Multiple-unit ownership**, the ownership of more than one unit of the franchised business by a single franchisee.
- **Area developers**, individuals or firms that obtain the legal right to open several franchised businesses in a given area.
- **Piggyback franchising**, the operation of a retail franchised outlet within the physical facilities of another business. An example of piggyback franchising occurs when Subway operates a restaurant within a truck stop.
- **Multibrand franchising**, the operation of several franchised businesses within a single corporate structure. Multibranding can occur at the franchisor level—Neighborly is a platform for nine home service franchise brands, including Glass Doctor, Molly Maid, Mr. Handyman, and more.[6] And it can be used by franchisees, such as Desirea and Justin Butler, who purchased both Rita's Italian Ice and Duck Donuts.
- **Co-branding**, bringing two franchise brands together under one owner. You often see co-branding by service station owners who obtain a franchise from their oil and gasoline suppliers, as well as from quick-service restaurant organizations, such as Subway or McDonald's.

master licensee
An independent firm or individual acting as an intermediary or sales agent with the responsibility of finding new franchisees within a specified territory.

multiple-unit ownership
Ownership by a single franchisee of more than one unit of the franchised company.

area developer
An individual or firm that obtains the legal right to open several franchised outlets in a given area.

piggyback franchising
The operation of a retail franchised outlet within the physical facilities of a host business.

multibrand franchising
The operation of several franchised businesses within a single corporate structure.

co-branding
Bringing two or more franchise brands together within a single enterprise.

4-1b The Impact of Franchising

The International Franchise Association (IFA) sponsors studies of the impact of franchising on the U.S. economy. The mission of the IFA is to protect, enhance, and promote franchising.[7] Founded in 1960, one of the first actions taken by the original

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members was to establish a Code of Ethics. The IFA provides franchisors, franchisees, and suppliers with guidelines for self-regulation through a framework for best practices.

The IFA conducts periodic studies and offers projections of the impact of franchising in the United States economy. The Franchise Business Economic Outlook 2021 report reflected the downturn resulting from the COVID-19 pandemic. Total employment among franchises was reported as 7.5 million, representing a loss of 940,000 jobs. The number of franchise establishments declined by 2.6 percent, to 753,770. The contribution of franchising to the gross domestic product (GDP) of the United States also declined—it was 5.6 percent lower in 2020 than in 2021.[8] Nevertheless, franchising plays an enormous role in the American economy. These figures provided by the IFA actually underestimate the full impact of franchising on the economy because franchising stimulates activity and generates growth in many non-franchised businesses, such as suppliers and lenders.

4-2 The Pros and Cons of Franchising

4-2 Distinguish the pros and cons of franchising.

"Look before you leap" is an old adage that should be heeded by entrepreneurs who are considering franchising. Weighing the purchase of a franchise against alternative paths to starting a business is an important task, as is the selection of the franchisor with which the entrepreneur will affiliate. There are both advantages and disadvantages to the franchise model.

4-2a The Pros of Franchising

Perhaps the most fundamental argument in support of the franchise model is that it reduces the level of risk for business owners. Although research studies have shown mixed results when comparing survival rates of franchised companies to those of independent businesses, franchising might increase the likelihood of success for a number of reasons:

1. *Established, reputable franchisors offer business models with proven track records.* Franchisors have already experienced the situations that you might face when starting a business independently. A good franchisor will likely have a lower failure rate as a result of careful screening of franchise applicants—even potential franchisees who qualify financially are sometimes rejected. Firms that grow through franchising begin with company-owned stores, where they develop their fundamental business model, leading to a tried-and-true method of operating the business. They document the procedures that work, compile them in an operations manual, and provide the manual to franchisees.
2. *Attractive franchisors offer value through trade names and trademarks that are well known to prospective customers*, such as Jiffy Lube, Century 21, and Pizza Hut. When you open your own business, it can take a long time and a lot of money to get your name established and customers in your door or to your website. When you become a franchisee, however, the franchisor has laid the groundwork. If customers have been satisfied with the products and services they have received from one unit in a chain, they are likely to do business with another store that carries that company's name.
3. *When a new franchisee comes on board, franchisors provide detailed operations manuals that explain the specific steps required to operate the enterprise profitably.* An operations manual may be the single most valuable tool provided to

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a franchisee. Following the path laid out in the manual helps the new owner avoid mistakes that often occur with a start-up business, such as failing to control costs and investing in the wrong equipment or inventory.

4. *Franchisors support their franchisees by providing training, reducing purchasing costs, and designing promotional campaigns.* Individual franchisors vary in the depth of support they provide. The training received from franchisors may be invaluable to many small entrepreneurs because it compensates for weaknesses in their managerial skills. Training by the franchisor often begins with an initial period of a few days or weeks at a central training school and then continues at a franchise site. McDonald's is widely recognized for its off-site franchisee training at Hamburger University.
5. *A number of franchisors provide or facilitate financing for franchisees.* Companies such as GNC and Wingstop have formed alliances with banks to create preferred lending programs for franchisees. The International Franchise Association encourages franchisors to recruit minorities and veterans as franchisees by offering financial incentives. Many prospective franchisees find that they can work with banks to obtain loans guaranteed by the U.S. Small Business Administration (SBA) in order to finance the franchise fee and start-up costs. The SBA maintains a registry of franchisors who have gone through an eligibility review service, which speeds up loan processing for franchisees.
6. *Franchising can be a way for existing companies to diversify.* Owners of a small business who have achieved success may find themselves in mature industries with limited growth potential. Their current company may provide the resources for acquiring a franchised business in an industry with more opportunities. As managers of a successful enterprise, they may decide that adopting a proven model will lead to faster growth than starting from scratch.

4-2b The Cons of Franchising

Despite the publication of the IFA's ethics code, some franchisors engage in practices that trouble regulators, legislators, and the business community at large. These concerns include the following:

1. *Financial issues.* Although we identified financial support as one of the advantages of franchising, potential negative factors also exist. Some franchisees have felt misled about earnings opportunities. They report being told that they could expect high returns on their investment, only to discover that few, if any, franchisees achieved those results. I Heart Mac & Cheese is one example of a franchisor being sued by franchisees. One plaintiff contended that she was told the flagship store of the chain had $700,000 in sales each year. Documents showed actual sales were $262,054.[9]
2. *Churning.* Some franchisors have been accused of **churning**, or attempting to void the contracts of existing franchisees in order to sell the franchise to someone else and collect an additional fee. A number of franchisors have been sued by franchisees for churning.
3. *Encroachment.* A franchisor is said to **encroach** on a franchisee's territory when the franchisor sells another franchise location within the market area of an existing franchisee. Such actions can be virtual. For example, H&R Block was sued by a franchisee for selling Internet services within the franchisee's territory without offering any compensation.[10] On occasion, franchisors have actually competed directly against their franchisees, such as when a

churning
Actions by franchisors to void the contracts of franchisees in order to sell the franchise license to someone else and collect an additional fee.

encroach
To sell another franchise location within the market area of an existing franchisee.

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franchisor opened a corporate-owned store near the franchisee's location or sold products by mail or online.

4. *Management issues.* Finally, a franchisee doesn't always have the freedom to operate independently. As a franchisee, you have a contractual arrangement with the franchisor that stipulates various conditions, and that contract may specify the products you carry, the services you offer, your hours of operation, and other aspects of how you run your company. The contract was drafted by, and most likely favors, the franchisor. You should always have an attorney review the contract before you sign it. Some of the most common restrictions imposed on franchisees fall into the following categories:
   a. Limiting sales territories.
   b. Requiring site approval for the retail outlet.
   c. Imposing requirements regarding outlet appearance.
   d. Limiting goods and services offered for sale.
   e. Limiting advertising and hours of operation.

4-2c The Costs of Being a Franchisee

If you choose to become a franchisee, you pay for the privilege. You are buying what should be a proven model, and the franchisor will charge you for the benefits being offered. Generally speaking, higher costs characterize the better-known and more successful franchises. Franchise costs have several components, all of which need to be recognized and considered. They include the initial franchise fee, investment costs, royalty payments, and advertising costs.

1. *Initial franchise fee*. The total cost of a franchise begins with an initial franchise fee, which may range from several hundred to many thousands of dollars. The initial franchise fee for Duck Donuts is $40,000.[11]
2. *Investment costs*. Significant costs may be involved in renting or building an outlet and stocking it with inventory and equipment. Certain insurance premiums, legal fees, and other start-up expenses must also be paid. Rita's Italian Ice estimates a total investment ranging from $196,000 to $456,000. They offer special financing to qualified veterans.[12]
3. *Royalty payments*. A royalty is a fee charged to the franchisee by the franchisor. It is calculated as a percentage of the gross income that the franchisee receives from customers for selling the franchised products and services. Royalty fees typically range between 5 and 9 percent.[13] When Pet Supplies Plus won a *Franchise Times* Zor Award as a top franchise to explore, one of the factors cited was its low royalty fee: 2 percent of gross sales for the first 12 months and 3 percent after that.[14]
4. *Advertising costs*. Many franchisors require that franchisees contribute to an advertising fund to promote the franchise. These fees are generally 1 to 2 percent of sales, sometimes more. Franchisees pay these fees to support the franchisor in establishing the name and reputation of the business in the minds of targeted customers. Successful, well-managed franchise organizations are able to promote the company and its products and services more cost-efficiently than individual stores can on their own.

If entrepreneurs could generate the same level of sales by establishing an independent business as they could by buying a franchise, they would save the fee and some of the other franchise costs just mentioned. However, if the franchisor provides

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the benefits described, the money that franchisees pay to start and maintain their relationship with the franchisor may well prove to be a very good investment.

4-3 Outline the process for evaluating a franchise opportunity.

4-3 Evaluating Franchise Opportunities

Both the franchisee and the franchisor must fully assess a decision to pursue a franchising opportunity. The prospective franchisee must identify a franchising company of interest and investigate it completely. A potential franchisor that is interested in expanding its business must address certain questions before offering the franchise option to possible franchisees. Both parties to a franchise agreement must have knowledge of the legal issues involved.

4-3a Selecting a Franchise

With the growth of franchising over the years, the task of selecting an appropriate franchise has become both easier and harder. Personal observation frequently sparks interest, or awareness may begin with exposure to an advertisement in a newspaper or magazine or online. The availability of information provides more details and a better picture of a franchisor, but the increase in number and variety of opportunities can cause information overload. So, to better understand what a franchise can offer you, you must do your homework.

4-3b Investigating the Potential Franchise

The nature of the commitment required in franchising justifies careful investigation of the situation. The investment is substantial, and the business relationship generally continues over many years.

The evaluation process is a two-way effort. The franchisor wishes to investigate the franchisee, and the franchisee obviously wishes to evaluate the franchisor and the type of opportunity being offered. This requires time. You should be skeptical of a franchisor that pressures you to sign a contract without time for proper investigation. As a potential franchisee, consider asking the following questions when assessing different franchise opportunities:

- Is the franchisor dedicated to a franchise system as its primary means of product or service distribution? Does the company primarily distribute its goods or services through corporate-owned outlets? If so, will the franchisor give as much attention to franchisees as it does to the units it owns?
- Does the franchisor produce and market quality goods or services for which there is an established consumer demand?
- Does the franchisor enjoy a favorable reputation and broad acceptance in the industry?
- Can the franchisor offer an established, well-designed marketing plan and provide substantial and complete training to franchisees?
- Does the franchisor have good relationships with its franchisees? Be sure to speak with current and past franchisees. What is/was their working relationship with the franchisor? Would they do it all over again?
- Do franchisees have a strong franchisee organization that has negotiating leverage with the franchisor?
- Does the franchisor have a history of attractive earnings by its franchisees?

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There are many sources of information about franchisors, such as the U.S. Small Business Administration (sba.gov), to help you in your evaluation. Since many states require registration of franchises, a prospective franchisee should not overlook state offices as a source of assistance. Also, a comprehensive listing of franchisors can be found on the website of the International Franchise Association (franchise.org).

The better-known, more successful franchisors are likely to offer a greater chance of long-term survival and prosperity, but they are also in a position to charge you a premium price to become part of their network. *Entrepreneur* magazine ranks franchises every year. The rankings are based on a number of factors, with financial strength and stability, growth rate, and system size being the most important. In 2021, the top five franchise organizations were Taco Bell, Dunkin' Donuts, The UPS Store, Popeyes Louisiana Kitchen, and Culver's.[15]

Obviously, the franchisor being evaluated is a primary source of information. However, information provided by a franchisor must be viewed in light of its purpose—to promote the franchise. One way to obtain information about franchisors is to review their websites. Most franchisor websites will be directed toward customers, presenting information about products, services, store locations, and more. The websites should also direct you to information for prospective franchisees. If you enter your contact information, you can expect to receive brochures and marketing materials that contain such information as start-up costs and franchisees' testimonials. Your search may also lead you to websites or blogs of disgruntled franchisees, customers, and others.

If you express further interest in a franchise by completing the application form and the franchisor has tentatively qualified you as a potential franchisee, a meeting is usually arranged to discuss the Franchise Disclosure Document, which provides information about both the franchisor (finances, experience, etc.) and the franchise itself (restrictions, costs, etc.). Important considerations related to this document are examined more fully later in this chapter.

4-3c Becoming a Franchisor

After a few years of running your own independent business, you may conclude that you want to expand and that franchising is a reasonable option for you. It is not unusual for the owners of successful businesses to be approached by individuals who ask to become franchisees. Before entering into an agreement with a potential franchisee, consider the questions discussed in the following list.

- *Is your business replicable?* In other words, do you have a model of doing business that someone else could adopt and use successfully in another location? A franchisee purchases an operating system as well as a product or service and a brand name. Is your system efficient, and can it be clearly explained so that others can apply it?
- *How will you finance the growth of the company?* Many entrepreneurs think that franchising is a novel mechanism for financing their growing enterprises. They come up with a concept, collect franchise fees, and use those revenues to expand their operations. However, franchising is not cost-free for the franchisor. There are legal documents to prepare, an operations manual to write, personnel to hire, and other tasks to be completed. Who will recruit and select franchisees? Who will train them and their managers? Who will monitor their performance to ensure that they conform to contract requirements? Responsible franchisors often find that establishing a franchise costs more than the fee covers and that they only become profitable as a result of the royalties they eventually collect from successful franchisees.

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Living the Dream

Building a Business and Opening the Door for Others

There are only so many hours in a day, so how do you find time to start a new business? Despite all the research that has been done on entrepreneurs, no one answer has been found to that question. Pure tenacity and dedication to accomplishing goals seem to be key for many. One example is Shelly Sun. Sun completed her accounting degree at the University of Tennessee at Knoxville in 2002 while working in executive-level finance positions in different companies, including a start-up in the airline industry. Within a few months of graduation, she co-founded a venture of her own, BrightStar Care®, a healthcare staffing company.

The motivation for BrightStar was the experience Shelly and her husband (and BrightStar co-founder), JD Sun, had in trying to find homecare for JD's grandmother. When contacting different agencies, they felt that the people with whom they spoke were more interested in the price they charged than in the services they provided. The Suns decided to create an enterprise that would offer homecare to private clients and supplemental staff to corporate clients. They made a $100,000 investment with a commitment to offer a high standard of dependable and supportive care.

Despite the demands of launching and growing her own business, Shelly made time to continue her education, earning an M.S. degree in accounting from the University of Colorado at Boulder. This effort did not detract from the growth of BrightStar. By 2005, the Suns and their team felt their business model was ready to begin franchising. The initiation of the franchise model coincided with Shelly giving birth to twins.

SOURCE: BRIGHTSTAR CARE®

The franchising model proved to be a successful one for BrightStar. In 2019, the company had $500 million in revenue, and by 2020, it had more than 200 small business partners in over 340 locations. Its range of services also expanded to include medical staffing and senior living communities. Despite the growth, the Suns continue to identify closely with small business owner franchisees and value them as partners in their network. They do not simply offer management support services to those business owners; they also work with them to seek unique opportunities that exist within their local markets.

As their company grew, the Suns became active in the International Franchise Association (IFA). In 2009, the IFA named Shelly Sun Entrepreneur of the Year. She was the youngest recipient in the history of that award. She was later elected chair of the board of directors for the IFA (2017–2018).

Shelly Sun continues to be recognized as a change maker, having navigated the 2020 pandemic successfully. She was named one of the top 25 women business owners in the United States. She does not wait for the economy and competitors to force change—she sees opportunities for more change ahead.

Sources: "Our History & Mission," https://brightstarcare.com/about-us/history-mission, accessed March 28, 2021; Robert Holly, "Changemakers: Shelly Sun, Founder and CEO, BrightStar Care," https://homehealthcarenews.com/2020/05/changemakers-shelly-sun-founder-and-ceo-brightstar-care/, accessed March 28, 2021; "Shelly Sun," https://www.linkedin.com/in/brightstarshellysun, accessed March 28, 2021; and "BrightStar Names JD Sun Executive Vice President of Franchise Development," https://www.franchising.com/news/20101118_brightstar_names_jd_sun_executive_vice_president_o.html, accessed March 28, 2021.

- *What expert assistance will you need to become a franchisor?* Successful entrepreneurs who want to become franchisors learn quickly that they must choose the right experts, individuals who are qualified to provide the necessary help. If you decide to franchise your business, be sure to hire an attorney with

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knowledge of the franchise method. Many consultants specialize in franchising and can assist with drafting operations manuals, preparing disclosure documents, assisting with franchisee selection, and other aspects of the process. A good starting place for any prospective franchisor is becoming a member of the International Franchise Association (IFA). Shelly and JD Sun, founders of BrightStar Care (see the Living the Dream feature), benefited from mentors and other support gained through their involvement with the IFA.

- *What will go into your operations manual?* Earlier in this chapter, we looked at the operations manual from the franchisee's point of view. For the franchisor, this is an essential element in the value the business model offers to franchisees. Many companies that have grown successfully through franchising brought in consultants who specialize in making the business operating model more efficient and easier to replicate prior to writing the manual.

You should be able to present an operations manual to your franchisees that spells out what steps to take in daily activities to ensure customer satisfaction while controlling expenses. The manual should offer detailed instructions that help franchisees avoid pitfalls and increase sales. It needs to be written from the perspective of the franchisee, who will not know the business as well as the franchisor. It is usually wise to hire a professional technical writer to put the manual together so that it communicates the process effectively. Many new franchisors have found that experts who assist in writing operations manuals also help businesses improve the efficiencies of their operations, making start-up and management easier and lowering the cost for franchisees.

- *Are you willing to satisfy the government's disclosure requirements?* The Federal Trade Commission issued an amended **Franchise Rule** in May 2008. This rule requires that the franchisor disclose certain information to prospective franchisees. Some business owners may decide that they would rather not disclose information that they consider confidential, such as prior bankruptcies, the business experience of the principals, or litigation in which the firm is involved. In such cases, franchising may not be the appropriate method to use for growth.
- *Can you add value for your franchisees year after year?* There are many successful franchising models that may provide the right steps for you to follow in order to avoid pitfalls in the start-up process. However, prospective franchisees will want to see an honest assessment of their benefits and earnings potential.

A franchise agreement is in effect for a long time, typically between 10 and 15 years. What benefits will the franchisees derive from the franchisor each year? Will new products or services be introduced? Will improved marketing strategies be implemented? Will additional, updated training be offered to franchisees and their managers? Why will franchisees want to continue to make royalty payments once they have been up and running and have learned the operating procedures? If your business model does not add value for franchisees each year, franchising won't sustain your company's growth.

Franchise Rule
The federal regulation that requires a franchisor to disclose certain information to prospective franchisees.

4-3d Legal Issues in Franchising

For a business alliance to be successful for both parties, trust is important. However, a contract is essential to avoid or resolve problems that may arise.

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The Franchise Contract

The basic features of the relationship between the franchisor and the franchisee are embodied in the franchise contract. This contract is typically a complex document of many pages. Because of its importance as the legal basis for the franchised business, the franchise contract should never be signed by the franchisee without legal counsel. In fact, reputable franchisors insist that the franchisee have legal counsel before signing the agreement. An attorney may anticipate trouble spots and note any objectionable features of the contract.

A prospective franchisee should also use as many other sources of help as would be practical. In particular, they should discuss the franchise contract in detail with a banker. The prospective franchisee should also obtain the services of a professional accounting firm to examine the franchisor's statements of projected sales, operating expenses, and net income. An accountant can help evaluate the quality of these estimates and identify any projections that may be overstated. These experts are essential to ensure that parties on both sides of the agreement comprehend their obligations. Disagreements between the parties can wind up in court. For example, several Seva Beauty franchisees sued the franchisor claiming they were enticed by the company's contention that they had an exclusive partnership with Walmart for retail locations. The plaintiffs argued that Walmart not only refused to enter into any new leases, but it also refused to extend leases and even terminated some. Another well-known franchisor, 7-Eleven, Inc., has been sued on multiple occasions by franchisees that claim their contracts were terminated without proper cause.[16]

One of the most important features of the franchise contract is the provision relating to termination and transfer of the franchise. Many franchisors have been accused of devising agreements that permit arbitrary cancellation of the franchise relationship. Of course, it is reasonable for the franchisor to have legal protection in the event that a franchisee fails to reach an appropriate level of operation or does not maintain satisfactory quality standards. However, the prospective franchisee should be wary of contract provisions that contain overly strict or vague cancellation policies. Similarly, the rights of the franchisee to sell the business to a third party should be clearly spelled out. A franchisor who can restrict the sale of the business to a third party could potentially take back ownership of the business at an unfair price. The right of a franchisee to renew the contract after the business has been built to a successful operating level should also be clearly stated in the contract.

Additionally, the control exercised by the franchisor through the franchise contract has been of concern to legislators, regulators, and others regarding the true level of separation between franchisor and franchisee. Some authorities have argued that franchisees are more like employees than business owners, based on the constraints of their contracts. Regulators have even interpreted some contracts to indicate that the employees of the franchisee are actually employees of the franchisor. These arguments have implications for liability and business expense issues throughout franchise systems. At present, the separation of the parties has been maintained, but that could change via a law or regulation designating franchisees as employees of their franchisors at some future point.

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Franchise Disclosure Requirements

The offer and sale of a franchise are regulated by both state and federal laws. At the federal level, the minimum disclosure standards are specified by the Franchise Rule. A guide to the rule can be found on the Federal Trade Commission's website (ftc.gov), as can contact information for the state offices that enforce franchise disclosure laws.

A **Franchise Disclosure Document (FDD)** is a detailed statement of information relating to the franchisor's finances, experience, size, and involvement in litigation. The document must inform potential franchisees of any restrictions, costs, and provisions for renewal or cancellation of the franchise. The FDD provides the accepted format for satisfying the legal requirements of the FTC. Most franchise experts recommend that a franchisee's attorney and accountant review the document.

4-4 Independent Contracting in the Gig and Sharing Economies

4-4 Explain the meanings of the terms *independent contractor, gig economy*, and *sharing economy* and their importance to entrepreneurs.

One of the most important lessons small business owners must learn is that they cannot do everything themselves. They may not have the expertise for certain tasks or the capacity to perform others. As a result, they may hire others to assist in the work but may not need full-time or even part-time employees for everything that needs to be done. A course of action taken by companies both large and small is to make agreements with independent contractors to get the extra or specialized work done. Business owners often use this practice because they find it cost efficient, as doing so avoids payroll and other employee benefit expenses.

The explosion of what have been labeled the gig and sharing economies in recent years reflects the value that many companies find by hiring independent contractors rather than employing workers. From the perspective of the independent contractors, many are accidental, even unintentional, entrepreneurs. Some take on the role because they were unable to find the full-time employment they desired. For others, contracting activity may be a source of extra income that they need but that their normal employment does not provide. And there are many other reasons as well.

Some college students are choosing to earn money working as independent contractors. While they may not have intended to become entrepreneurs, finding themselves in business for themselves has opened their eyes to other entrepreneurial activities.

4-4a Defining Independent Contractors

First, let us be clear about what an independent contractor is. According to the United States Internal Revenue Service, "an individual is an **independent contractor** if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done."[17] If you are an independent contractor, your earnings are subject to self-employment tax (see https://www.irs.gov/businesses/small-businesses-self-employed/self-employed-individuals-tax-center for more information). The advantages of independent contracting include the following:[18]

1. Avoiding having to adhere to direct orders from supervisors.
2. Working more flexible hours.
3. Deducting work-related expenses in order to reduce tax obligations.
4. Earning more on an hourly basis because the payer does not incur the benefit costs that they would for an employee.

Franchise Disclosure Document (FDD)
A detailed statement providing information about the franchisor that satisfies the franchise disclosure requirements of the FTC.

independent contractor
An individual or organization that agrees to complete an assignment but retains control over the actual work to be done.

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There are disadvantages as well:

1. Having to plan and process your own tax payments.
2. Lacking a steady paycheck.
3. Being ineligible for unemployment benefits.
4. Needing to provide your own tools.

These pros and cons are just a snapshot. We could easily add more items to both lists.

In this chapter, we have chosen to focus on the concept of independent contracting because it centers on the relationships that self-employed individuals may have with their employer under the contract and their freedom to engage in multiple entrepreneurial activities. Two traditional categories of people who contract with others for their work are consultants and freelancers.

Consultants and freelancers are typically individuals who choose to work independently providing advisory services, technical expertise, or other types of services or products for companies that do not need permanent employees to perform or deliver or that they cannot afford to keep on their payrolls. In recent years, there has been a significant increase in independent contracting by many people who never intended to be in business for themselves, some of whom have permanent employment in existing organizations. By experimenting with independent contracting, they have discovered other opportunities. This increase has been triggered by the gig and sharing economies.

4-4b Defining the Gig and Sharing Economies

New business models have recently emerged that are designed to grow through independent contracting. Advances in communication technologies, particularly digital or app-based platforms, have increased the ease with which companies can recruit and work with people who may want flexibility in their schedules or income to supplement earnings from other sources.

Several labels are in use for these new economies. *Gig* and *sharing* have become the most popular, but you may also hear the terms *access*, *collaborative*, *shared*, *gift*, *barter,* and more. The various definitions of each of these terms blur the distinctions among them. A broad perspective may describe the economies as using online platforms to find small jobs or, even more simply, providing services upon demand.[19]

In popular culture, the labels *gig* and *sharing* are often interchangeable. To help you understand how these economies are stimulating entrepreneurial activity, we will draw a slight distinction. In the **gig economy**, a person charges for their labor. Uber offers drivers the opportunity to be independent contractors, driving when they want, where they want, how they want, and choosing how and when to get paid.[20] Caregivers on Care.com have access to a platform that connects them with opportunities to meet a variety of needs, including child care, senior care, special needs care, pet care, housekeeping, and tutoring. The caregivers are independent but have access to tools and resources for getting paid, paying taxes, and even signing up for benefit packages.[21]

In the **sharing economy**, a person is paid for their resources. For example, Airbnb invites individuals to "[e]njoy the flexibility of being your own boss, earn extra income, and make lifelong connections through hosting."[22] By hosting, you provide a space where others pay to stay for limited amounts of time. While the gig example of Uber enables an individual to get paid for driving, the sharing company Turo lets a person rent out their car for others to use.[23] Turo does not charge for listing the car. Each person sets their own price and rental conditions, and Turo arranges a direct deposit after each rental.

gig economy
The gig economy is a free market system in which businesses hire independent contractors to perform individual jobs, called "gigs."

sharing economy
The sharing economy is a free market system in which assets or services are shared between private individuals, either free or for a fee, typically by means of internet platforms.

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Living the Dream

College Students in the Gig and Sharing Economies

Is there such a thing as a traditional college student anymore—the full-time student who does not take a job until graduation, perhaps with the exception of summer internships? Students are leaping into previously unthinkable income-generating activities, thanks to the new opportunities in the gig and sharing economies. Some are even passing on internships, choosing to work independently as opposed to taking a job with a low or no salary. Here are a few examples of student entrepreneurs:

- Allison Rigterink, Saginaw Valley State University, worked as a courier for Shipt, an app-based company that arranges deliveries of merchandise to the front doors of consumers. Rigterink wanted to earn extra cash but also to gain work experience.
- Esmeralda Nuñez , University of California, Merced, studied the Uber and Lyft models and decided she could operate on her own. She started a business giving rides to UC Merced students and delivering food to them. Customers text her with their requests. She discovered that a digital wallet company, Venmo, could process payments for her.
- Jonnette Oakes, University of Missouri–Columbia, learned sewing skills from her mother. While quarantined in 2020, Oakes had time to experiment with some creative clothing designs, which she began selling on Etsy. The quick success she enjoyed led her to form her own t-shirt company, Shadedby-Jonnete (shadedbyjonnette.com). She sees an in-person store as her next step.
- Huy Nguyen and Abhishek Chakrabarti, The Ohio State University, drew from their own freelancing experience in product marketing and translation services to create a new company while working on their MBA degrees. Uplancer is a platform that connects students to gig work with small and medium-sized companies.

Be aware that not all gig experiences are positive. Jacob Hanna, an economics major at Binghamton University, found that being a food delivery driver did not provide significant or continuous income. As an independent contractor, he had to pay for the meals in advance and experienced delayed payment from the platform company. There was always the risk of a traffic accident, and late-night deliveries led to sleep deficiency.

Colleges and universities are not ignoring the effects that the gig and sharing economies are having on their students. Some, like Babson College and the University of Michigan, have initiated programs and services to help students prepare for and enter these changing environments.

We should add that colleges and universities have long been employers of independent contractors. Many of these independent contractors carry the title of adjunct professor. There have long been concerns about how universities treat adjunct faculty regarding pay, fringe benefits, and working conditions. Along with the growing numbers of others in the gig economy, many of these adjunct instructors value the flexibility of hours and access, the lack of supervisory control, the freedom to simultaneously hold other employment, and more.

There are many more examples that could be cited indicating the wide variety of opportunities in the new economies. In this new business environment, individuals can readily create their own ventures, either as limited experiments or as life callings.

Sources: "How Gig Work Is Helping One Student through College—and Why Lawmakers Should Embrace It," https://americansforprosperity.org/how-gig-work-is-helping-one-student-through-college-and-why-lawmakers-should-embrace-it/, accessed March 29, 2021; Brett Owens, "Universities Are Preparing Students for the Gig Economy and the Future of Work," https://www.jdsupra.com/legalnews/universities-are-preparing-students-for-39083/, accessed March 30, 2021; Tim Roe, "Uplancer Connects Students into the Gig Economy," https://www.rev1ventures.com/blog/uplancer-connects-students-into-the-gig-economy/, accessed March 30, 2021; Jacob Hanna, "'Gig Economy' Work Is Too Precarious for College Students," https://www.bupipedream.com/opinions/98129/gig-economy-work-is-too-precarious-for-college-students/, accessed March 30, 2021; Janelle Finch, "How College Students Are Turning Hobbies into Side Hustles—and Extra Cash," https://www.cnbc.com/2020/12/29/how-college-students-are-turning-hobbies-into-side-hustles-.html, accessed March 30, 2021; Stephanie Medina, "The Gig Economy Doesn't Always Pay," https://notsogolden.org/employment/the-gig-economy-doesnt-always-pay, accessed March 30, 2021; and Sarah Szczypinski, "Adjunct Professors in the Gig Economy," https://www.thebalancesmb.com/adjunct-professors-in-the-gig-economy-4174541, accessed March 30, 2021.

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A few examples indicating the wide variety of activities in these new economies are discussed in the Living the Dream feature. Clearly, companies can operate in both the gig and the sharing economies simultaneously, offering both labor and resources. Understand that these platforms provide the independent contractor with choices about whether and how to earn money for their own efforts and skills or for making use of resources they may have. Many people simply looking for extra income begin ventures within these economies. Some will demonstrate the necessary entrepreneurial vision that will lead to other opportunities where they can build companies with growth potential.

When you are investing your time, your property, and your money in a venture, you should weigh the pros and cons of your actions in advance. While you cannot perfectly predict the future, there are always lessons to be learned from the experiences of others who preceded you. Let's look at a few of these lessons.

Advantages of the New Economies

Once you become an independent contractor, you should be able to gain benefits from being independent from the partners whose platforms you are using. These benefits include the following:

1. *Extra income*. You may need the income because you haven't found permanent employment. Often, the income is sought as a supplement to what you are earning from your current employer.
2. *Trust.* Linking yourself to a platform can provide several benefits. The platform company may screen customers or offer protection from fraud that might occur when you deal directly with someone who is paying for your skill or your property.
3. *Flexibility.* Even as your own boss, there will still be conditions imposed by the platform company. But you are typically able to schedule your time as you choose, and you can turn down assignments that you do not want to take on.
4. *Ease of doing business.* Independent contractors are likely to work from their own homes. By leveraging the resources of your platform partners, you can avoid such business expenses as advertising and payroll.

Disadvantages of the New Economies

As an independent contractor, you want to plan for potential problems associated with relying on your contracting partner.

1. *Privacy issues.* Be cautious about compromising personal information that you put online or that you have in property that may be used by others.
2. *Safety issues.* Make sure that you know who is liable for any injuries to people or property resulting from your actions or the condition of your resources.
3. *Revenue flow issues.* As an independent contractor, you may not be paid as promptly or regularly as you would if you were an employee.
4. *Misclassification issues.* In the gig economy, it is important to know if you are really independent or an employee. This is a hotly debated subject, drawing attention both in the private sector and from government regulators and legislators. Given its significance, we will examine the issue of independent contracting versus employment next.

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4-4c Independent Contracting versus Employment

Within the gig and sharing economies, there have been heated debates over whether independent contractors are truly independent or if they should be classified as employees. (This parallels the concerns raised earlier in the chapter regarding the relationships between franchisors and franchisees.) For independent contractors, most of the attention has been focused on their lack of fringe benefits and worker protections, although liability issues have also been raised.

In 2020, a law known as AB5 (Assembly Bill 5) went into effect in California. This law establishes criteria (the ABC test) for determining whether someone is an independent contractor.[24]

> A worker is considered an employee and not an independent contractor, unless the hiring entity meets all three conditions of the ABC test:
>
> A. The person is independent of the hiring organization in connection with the performance of the work, both under the contract for the performance of the work and in fact.
> B. The person performs work that is outside the hiring entity's business.
> C. The person is routinely doing work in an independently established trade, occupation, or business that is the same as the work being requested and performed.

Recall that the gig economy deals with people's labor. If those providing the labor are classified as independent business owners rather than employees, they may lack protection regarding the minimum wage, along with health and insurance benefits. During the COVID-19 pandemic, many gig workers found that they did not qualify for unemployment benefits due to their status as independent contractors. Additionally, they have no right to form unions to bargain collectively.

The counter-argument is that independent contractors can freely shift their work from one platform to another, such as from Uber to Lyft, if they are not pleased with the conditions of their contract. In fact, many gig workers contract with both Uber and Lyft or with other companies providing services that they can supply.

People have long been able to share resources, but the ability to build viable, high-growth businesses has been made possible by big data and social media platforms. The sharing economy has opened opportunities for individuals and groups to be less dependent on their own belongings as they can access cars, apartments, co-workers, and even money through crowdsharing platforms. New ventures are catering to changes in purchasing behaviors.

4-4d The Future of the Gig and Sharing Economies

Estimates of the growth of the gig economy during the COVID-19 pandemic hovered around 33 percent.[25] The growth pattern was not consistent across all categories, however. For example, there was a decline in ride sharing, but an expansion in food delivery. Even so, with the millions of people who were already participating in the gig economy, there was a noticeable jump in the total number involved in 2020, with much of the increase attributed to workers being laid off by employers during the pandemic lockdown. The number is projected to increase in the coming years, soon to reach over 50 percent of the workforce.

It is reasonable to expect both federal and state legislation and regulations regarding independent contracting in the future. (Recall our recent discussion of the

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California law known as AB5, which establishes that workers are considered employees unless proven otherwise.)

Many gig workers may not have thought of themselves as entrepreneurs when they began their freelancing activities. This could particularly be true of college students who simply want to earn some spending money or funds to cover educational expenses. Stricter regulations may cause them to think differently. One way of maintaining the status of independent contractor is to perform work for more than one company. This calls for proactively seeking opportunities, a key characteristic of the entrepreneur. In this way, the gig and sharing economies may lead to more creative venturing on the part of individuals who begin their entrepreneurial journey by just seeking funds for a limited set of actions.

4-1. Define *franchise* and other key terms related to franchising.

- A *franchise* is a method of distributing products or services in a particular geographic area. It involves a franchisor, which establishes the brand's trademark or trade name and a business system, and a franchisee, which pays a royalty and often an initial fee for the right to do business under the franchisor's name and system.
  - *Franchising* is a process for expanding a business and distributing goods or services through a licensing arrangement.
  - A *franchisor* is the party in a franchise contract that specifies the methods to be followed and the terms to be met by the other party.
  - A *franchisee* is the party in a franchise contract that is granted a license to do business under a particular trademark and trade name by the franchisor.
  - In *product and trade name franchising*, a franchisor owns the right to a product or trademark and sells that right to a franchisee.
  - In *business format franchising*, the franchisor often provides a full range of services, including site selection, training, product supply, marketing plans, and even assistance in obtaining financing.
  - A *franchise contract* is the legal agreement between a franchisor and franchisee.
  - A *master licensee* is an independent firm or individual acting as an intermediary or sales agent with the responsibility of finding new franchisees within a specified territory.
  - *Multiple-unit ownership* is ownership by a single franchisee of more than one unit of a franchised business.
  - *Area developers* are individuals or firms that obtain the legal right to open several outlets in a given area.
  - *Piggyback franchising* is the operation of a retail franchised outlet within the physical facilities of another business.

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- *Multibrand franchising* involves operating several franchised businesses within a single corporate structure.
- *Co-branding* brings two or more franchise brands together within a single enterprise.

4-2. Distinguish the pros and cons of franchising.

- The primary advantage of franchising is its high probability of success.
- Other advantages of franchising include the value of a business model with a proven track record, trade names and trademarks, the franchisor's operations manual, training and promotional support, immediate access to supply lines and purchasing power, and financial support. It also is a way for existing businesses to diversify.
- Disadvantages of franchising include financial issues, such as being misled about earnings opportunities, and limits imposed by franchisors. Other disadvantages include churning and encroachment.
- *Churning* is the action by franchisors to void the contracts of franchisees in order to sell the franchised business to someone else and collect an additional fee.
- *Encroachment* is the franchisor's selling of another franchise location within the market area of an existing franchisee.
- Costs associated with franchising include the initial franchise fee, investment costs, royalty payments, and advertising costs.

4-3. Outline the process for evaluating a franchise opportunity.

- Independent third parties such as state and federal government agencies, the International Franchise Association, and business publications can be valuable sources of franchise information for potential franchisees.
- A primary source of information about a franchise opportunity is the franchisor.
- Existing and previous franchisees are also good sources of information.
- If you are thinking about becoming a franchisor, consider the efficiency of your business model, how you will finance growth, what expert assistance you will need, the content of your operations manual, government disclosure requirements, and your ability to add long-term value for franchisees.
- A franchise contract is a complex document and should be evaluated by a franchise attorney, especially the provision relating to termination and transfer of the franchise.
- The Franchise Disclosure Document (FDD) provides the accepted format for satisfying the franchise disclosure requirements of the FTC.

4-4. Explain the meanings of the terms *independent contractor, gig economy*, and *sharing economy* and their importance to entrepreneurs.

- According to the IRS, an individual is an *independent contractor* if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done.
- In the *gig economy*, a person charges for their labor.
- In the *sharing economy*, a person is paid for their resources.
- Advantages of the new economies include extra income, trust, flexibility, and the ease of doing business.
- Disadvantages of the new economies include privacy and safety issues, as well as revenue flow and misclassification issues.
- There are estimates that in the years ahead over 50 percent of the workforce in the United States will participate in the gig and sharing economies.
- As independent contractors, many of those participants are expected to discover opportunities that lead to more creative new ventures.

Key Terms

area developers p. 94
business format franchising p. 94
churning p. 96
co-branding p. 94
encroach p. 96
franchise p. 93
franchise contract p. 94
Franchise Disclosure Document (FDD) p. 103
franchisee p. 93
Franchise Rule p. 101
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Discussion Questions

1. What makes franchising different from other forms of business? Be specific.
2. What is the difference between product and trade name franchising and business format franchising?
3. Describe at least four key terms in franchising.
4. What are the pros and cons of franchising from the viewpoints of both the potential franchisee and the franchisor?
5. Should franchise information provided by a franchisor be discounted? Why or why not?
6. Do you believe that the Franchise Disclosure Document is useful for franchise evaluation? Defend your position.
7. Evaluate loss of control as a disadvantage of franchising from the franchisor's perspective.
8. Do you feel that an independent contractor is an actual business owner or just a contract employee of another company?
9. What are some advantages and disadvantages of being a gig worker?
10. In what ways might someone grow their involvement in the sharing economy into a viable business?

You Make the Call

Situation 1

Two factors in her childhood triggered Letha Tran's decision to become a franchisee. The first was growing up with a mother who owned her own business and was a role model. The second was falling in love with the sandwiches she ate at her local Togo's restaurant. She tried to get her mother to finance her purchase of a Togo's franchise, but her mom wanted her to go to college.

College led to a corporate job. Some entrepreneurs say they don't want to become franchisees because they have to give up their freedom. For Tran, it was just the opposite. She found corporate life too constraining. As Tran expressed it, "They kept telling me what to do. I just couldn't see the rest of my life doing that and knew I had to do something else. I cashed out basically everything I owned to open my first Togo's and never looked back."

Running a restaurant consumed Tran 24/7. She was nervous about opening a second location but had seen how other franchisees grew their businesses by adding units. For Tran, multiple-unit ownership improved her quality of life. She discovered that she gained free time and a sense of accomplishment from nurturing her managers and letting them make decisions.

Sources: Nicholas Upton, "No Plan B, Togo's Zee Grows to 5," *Franchise Times*, May 2021, p. 16; and Sarah Brown, "How to Succeed as a Multi-Unit Franchisee: Letha Tran, Togo's," https://1851franchise.com/togos/how-letha-tran-thrived-with-togo-s-as-a-multi-unit-franchisee-11793, accessed July 9, 2021.

Question 1 What would make being a franchisee attractive to you?

Question 2 What do you think you would not like about being a franchisee?

Question 3 Do you think you would be more satisfied running your own franchise or overseeing the managers of multiple franchise units? Why?

Situation 2

After retiring from a career in information technology, Tom Kelley wanted to try something that he would find exciting. He started driving for both Uber and Lyft, giving him a chance to go different places and meet different people. He liked the flexibility of the work hours and the amount of money he earned, and he felt that he was offering value to his customers.

A lot of Kelley's time was spent at the airport in Houston, Texas, where he had a chance to talk with other drivers. Many of them complained about how little information was available to them on the Uber app. A light came on for Kelley, and soon TNCRadio was launched. As the company's website states, "TNCRadio.Live is an Internet Radio station that provides Commercial Drivers up-to-the-minute details they need to be safer, smarter, and more successful. TNCRadio.Live does this by providing accurate and timely traffic, weather, and emergency information along with driver-designed programming throughout the broadcast day." Despite going on the air in the midst of the COVID pandemic, TNCRadio caught on with drivers and rapidly built a loyal listener base.

Sources: https://tncradio.live/, accessed July 12, 2021; Mike McGuff, "TNCRadio Wants to Be Houston's Online Driving Station," https://mikemcguff.blogspot.com/2020/06/tncradio-houston-online-radio-driving-traffic.html, accessed July 12, 2021; and "From Uber Driver to Radio Entrepreneur: Meet the Founder of TNCRadio.Live," https://gridwise.io/from-uber-driver-to-radio-entrepreneur-meet-the-founder-of-tncradiolive, accessed July 12, 2021.

Question 1 Do you think Kelley would have started TNCRadio if he had not become an Uber and Lyft driver? Why or why not?

Question 2 Most people who take on gig jobs do not start other businesses. What might be some of the reasons?

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Experiential Exercises

1. Interview a local owner-manager of a franchise. What was the process by which the owner obtained the franchise? Would they do it all over again?
2. Select a franchise in an industry that interests you, and visit that company's website. Read what it says about becoming a franchisee with the organization, and report back to the class on what you discover there.
3. Have you done any gig or sharing economy work? If so, describe your experience and how it influenced your ambition to own a business. If not, find a classmate who has tried gig or sharing work. What did that person experience that was positive? What was negative?

Chapter 4 Case

Please see Appendix A for the Chapter 4 Case Study.

Endnotes

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Chapter 5

The Family Business and Buyouts

Looking Ahead

Learning Objectives

The Family Business and Buyouts chapter addresses the likelihood that you may become part of a family business, whether you intend to or not, or perhaps decide to purchase an existing business. By studying this chapter, you should be able to . . .

5-1 Define the terms *family* and *family business*.

5-2 Explain the complex roles and relationships involved in a family business.

5-3 Identify management practices that enable a family business to function effectively.

5-4 Describe the process of managerial succession in a family business.

5-5 Describe some specific reasons for buying an existing business and how to evaluate an existing business for purchase.

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Spotlight on Small Business

Dietz & Watson

www.dietzandwatson.com

She was not the founder of the company, but if there was a guiding spirit for Dietz & Watson, it was Ruth Dietz. The business originated with her father, Gottlieb Dietz, who purchased the company from Walter Watson in 1939. Although Watson's name was retained, his subsequent position in the firm was as the sales manager. Ruth started working in the sausage-making enterprise when she was 14 years old. She probably had no idea about the lifelong commitment she was making. She became known to all as "Momma Dietz," thanks to her being featured in the company's advertising campaigns. She served as company chairperson until her death in 2019 at age 94.

The family's third generation took the firm national. Despite the geographic expansion and increasing product lines, family members attribute their success to remaining "the same." By that, they mean adhering to some of the founder's original recipes, handcrafting spices, and slow-roasting meats. Just as important to the current owners are the values underlying the operation of the business. They proudly declare, "Dietz & Watson, It's a Family Thing." They stress that their family serves their customers' families. They see co-workers as extended family members, working hard to deliver premium meats and artisan cheeses.

Currently, three members of the third generation are active in the company. Momma Dietz's son Louis Eni, Jr., is president and CEO. He is quoted as saying that he doesn't make a decision without asking himself if his mother would approve.

Fourth-generation family members have also been assuming leadership positions. Lauren Eni Canseco, daughter of Louis, Jr., has the title Executive Vice President—Brand Strategy. She heard her grandmother's stories of working in the business from a young age, giving it everything she had, putting in hours on the job and not taking vacations. Lauren did not have the same experience but was always around the business and had fun going into the office with her dad. Although she interned with Dietz & Watson while working on her undergraduate degree, she did not join the family enterprise straight out of school. Instead, she chose to gain experience with an international firm specializing in social media and marketing communication services. When she accepted a position at Dietz & Watson, she was able to directly take on responsibility and initiated strategies for marketing the company and its products.

Dietz & Watson did not have a marketing department at the time Lauren assumed her role. As a result, nearly everything she tried was new to the firm. Lauren reported that her relatives often thought her ideas were "crazy," but they still supported her efforts.

One of Lauren's early successes was the Four Generations of Flavor Tour. This involved sending a food truck to 30 cities around the country, giving consumers the chance to compare Dietz & Watson products directly with those of its competitors. The company may not have served millions from that truck, but the media attention resonated beyond those who were able to taste the samples. This was followed by the pop-up Delishop, which introduced new products from a brick-and-mortar location that was intentionally temporary. Subsequently, it transitioned to an e-commerce site. The idea that family members probably thought was Lauren's craziest involved running a Super Bowl ad in 2019. Imagine the expense! Introducing their new bite-sized sausage snacks, comedian Craig Robinson just kept saying "Dietz Nuts" for the length of the ad. It was one of the hit commercials that year.

Stay tuned for what this family business tries next!

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At some time in your life, you may find yourself employed in a family business. It may be your own family's business or perhaps a company owned by another family. At a minimum, you will come into contact with family-owned firms as a supplier, lender, investor, or customer. That is because family enterprises comprise over half of all businesses in the United States and are dominant worldwide.[1] Need examples? How about Walmart, Ford Motor Company, Comcast, Dell Technologies, Tyson Foods?[2] And think about the local places that you do business with—the restaurants, laundries, flower shops, jewelry stores, bakeries, and more that are probably family-owned and -operated. You may think of the franchises you see everywhere as huge corporations, but many franchisees are families in your community. Some of the largest franchisors started as family businesses and are still run that way.

Although the Spotlight feature related how the Dietz family enterprise survived for four generations, family members are not always cordial, cooperative, and compatible when they work together. They know how to make each other mad or feel guilty, how to embarrass each other. Such actions have caused the downfall of many a family firm, large and small. In this chapter, we investigate how family and business interact, what makes them strong, and what can destroy them. Fortunately, scholars have been conducting extensive and intensive research regarding family businesses for over 30 years, enabling us to introduce you to strategies that have helped families succeed in their ventures.[3]

5-1 Define the terms *family* and *family business*.

5-1 What Is a Family Business?

It may seem like a silly question to ask what a family is, but try it with your friends and see how many answers you get. First, we should recognize that definitions of *family* vary in different parts of the world. They include the classic nuclear family, restricted to parents and children, and an extended family, comprising an entire community of other relatives and sometimes friends. No doubt you have seen many versions of families on television, in movies, and possibly in your own life. The definition dilemma can be extended to the business. Given the interest and involvement that family members have in each other's lives, it should not be surprising that they have opinions about a business owned by one or more family members, whether or not they are officially connected with the company.

In this book, the word **family** refers to a group of people bound by a shared history and a commitment to share a future together, while supporting the development and well-being of individual members.[4] This definition encompasses the considerable differences in the composition of families. They can vary by blood relationships, generational representation, legal status, and more. We define **family business** as an organization "in which either the individuals who established or acquired the firm or their descendants significantly influence the strategic decisions and life course of the firm. Family influence might be exerted through management and/or ownership of the firm."[5]

Family business educators and consultants have come up with labels to identify how firms evolve from one generation to another:

1. *First generation*: An **owner-managed business** is operated by a founding entrepreneur.
2. *Second generation*: A **sibling partnership** exists if the children of the founder become the owners and managers of the business.

family
A group of people bound by a shared history and a commitment to share a future together, while supporting the development and well-being of individual members.

family business
An organization in which either the individuals who established or acquired the firm or their descendants significantly influence the strategic decisions and life course of the firm.

owner-managed business
A venture operated by a founding entrepreneur.

sibling partnership
A business in which children of the founder become owners and managers.

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3. *Third generation and beyond*: A **cousin consortium** occurs when children of the siblings take ownership and management positions.

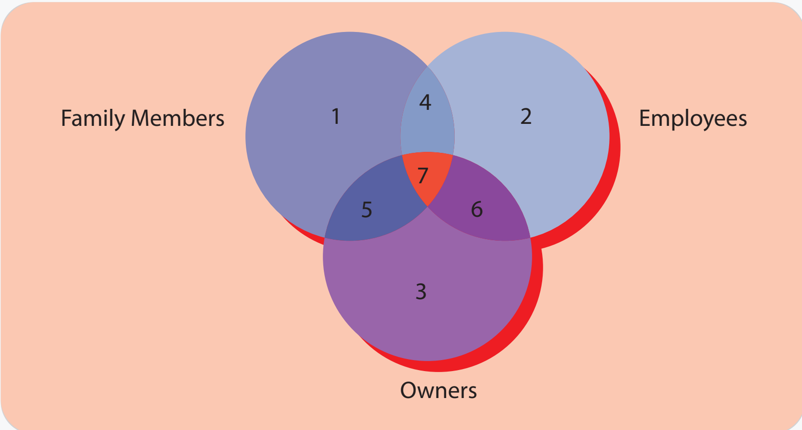
Not every family enterprise follows this pattern, but thinking about these stages has helped many business owners plan for the future.

5-1a Family and Business Overlap

Families and businesses exist for different reasons. A family's primary function is the care and nurturing of its members, while the business is concerned with the production and distribution of goods and/or services. The family's focus is on creating value for family members and emphasizing cooperation, unity, and stability. The goals of a business, on the other hand, are to create value for customers, make a profit, and emphasize competition, diversity, and flexibility.

Individuals involved in a family business have interests and perspectives that differ according to their particular situations. The model in Exhibit 5.1 shows the ways in which individuals may be involved—as owners, members of the family, employees of the business, and various combinations of these. In addition, the configuration of roles can affect the way these individuals think about the enterprise. For example, whereas a family member who works in the firm and has an ownership interest (segment 7) might

Exhibit 5.1 The Three-Circle Model of Family Firms



Legend:

1. Family members (not involved in business)
2. Nonfamily employees
3. Nonfamily owners (not involved in operations of the business)
4. A family member employee (not an owner)
5. A family member owner (not involved in operations of the business)
6. An employee owner (not a member of the family)
7. A family member owner and employee

FAMILY MEMBERS	=	Individuals in areas 1+4+5+7
EMPLOYEES	=	Individuals in areas 2+4+6+7
OWNERS	=	Individuals in areas 3+5+6+7

Sources: Based on Renato Tagiuri and John A. Davis, "On the Goals of Successful Family Companies," *Family Business Review*, 5 (March 1992); Frank Hoy and Pramodita Sharma, *Entrepreneurial Family Firms* (Boston: Prentice Hall, 2010); and James J. Chrisman, Franz W. Kellermanns, Kam C. Chan, and Kartono Liano, "Intellectual Foundations of Current Research in Family Business: An Identification and Review of 25 Influential Articles," *Family Business Review*, Vol. 23 (2010), pp. 9-26.

cousin consortium
A business in third and subsequent generations, when children of the siblings take ownership and management positions.

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favor reinvesting in order to grow the business, a family member with an ownership share but who works elsewhere (segment 5) might want dividend payouts, and an employee with neither family nor ownership interest (segment 2) might seek higher wages.

Imagine the complications that might have arisen if Walter Watson maintained an ownership share in the company profiled in the Spotlight feature, Dietz & Watson. Could two families find ways to work together for four generations? It has happened. The descendants of Gottlieb Dietz, however, are probably pleased that they have had to only work out arrangements with their own relatives.

5-1b Advantages and Disadvantages of a Family Business

Has anyone ever told you, "Don't go into business with your family!"? There are horror stories of businesses failing, families breaking up, even crimes committed by members of families working together. Sometimes, staying an arm's-length distance from your relatives is the right advice to follow. Remember, though, that most companies in the world can be defined as family businesses. Many are extraordinarily successful, meaning that there must be some advantages for this type of enterprise.

Businesses that are family owned may promote their family values to set themselves apart from competitors. Dietz & Watson certainly did that. Another example can be found on the SC Johnson website (scjohnson.com): "We're SC Johnson. A family company at work for a better world." With annual revenue in the billions of dollars, this company, founded in 1886, is proud to be led by a member of the fifth generation of the Johnson family.

Many companies have policies against hiring family members. The assumption is that employees and executives may show favoritism toward their relatives, regardless of competence level or performance. The practice of employing relatives is sometimes referred to as **nepotism**. In fact, many family businesses do provide employment to relatives, regardless of their qualifications, and may keep them on the payroll even after their poor performance has become obvious to everyone. Not only is the effectiveness of the company diminished, but these practices also demoralize competent employees.

Some positives and negatives associated with family businesses are summarized in Exhibit 5.2. The fact that so many family firms are able to survive generational transitions, however, demonstrates that the negatives can be overcome.

nepotism
The practice of employing relatives.

Exhibit 5.2 Positives and Negatives of Family Businesses

Positives (+)	Negatives (−)
Trust among family members	Mistrust by nonfamily employees of incompetent family employees
Loyalty to the family by those within the firm	Lack of loyalty to the firm by family members not directly involved in the business
Commitment to the firm by all family members	Sense of entitlement by the succeeding generation and those not working in the firm
Knowledge among extended family members	Lack of knowledge among those family members outside the firm
Long-range thinking by leaders of the firm	Demand for instant gratification from those who feel entitled
Close communication among family members	Failure to communicate across generations and with family not involved in the firm

Sources: Based on Priscilla M. Cale and David C. Tate, *Sink or Swim: How Lessons from the* Titanic *Can Save Your Family Firm* (Santa Barbara, CA: Praeger, 2011); Frank Hoy and Pramodita Sharma, *Entrepreneurial Family Firms* (Boston: Prentice Hall, 2010); and Ritch L. Sorenson, Andy Yu, Keith H. Brigham, and G. T. Lumpkin (eds.), *The Landscape of Family Business* (Cheltenham, UK: Edward Elgar, 2013).

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5-2 Explain the complex roles and relationships involved in a family business.

5-2 Family Roles and Relationships

Northeastern University is the home of one of the nation's premier family business centers. In one of the center's newsletters, a family business owner offered an observation: "Keeping family members from stepping on each other can go a long way toward preventing conflict in your family business."[6] The owner contended that distinct, defined roles and responsibilities are essential. In this section, we examine a few of the many possible family roles and relationships that can contribute to managerial complexity in a family business.

5-2a Co-Preneurs

Some family businesses are owned and managed by couples, popularly known as **co-preneurs**. Their roles vary depending on their backgrounds and expertise. Whatever the arrangement, both individuals are integral parts of the business.

One potential advantage of a couples team is the opportunity to work with someone you really trust and to share more of your lives together. For some couples, however, the benefits can be overshadowed by problems related to the business. Differences of opinion about business matters can carry over into family life. And the energy of both parties may be so spent by working long hours in a struggling company that little zest remains for a strong family life.

Kosal and Tanisha Chea became franchisees with Idea Lab Kids just before the COVID-19 pandemic lockdown. Idea Lab Kids is a hands-on learning program offering science, technology, engineering, arts, and mathematics (S.T.E.A.M.) to kids ages 4 to 14. Instead of leasing a physical space for their courses, the couple found they could provide online instruction from their kitchen. Their recommendation to other co-preneurs is to understand your partner's strengths so they can excel.[7] On the other hand, some co-preneurs have found that there can be too much togetherness, in which case they must establish rules for time apart.[8] Family members may think that simple rules, guidelines, or goals are unnecessary, but for many people working with relatives, such goals can keep a focus on what they want both the business and the family to become.

5-2b Parents as Founders

Many entrepreneurs expect to pass the enterprise on to their children. The idea is that the business and the family will grow and prosper together. Some of the approaches taken to prepare prospective successors for ownership and leadership include the following:

- Demonstrating the founders' commitment to both the business and the family through actions and words.
- Permitting and supporting entrepreneurial behavior by the children; letting them take calculated risks, and encouraging them to learn from failure.
- Supporting educational efforts that contribute to skills for leading the business while helping the children to develop their own special talents.
- Helping the children to recognize that rules and responsibilities have their place in both business and life.

co-preneurs
Couples who own and manage businesses.

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Parents sometimes have difficulty accepting that their children may choose a different path than joining the family business. In recent years, more viable solutions have become apparent as a result of research studies and increased numbers of professional consultants specializing in family business issues. Examples include helping grown children to launch their own independent ventures, supporting the interest that children may be showing in alternative careers, or providing opportunities for children to work in family charitable foundations.

5-2c Children

Should children be recruited for the family business, or should they pursue careers of their own choosing? Experts recommend introducing children to the family firm at an early age. Parents may take small children to the firm on occasion, then hire them as interns on weekends or during summer breaks. This exposes the children to the lives their parents are living and to what the company is contributing to the family. Parents can make a conscious effort to teach their children that a successful enterprise demands hard work and is not just an inheritance.

Another issue is personal freedom. Our society values the right of the individual to choose their own career and way of life. If this value is embraced by a child, that child must be granted the freedom to select a career of their own choosing. In the entrepreneurial family, the natural tendency is to think in terms of a family business career and to push a child, either openly or subtly, in that direction. Little thought may be given to the child's talent, aptitude, and temperament. They may prefer music or medicine to the world of business and may fit the business mold very poorly. It is also possible that the abilities of the child may simply be insufficient for a leadership role.

A child may feel a need to work outside the family business, for a time at least, to prove that they can make it without help from the family. Family business consultants typically give this advice to parents. Grown children who find they can succeed on their own are likely to have more self-confidence in their abilities if they choose to join the family firm at a later date. Nonfamily employees may have more respect for the new entrant if the child was hired after demonstrating competence in a different organization.

5-2d Sibling Cooperation, Sibling Rivalry

It is not unusual for more than one child to take a position within the company as they enter the workforce or make a career change. Even if they do not work in the business, siblings of those who do may be more than casual observers on the sidelines. They may have a stake as heirs or partial owners.

At best, siblings work as a smoothly functioning team, each contributing according to their respective abilities. Just as families can experience excellent cooperation and unity in their relationships with one another, some family businesses benefit from effective collaboration among siblings. The Living the Dream feature focuses on two sisters who found themselves starting a business in response to being laid off from their respective jobs. Under stress, they could have found much to argue about. Instead, they recognized their respective strengths and worked well together in making their new venture a success.

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Living the Dream

A Sweet Sibling Success Story

We have all heard and perhaps lived through stories of sibling rivalries, siblings who drive each other crazy, who each feel they are not getting their fair share, who cannot agree on anything. Still, many relatives somehow find ways of getting along and are able to start and grow businesses together. When times get tough, it is often a family member that you turn to first, someone you know who has your back. Sisters Nikki Howard and Jaqi Wright found themselves in just such a situation when they were laid off from their jobs. Their solution was a business of their own, The Furlough Cheesecake.

In 2018, Howard was employed in recruitment by the U.S. Food and Drug Administration. Her sister was an analyst in the U.S. Department of Justice. When the federal government shut down due to a failure of Congress to pass legislation to fund government operations and agencies, the sisters were furloughed by their respective agencies. It was not long before they were worried about feeding their families.

On New Year's Day of 2019, Howard made a sweet potato cheesecake for the family. Her mother's reaction was "You should sell those." That was all the encouragement the sisters needed. Wright came up with the company name and registered it. Howard already had a food handler license. Her daughters created a website and got the word out through social media. Within two weeks, they sold over 4,000 cheesecakes and were interviewed on CNN. That was followed by an appearance on the Ellen DeGeneres show and OWN's *Mind Your Business*. DeGeneres, partnering with Cheerios, gave the sisters $20,000 to cover production costs. The host of *Mind Your Business with Mahisha*, Mahisha Dellinger, became their mentor and helped them get into Walmart.

© THE FURLOUGH CHEESECAKE

Before long, Wright and Howard felt their biggest challenge was keeping up with demand. They made the decision to become full-time business owners and quit their government jobs. Dellinger saw two women who were capable of hard work, planning, and determination. She saw her role as a coach, helping them to understand the details of making a small business work. She advised them on managing production, budgeting, hiring, pricing, and other aspects of organizing and operating a company.

Conducting business online rather than setting up a physical location for retail sales may have been critical in the survival and growth of their firm through the lockdown months of the COVID-19 pandemic. The company has enjoyed steady growth and added new flavors to the two initial products: original and sweet potato cheesecakes.

Howard and Wright are grateful for the help of their family members, Mahisha Dellinger, and others who were there for them from the beginning. One of their long-range goals is to pay back by helping other entrepreneurs achieve their dreams.

Sources: Liz Brody, "Lessons from Past Crises," *Entrepreneur*, July–August 2020, p. 28; Michelle Darrisaw, "How These Furloughed Sisters Used the Government Shutdown to Launch a Cheesecake Business," https://theopendaily.com/life/work-money/a26088711/furlough-cheesecake-company-sisters-interview/, accessed April 1, 2021; Jennifer Calfas, "After the Government Shutdown Put These Sisters Out of Work, They Started a Cheesecake Business—and Now It's Taking Off," https://money.com/the-furlough-cheesecake-sisters/, accessed April 1, 2021; The Furlough Cheesecake, https://thefurloughcheesecake.com/, accessed April 1, 2021; and Brittany Chambers, "A Game-Changing Mentor Takes Two Women from Furlough to a National Household Cheesecake Brand," https://www.forbes.com/sites/brittanychambers/2019/04/26/one-game-changing-mentor-takes-two-women-from-furlough-to-a-national-household-cheesecake-brand/?sh=20772db72765, accessed April 1, 2021.

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Don't be surprised, however, if business issues generate competition affecting family, as well as nonfamily, members. Siblings, for example, may disagree about business policy or about their respective roles in the business. And, in some cases, the conflicts can spiral seriously out of control.[9]

One classic example occurred in 1948 when brothers Adolf and Rudolf Dassler had an argument and decided to split the shoe company that they had founded together. Two new companies emerged, Adidas and Puma. Both businesses grew successfully, but the brothers never reconciled. Similarly, divisions among the four Koch brothers of Koch Industries and between siblings Shari and Brent Redstone of Viacom led to prosperous businesses, but irreconcilable family issues. Business survival is certainly not guaranteed when these frictions arise. The Steinberg supermarket chain, one of the largest in Canada, went bankrupt when the three daughters of the founder fought over ownership. Countless small business failures could be added to these lists.[10]

Nonfamily members can play a key role in resolving or avoiding conflict among siblings. Sometimes, nonfamily executives become mentors when a family member joins the firm. This can occur formally or informally. Mentoring is often job-related, focusing on developing work and leadership skills. But the mentor can also guide the child with regard to the culture and values that underlie the company and its success. A member of the firm's board of directors or board of advisers may play a similar role. While these mentors should not be seen as referees, they may be able to coach siblings in how to reach agreement on issues by setting lifetime memories and resentments aside.

Another sibling dilemma has been labeled the *predator/parasite conflict*. Family members working in the firm are sometimes seen by relatives who work outside the company as predators—extracting money from the business that the outsiders believe is rightfully theirs. From the inside, family members external to the firm are seen, in turn, to be parasites. That is, they have ownership rights, receive dividends, or make other claims on the business without contributing to its success.

Later in the chapter, you will learn that many family enterprises have sought to preempt conflicts by formalizing structures. Some have implemented written guidelines by way of family business constitutions, while others have created frameworks such as family business councils.

5-2e In-Laws In and Out of the Business

You are born or adopted into a *family of origin*, the relatives who form your world in your childhood. When you partner with another individual, you discover yourself with a new *family of attachment*, which refers to the new, separate relationship you just formed plus the family connections you acquire from your partner. Suddenly, the members of your family of origin find themselves linked to your new family, with its own values and traditions. For many family firms, the families of attachment may influence the business in some way. In-laws may become directly or indirectly involved in the firms. They may have been employed in the company and married a family member. They may have accepted a position in the company following the marriage. At a minimum, they will have opinions about the family business and their partner's relatives, which they are likely to express.

When an in-law joins a company, effective collaboration may be achieved by assigning family members to different branches or roles within the company. However, competition for leadership positions may eventually force decisions that distinguish among the children and in-laws employed in the business. Being fair and maintaining family loyalty become more difficult as the number of family employees increases.

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In-laws who are on the sidelines also have considerable influence on the business and the family. They are keenly interested in family business issues that impact their partners. When family frustrations come up at work, partners tend to hear all about it at home, often just before the couple goes to bed. The family member vents, then feels better, and goes to sleep. The partner, on the other hand, is just hearing about the situation and spends the rest of the night worried, angry, or both. Then, when everything is sorted out at the office the next morning, no one even thinks about phoning the partner to let them know that everything is fine. Partners tend to hear only one side of the story—the bad side—and it shades their view of the business. So, the criticism they receive for having a bad attitude about the family and its enterprise is often undeserved.[11]

PALO ALTO SOFTWARE, INC

5-2f The Entrepreneur's Partner

Couples don't always become co-preneurs. But even if a partner does not work in the business, they may still play a critical role behind the scenes. As a parent, the partner helps prepare the children for possible careers in the family business. Researchers have found that one of the most frequent and stressful roles performed by the partner is to serve as a mediator in business relationships between the entrepreneur and the children.

Ideally, the entrepreneur and partner form a team committed to the success of both the family and the family business. Such teamwork does not occur automatically—it requires a collaborative effort by both parties in the relationship. Tim Berry, chairman and founder of Palo Alto Software, explained the endorsement he received from his wife when he was weighing whether to start the company:[12]

> [This was the] biggest boost to starting a business: My wife said, "Go for it; you can do it." And she meant it. At several key points along the way, she made it clear that we would take the risk together. There was never the threat of "I told you so, why did you leave a good job, you idiot!" What she said was, "If you fail, we'll fail together, and then we'll figure it out. We'll be okay."

5-3 Identify management practices that enable a family business to function effectively.

5-3 Good Governance in the Family Business

Family businesses sometimes face the stereotype of not being professionally managed. Yet several research studies have shown that publicly traded family firms perform as well as or better than nonfamily corporations.[13] The complex relationships in family firms require the oversight of competent and professional management, whether from inside or outside the family. The family firm is a competitive business. Practicing good management will help the business thrive and permit the family to function as a family. Failing to do so poses a threat to the business and strains family relationships.

5-3a Nonfamily Employees in a Family Firm

Nonfamily members often discover that they have limited opportunities in a family firm. In some cases, promotions are missed because of the presence of family members who may have the inside track. Few parents will promote an outsider over a competent child who is being groomed for future leadership, and this is understandable. But this limits the potential for advancement of nonfamily employees, which may lead them to become frustrated or to leave the firm.

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Owners should make clear, when hiring nonfamily employees, the extent of the opportunities available to them and identify the positions, if any, that are reserved for family members. The leader of a family-owned enterprise might decide to bring in a nonfamily member as an executive with the firm for the following reasons:

- To bridge the gap between generations.
- To set a new direction for the firm.
- To deal with change.
- To provide new skills and expertise.

5-3b Family Retreats

Ideally, founders would think about how the business and the family might affect each other from the time they start on their adventure. The truth is, however, that most owners don't start thinking about how the two will interact until some problem comes up, often when the business matures and has created wealth. One of the first steps experts recommend for building a healthy family-to-business relationship is to hold a retreat. A **family retreat** is a meeting of family members (often including in-laws), usually held away from company premises, to discuss family business matters. The retreat is not so much an *event* as it is the *beginning of a process* of connecting family members. It presents an opportunity to celebrate the founders and their sacrifices, as well as to highlight the legacy they want to pass down to future generations of the family.

The prospect of sitting down together to discuss family business matters may seem threatening to some family members. As a result, some families avoid open communication, fearing it will stir up trouble. They assume that making decisions quietly or secretly will preserve harmony. Unfortunately, this approach often covers up serious differences that become increasingly troublesome. Family retreats are designed to improve lines of communication and to bring about understanding and agreement on family business issues. Retreats may address any number of topics:[14]

- Rules for joining the business.
- Treatment of family members working and not working in the business.
- The role of in-laws.
- Evaluations and pay scales.
- Stock ownership.
- Ways to provide financial security for the senior generation.
- Training and development of the junior generation.
- The company's image in the community.
- Philanthropy.
- Opportunities for new businesses.
- The diverse interests of family members.

Honest and candid discussion can be difficult, so it is standard for family leaders to invite an outside expert or facilitator to coordinate the early sessions. The facilitator can help develop an agenda and set ground rules for discussion. While chairing early sessions, they can establish a positive, nonthreatening tone that emphasizes family achievements and encourages rational consideration of sensitive issues. Family members who are able to develop and support an atmosphere of neutrality, however, may be able to chair the sessions without using an outsider.

family retreat
An informal gathering of family members, usually at a remote location, to discuss family business matters.

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But the talk at family retreats is not always about business. After a retreat, families often speak of the joy of sharing family values and stories of past family experiences. Thus, retreats can turn into vacations with participants enjoying each other's company socially. When members of an extended family grow to like each other, it strengthens the family as well as the company.

5-3c Family Councils

A logical follow-up to the retreat is the creation of a **family council**, in which family members meet to discuss values, policies, and a direction for the future. A family council is the organizational and strategic planning arm of a family. It provides a forum for listening to the ideas of all members and discovering what they believe in and want from the business. A family council formalizes the participation of the family in the business to a greater extent than a family retreat does. It can also be a focal point for planning the future of individual family members, the family as a whole, and the business, as well as how each relates to the others.

A council isn't a casual get-together. It should be a formal organization that provides governance for family members in their relationship with the business. Council members are normally elected by the extended adult family members. The representatives hold regular meetings, keep minutes, and make suggestions to the firm's board of directors. During the first several meetings, an acceptable mission statement is usually generated, as well as a family business constitution.

5-3d Family Business Constitutions

As we just explained, family councils may be charged with the responsibility of writing a **family business constitution**, which is a statement of principles intended to guide a family firm through times of crisis and change, including the succession process. This is not usually a legally binding document, but it helps preserve the intentions of the founder and ensures that the business survives periods of change largely intact. When a transfer between generations occurs and there is no guiding document, issues such as ownership, performance, and compensation can become flashpoints for conflict.[15]

A family business constitution is sometimes called a *family creed*. It provides the framework for a family's system of governance of the firm and serves multiple purposes:[16]

- It documents the mission, values, philosophy, and principles that govern the family and its business, including the struggles of past generations.
- It outlines the business's strategy and its long- and short-term goals.
- It defines dispute-resolution processes to deal with potential conflicts affecting the business and the family.
- It defines the roles, composition, and powers of key governing and other constituencies of the business, including key management, directors, shareholders, and family members.

A family business constitution cannot foresee every eventuality, but like any such document, it can be amended as needed. The important point is that this document can smooth any transitions, including a change in leadership, which is the subject of the next section.

family council
An organized group of family members who gather periodically to discuss family-related business issues.

family business constitution
A statement of principles intended to guide a family firm through times of crisis and change; sometimes called a *family creed*.

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5-4 Management and Ownership Succession

5-4 Describe the process of managerial succession in a family business.

The task of preparing family members for careers, leadership, and ownership within the business is difficult and sometimes frustrating. Professional and managerial requirements are intertwined with family feelings and interests. Making the process work can take years.

The results of the 2016 PricewaterhouseCoopers' (PwC) survey of key decision makers of family-owned businesses in the United States noted a recurring theme of inattention to succession planning.[17] Because everyone is so uncomfortable with the subject, plans for succession often were described as informal and poorly developed or at least poorly communicated. PwC posted the results of its tenth survey in 2021. COVID-19 was on the mind of the respondents, who expected the pandemic to have a greater impact on growth than the Great Recession did. Although most business owners were optimistic about economic growth in 2022, sustainability was rated as a critical issue. The top priority of respondents was diversification into new markets and consumer segments. Preparing the next generation for their management roles ranked ninth out of 16 actions for the coming two years.[18]

5-4a Available Family Talent

Companies that survive long enough to face a generational transition generally have talented, visionary leadership. But the leadership that made the business successful at one time may not be right as conditions change. A business is dependent, therefore, on developing or attracting effective leaders for the future. If the available talent is not sufficient, the owner must bring in outside leadership or supplement family talent to avoid a decline in the business under the leadership of second- or third-generation family members.

The question of competency is both critical and sensitive. With experience, individuals can improve their abilities. Learning from mistakes may be essential for later success. Parents may be overly cautious about delegating authority to their children, but how will those children be ready if they haven't tested their wings?

A family firm should not accept the existing level of family talent as unchangeable. Using development programs to teach younger family members and improve their skills is imperative. It is not unusual for firms to specify training programs and other requirements in formal documents, such as a family business constitution. Some firms include mentoring as a part of such programs. *Mentoring* is the process by which an experienced person guides and supports the work, progress, and professional relationships of a new or less experienced employee. In a family business, a mentor and protégé have the opportunity to navigate and explore family as well as business roles and responsibilities.


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5-4b Preparing for Succession

Barring the death of the founder or some other emergency, children do not typically assume leadership of a family firm at a particular moment in time. Instead, a long, drawn-out process is involved. This process can be intentionally designed and implemented, or it can simply occur as all parties age. In the latter case, no one should be surprised if the next generation is not prepared

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at the time a transition is necessary. Successful management and ownership transitions require thoughtful action by both the current and the future leadership teams.

Preparation by the Senior Generation

Members of the senior generation should be able to answer the following questions in order to prepare for succession:[19]

- Do any of the children want to take over the business?
- How do we choose between equally capable children?
- Will they become good leaders, or will the company suffer due to their weak leadership skills?
- Will the successors collaborate in the future, or will they engage in sibling rivalry?
- How do we nurture the needed competencies to take the business forward?
- How will we support those who want to pursue a career outside the family business?

Because members of the next generation sometimes have trouble seeing the current generation as managers rather than parents, many members of the senior leadership decide to bring in outside experts to resolve these concerns.

Preparation by the Next Generation

If prospective future leaders of the family enterprise expect to advance to executive positions, they should ask themselves the following questions:[20]

- Do I really want to join the family business at all?
- Should I join the family business right now, or should I wait and get experience outside the family business first?
- What do my parents think about the timing of succession and their retirement?
- How will they transfer ownership of the firm?

A key responsibility of members of the younger generation is to keep in mind that they are not entitled to a leadership position. Such positions need to be earned.

5-4c Transfer of Ownership

The succession process for a sustainable family firm eventually requires the transfer of ownership. Questions of inheritance affect not only the leadership successor, but also other family members who have no involvement in the business. In distributing their estate, parent-owners typically wish to treat all their children fairly, both those involved in the business and those on the outside. And for many family-controlled enterprises, nonfamily members may have shares of ownership in the firm.

One step taken by some parents involves changing the ownership structure of the firm. Those children active in the firm's management, for example, might be given common (voting) stock and others given preferred (nonvoting) stock.

Typically, a variety of legal issues need to be resolved. Tax considerations are relevant, and they tend to favor gradual transfer of ownership to all heirs. As noted, however, transfer of equal ownership shares to all heirs may be inconsistent with the future successful operation of the business. Tax advantages should not be allowed to blind one to possible adverse effects on management.

In addition, government regulations exist to protect minority shareholders. Outside investors, business partners, and even employees who may hold stock are not interested in watching the value of their stock lie dormant or deteriorate.

Ideally, the founder has been able to arrange their personal holdings to create wealth outside the business as well as within it. This is an area where outside experts

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who grasp financial and estate planning, as well as tax law and accounting, can be invaluable. Planning and discussing the transfer of ownership is not easy, but it is strongly recommended. Over a period of time, the owner must reflect seriously on family talents and interests as they relate to the future of the firm. The plan for transfer of ownership can then be established and modified as necessary when it is discussed with the children or other potential heirs. In discussing exit strategies in Chapter 13, we explain a variety of possible financial arrangements for the transfer of ownership.

In this chapter, we have tried to make one message very clear to prospective family business owners—families and family businesses are interrelated. Trying to separate them would be like trying to unscramble eggs. The better you understand that going in, the more successful you can be in both areas of your life. Despite what many people believe, family members can work together successfully and happily. Advance planning can help avoid a lot of problems, as well as boost the success of the business.

5-5 Buying an Existing Business

5-5 Describe some specific reasons for buying an existing business and how to evaluate an existing business for purchase.

Transferring ownership is not restricted to family enterprises. You may discover the best way for you to become a business owner is to purchase a firm from someone who is not related to you. As you look at companies available for purchase, you may discover an opportunity to turn around a company in trouble. Or perhaps you have the skills needed to make an already good business excellent. An existing firm may be the perfect platform on which to build your dream.

The decision to purchase an existing business should not be made lightly. It involves a serious investment of funds, so you must give careful consideration to the advantages and disadvantages of this option.

5-5a Reasons for Buying an Existing Business

The reasons for buying an existing business can be condensed into the following four general categories:

1. To reduce some of the uncertainties that must be faced when starting a business from the ground up.
2. To acquire a business with ongoing operations and established relationships with customers and suppliers.
3. To obtain an established business at a price below what it would cost to start a new business or to buy a franchise.
4. To get into business more quickly than by starting from scratch.

Let's examine each of these reasons in more detail.

Reduction of Uncertainties

A successful business has already demonstrated its ability to attract customers, manage costs, and make a profit. Although future operations may be different, the firm's past record shows what it can do under actual market conditions. For example, sales and profit data can confirm that the location is satisfactory, which eliminates one major uncertainty. Noncompete agreements are needed, however, to discourage the seller from starting a new company that will compete directly with the one he or she is selling.

Acquisition of Ongoing Operations and Relationships

The buyer of an existing business typically acquires its personnel, inventories, physical facilities, established banking connections, and ongoing relationships with trade

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Living the Dream

Buying an Existing Business to Satisfy the Need for Independence

The entrepreneurial bug was there from the beginning. There had been generations of business owners in the Deike family. Tyler Deike and his brother started their lawn care business while in high school, and Tyler kept it running through college. After completing his industrial engineering degree, though, Deike went in another direction. He accepted a corporate job at Kato Engineering, holding a number of engineering roles over the next eight years.

Still, Deike saw himself as an idea guy and had a hard time fitting into a conservative corporate structure. After studying how businesses were being run in different environments, he decided his entrepreneurial focus would be on bringing new ideas to existing companies. Specifically, he concluded that a lot of businesses were owned by aging founders who did not see new opportunities for their firms or did not have the attitude and energy to take on the challenge of new growth.

Deike contacted business brokers to help him find a company he could rejuvenate. One of the brokers encouraged him to look at Blackhawk Industries, Inc., a fiberglass business. Deike knew nothing about fiberglass products and the industry, but he found the owner to be friendly and trustworthy—someone who wanted to see his business continue. Taking over an existing business was much different from Deike's experience in lawn care service, so he knew there would be a learning curve. He reached out to an attorney, an accountant, the small business center in his hometown of Mankato, Minnesota, and a few other professionals.

PHOTO BY CONNECT BUSINESS MAGAZINE

Any number of problems might crop up when an entrepreneur takes over a business. The biggest surprise for Deike turned out to be having more orders for products than the company had the capacity to fill. He took immediate action, investing in more space and more equipment. As he gained more control, he expanded the product line and undertook new projects, including outdoor living products and powersports accessories.

As he pushed ahead with the company that he renamed Blackhawk Fiberwerx to reflect the direction he was taking the business, Deike continued operating his lawn care company, Maverick Lawn Care. He has added customers, workers, and lines of service. The business has moved into fertilizing, aerating, weed control, mosquito spraying, salt and snow removal, and more.

Deike sees spin-offs and more start-ups in his future. He reports three keys to his success: surrounding himself with the right people, being able to pivot fast, and recognizing when and how to scale up the company. In the long run, he and his wife want to concentrate on giving back. Deike wants to share his vision with college students, letting them know that the corporate employment route is not their only option. He wants to introduce them to trades and entrepreneurship, and he is certain that such learning can be integrated into the educational system.

Sources: BizBuySell, "Bringing Life to Small Businesses: An 'Idea Guy' Makes Entrepreneurship His Reality," https://www.bizbuysell.com/success-story/blackhawk-fiberwerx-an-idea-guy-makes-entrepreneurship-his-reality/, accessed August 28, 2021; Dan Linehan, "The Restless Entrepreneur: after Buying Fiberglass Business, Tyler Deike Stays Hungry," https://www.mankatofreepress.com/news/local_news/the-restless-entrepreneur-after-buying-fiberglass-business-tyler-deike-stays-hungry/article_f239d4a8-aa73-59e2-8dbd-70e3bae321cd.html, accessed August 28, 2021; https://mavlawncare.com, accessed April 2, 2021; Lisa Cownie, "Blackhawk Fiberwerx," https://connectbiz.com/2019/11/blackhawk-fiberwerx/, accessed August 29, 2021; and "We Are Blackhawk," https://www.cabbacks.com/?fbclid=IwAR35fAPP8bwLqtvvCAUMO_oZuB-RKqe55YD83JWbLs_XhvznS40CCnzlWWA, accessed August 29, 2021.

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suppliers and customers. You are also acquiring the goodwill that the prior owner created. The advantage derived from buying an established firm's assets depends on the nature of the assets. For example, a firm's skilled, experienced employees constitute a valuable asset only if they will continue to work for the new owner. The physical facilities must not be obsolete, and the firm's relationships with banks, suppliers, and customers must be healthy. In any case, new agreements will probably have to be negotiated with current vendors and leaseholders.

A Bargain Price

If the seller is more eager to sell than the buyer is to buy, an existing business may be available at what seems to be a low price. Whether it is actually a good buy, however, must be determined by the prospective new owner. Several factors could make a "bargain price" anything but a bargain. For example, the business may be losing money, the location may no longer hold promise, or the seller may intend to open a competing business nearby. On the other hand, if research indicates that the business indeed is a bargain, purchasing it is likely to turn out to be a wise investment. And it can be easier to get financing for an ongoing business than for a start-up.[21]

A Quick Start

Most entrepreneurs are eager to get going in their new business and may not be comfortable waiting the months and years sometimes required to launch a business from scratch. Buying an existing business may be an excellent way to begin operations much more quickly.

5-5b Finding a Business to Buy

Sources of leads about businesses available for purchase include suppliers, distributors, trade associations, and even bankers. Realtors—particularly those who specialize in the sale of business firms and business properties—can also provide leads. In addition, business brokers can assist in buying and selling businesses.[22] Entrepreneurs need to be wary of potential conflicts of interest with realtors and business brokers, however. For example, if those agents and brokers are paid only if a buy-sell transaction occurs, they may be tempted to do whatever it takes to close the deal, even if doing so is detrimental to the buyer.

The Small Business Administration offers the following guidance on finding a business that might be a good match for you:[23]

- *Quantify your investment.* Review your financial landscape, and decide how much you're willing to spend to purchase—and ultimately manage—the business. This will help you determine what types of businesses or brands are best for your budget.
- *Consider your talents and lifestyle.* Be honest about your skills and experience, as they can help you eliminate unrealistic business ventures. For example, if you prefer hands-on assistance, then franchising might be best for you. On the other hand, if you're an experienced business owner, you may want to consider buying an existing business.
- *See the big picture.* Look at the existing infrastructure, and make sure you understand everything that comes along with the purchase. Don't be afraid to ask questions about contracts, leases, existing cash flows, and inventories. The more you know, the better equipped you'll be to make a sound decision.

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5-5c Investigating and Evaluating Available Businesses

A business opportunity requires **due diligence**, the exercise of reasonable care in the evaluation of the opportunity. As a preliminary step, the buyer needs to acquire background information about the business, some of which can be obtained through personal observations and discussions with the seller. Talking with other informed parties, such as suppliers, bankers, and employees of the business, is also important. You may find it exhausting to examine all the details associated with a company you want to buy. Here is a short list of some aspects you specifically need to investigate:[24]

1. Review and verify all financial information.
2. Review and verify the business structure and operations.
3. Review and verify all material contracts.
4. Review and verify all customer information.
5. Review and verify all employee information.
6. Check for any legal issues.
7. Review and verify all physical assets and real estate.
8. Review and verify all intellectual property.

If a seller cannot supply the documents on this list, you may want to back away. Some items will not exist for every business. For example, not every company will possess intellectual property. Nevertheless, you should be exhaustive in your efforts to uncover relevant information that could influence the selling price or whether you should even offer to buy the business.

Relying on Professionals

Although some aspects of due diligence require personal investigation, a buyer can also seek the help of outside experts. The two most valuable sources of outside assistance are accountants and attorneys. It is also wise to seek out others who have acquired a business in order to learn from their experiences. The time and money spent on securing professional help in investigating a business can pay big dividends, especially when the buyer is inexperienced.

Finding Out Why the Business Is for Sale

The seller's real reasons for selling may or may not be the stated ones. When a business is for sale, always question the owner's reasons for selling. There is a real possibility that the firm is not doing well or that underlying problems exist that will affect its future performance. The buyer must be wary, therefore, of taking the seller's explanations at face value. Here are some of the most common reasons why owners offer their businesses for sale:

- Retirement
- Illness
- Partnership or family disputes
- Unprofitability or failure of the business
- Burnout
- Lack of capital for growth potential

A prospective buyer cannot be certain that the seller-owner will be honest in presenting all the facts about the business, especially concerning financial matters. Background checks on key personnel are also essential when conducting due diligence.

due diligence
The exercise of reasonable care in the evaluation of a business opportunity.

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Examining the Financial Data

The first stage in evaluating the financial health of a firm is to review its financial statements and tax returns for the past three to five years or for as many years as they are available. (If these statements are not available, think twice before buying the business.) This review helps to determine whether the buyer and the seller are in the same ballpark on estimates and expectations. If so, the parties can move on to valuing the firm. You will find details on compiling and interpreting financial statements in Chapter 10.

As both a legal and an ethical matter, the prospective buyer may expect to sign a nondisclosure agreement, an agreement in which the buyer promises the seller that they will not reveal confidential information or violate the seller's trust. Buyers are typically allowed to share such information with others, such as a potential lender or legal adviser, on a need-to-know basis.

The buyer should recognize that financial statements can be misleading and may require normalizing to yield a realistic picture of the business. For example, business owners sometimes understate business income in an effort to minimize their taxes. Other examples are costs of the personal use of business vehicles appearing as business expenses, and family members receiving excessive compensation or none at all. All entries must be examined to ensure that they relate to the business and are appropriate.

The buyer should also compare the seller's balance sheet to actual assets and liabilities. Property may appreciate in value after it is recorded on the books, but physical facilities, inventories, and receivables may decline in value, so their actual worth may be less than their accounting book value.

5-5d Quantitative Factors in Valuing a Business

Once the initial investigation and evaluation have been completed, the buyer must arrive at a fair value for the firm. It will require more than just getting copies of the financial statements (income statements, balance sheets, and cash flow statements). Supplier invoices, customer receipts, state sales tax statements, and the company's bank statements should also be considered.

There are numerous techniques used for valuing a company, but they can be grouped into three basic methods: (1) asset-based valuation, (2) market-based valuation, and (3) cash flow–based valuation. Each of these methods can be used as a stand-alone measure of firm value. But, because valuation is a subjective process, most often the firm is valued using a variety of methods. Each approach generates firm values that, together, form a range rather than a specific number.

5-5e Nonquantitative Factors in Valuing a Business

You should also consider a number of nonquantitative factors in evaluating an existing business. In particular, is it likely that the firm you are considering buying might be subject to change regarding any of the following?

- *Market*. The ability of the market to support all competing business units, including the one to be purchased, should be determined. This requires doing marketing research and talking to customers.
- *Competition*. The prospective buyer should look into competing businesses. In particular, the buyer should check to see whether the business in question is gaining or losing in its race with rivals. Additionally, new competitors in the local marketplace may dramatically change an existing small firm's likelihood of success. Past performance is no guarantee of future performance.

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- *Legal commitments.* A firm's legal commitments may include contingent liabilities, unsettled lawsuits, delinquent tax payments, missed payrolls, overdue rent or installment payments, and mortgages of record on any of the real property acquired.
- *Union contracts.* The prospective buyer should determine what type of labor agreement, if any, is in force, as well as the quality of the firm's relationship with its employees. Private conversations with key personnel and rank-and-file employees can be helpful in determining their job satisfaction and the company's likelihood of success.
- *Physical facilities.* The quality of the physical structures that house or are used by the business should be checked, with particular attention paid to any fire hazards. In addition, the buyer should determine whether there are any restrictions on access to buildings.
- *Product prices.* The prospective owner should compare the prices of the seller's products with those listed in manufacturers' or wholesalers' catalogs and also with the prices of competing products in the locality. This is necessary to ensure full and fair pricing of goods whose sales are reported on the seller's financial statements.

5-5f Negotiating and Closing the Deal

The purchase price of a business is determined by negotiation between the buyer and the seller. Although the calculated value may not be the price eventually paid for the business, it gives the buyer an estimated value to use when negotiating price. Typically, the buyer tries to purchase the firm for something less than the full estimated value; of course, the seller tries to get more than that value.

In some cases, the buyer may have the option of purchasing the assets only, rather than the business as a whole. When a business is purchased as a total entity, the buyer not only takes control of the assets but also assumes any outstanding debt, including any hidden or unknown liabilities. Even if the financial records are audited, such debts may not surface. If the buyer instead purchases only the assets, then the seller is responsible for settling any outstanding debts previously incurred. When buying the business as a whole, an indemnification clause in the sales contract may serve a similar function, protecting the buyer from liability for unreported debt.

An important part of the negotiation process is the terms of purchase. In many cases, the buyer is unable to pay the full price in cash and must seek extended terms. At this point, a lender may enter the picture and alter the purchase price. If a bank is providing a loan for buying the business, the bank may require the assets of the company to serve as collateral for the loan. Any lender must perform its own due diligence and estimate a value for the assets, and that value may be at a different level than the buyer and seller have agreed upon.

At the same time, the seller may be concerned about taxes on the profit from the sale. Terms may become more attractive to the buyer and the seller as the amount of the down payment is reduced and/or the length of the repayment period is extended. As with the purchase of real estate, the purchase of a business is closed at a specific time, and a title company or an attorney usually handles the closing. Preferably, the closing will occur under the direction of an independent third party. If the seller's attorney is the closing agent, the buyer should exercise great caution—a buyer should never go through a closing without the aid of an experienced attorney who represents only the buyer.

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A number of important documents are completed during the closing, including a bill of sale, tax and other government regulation forms, and agreements pertaining to future payments and related guarantees to the seller. The buyer should apply for new federal and state tax identification numbers to avoid being held responsible for past obligations associated with the old numbers. If you want a happy ending from the purchase and a clear path to your future, do not take short cuts at this stage. Meeting all legal and regulatory requirements secures your investment and your ability to successfully manage the business.

Starting a business, becoming a franchisee, joining a family firm, and buying an existing business are all potential paths to your entrepreneurial dream. Whatever your particular circumstances, keep in mind that business owners must invest themselves, as well as their money, if they want their companies to succeed. As is so often the case in life, it is up to you to devote your time, effort, and resources if you really want to achieve your goals.

5-1. Define the terms *family* and *family business*.

- The word *family* refers to a group of people bound by a shared history and a commitment to share a future together, while supporting the development and well-being of individual members.
- A *family business* is an organization in which either the individuals who established or acquired the firm or their descendants significantly influence the strategic decisions and life course of the firm.
- A family business can be described as an owner-managed business, a sibling partnership, or a cousin consortium.
- The long-term survival of the business is dependent on the commitment of family members. They may be committed to the family business for different reasons, and these reasons will likely determine the nature and strength of that commitment.
- Businesses that are family owned may promote their family values to set themselves apart from competitors.
- Trust and loyalty among family members are two advantages of a family business.

5-2. Explain the complex roles and relationships involved in a family business.

- Couples known as co-preneurs join in owning and managing a business together, which can strengthen or weaken their working and personal relationships.
- A primary and sensitive relationship exists between founders and their children. Some children decide to work outside the company to gain experience before joining the family business.
- Siblings and other relatives may strengthen or weaken their working and personal relationships through a family business.
- In-laws play a crucial role in the family business, either as direct participants or as sideline observers.

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- The role of the founder's partner is especially important, as that person often serves as a mediator in family disputes and helps prepare the children for possible careers in the family business.

5-3. Identify management practices that enable a family business to function effectively.

- Good management practices are as important as good family relationships in the successful functioning of a family business.
- Motivation of nonfamily employees can be enhanced by open communication and fairness.
- Family retreats bring all family members together, usually in an informal setting, to discuss business and family matters.
- Family councils provide a formal framework for the family's ongoing discussion of family and business issues.
- Family business constitutions can guide a company through times of crisis or change, including the succession process.

5-4. Describe the process of managerial succession in a family business.

- Discussing and planning the transfer of leadership in a family business is difficult and sometimes frustrating.
- The quality of leadership talent available in the family determines the extent to which outside managers are needed.
- Succession is a long-term process starting early in the successor's life.
- The succession process requires actions and effective communication on the part of both the current leadership and the next generation.
- Transfer of ownership involves issues of fairness, taxes, and managerial control.

5-5. Describe some specific reasons for buying an existing business and how to evaluate an existing business for purchase.

- Buying an existing firm can reduce the uncertainties associated with a start-up.
- In acquiring an existing firm, the entrepreneur can take advantage of the firm's ongoing operations and established relationships with customers and suppliers.
- An existing business may be available at a price below what it would cost to start a new business or buy a franchised business.
- Another reason for buying an existing business is that an entrepreneur may be in a hurry to start an enterprise.
- Investigating a business requires due diligence.
- A buyer should seek the help of outside experts, especially accountants and lawyers.
- The buyer needs to investigate why the seller is offering the business for sale.
- The company's financial statements and tax returns for the past three to five years (or longer) should always be examined.
- Other quantitative factors in valuing a business include state sales tax statements, supplier invoices, customer receipts, and the company's bank statements.
- Nonquantitative factors in determining the value of a business for sale include the market, competition, legal commitments, union contracts, buildings, and product prices.
- The terms of purchase are an important part of the negotiation between buyer and seller.
- Documents completed during the closing include a bill of sale, tax and other government regulation forms, and agreements regarding future payments and related guarantees to the seller.

Key Terms

co-preneurs p. 118
cousin consortium p. 116
due diligence p. 130
family p. 115
family business p. 115
family business constitution p. 124
family council p. 124
family retreat p. 123
nepotism p. 117
owner-managed business p. 115
sibling partnership p. 115

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Discussion Questions

1. How are family businesses different from nonfamily businesses? In what ways are they the same?
2. Suppose that you, as the founder of a business, have a sales representative position open. Your sister has a stepdaughter who is looking for a job, and your sister asks you to hire the young woman. What would you do? Why?
3. What advantages result from family involvement in a business? What are some disadvantages?
4. You have been offered a job with a family-owned company. You are not related to anyone in the business. What factors should you consider in deciding whether or not to take it?
5. If you start a venture and expect some of your family members to join you, what rules should be established in advance?
6. Should a child of business owners feel an obligation to carry on a family business? What might happen if the prospective successor chooses not to join the firm?
7. When the transfer of ownership of a family business from one generation to the next is being considered, how much emphasis should be placed on estate tax laws and other concerns that go beyond the family? Why?
8. What are some reasons for buying a company as opposed to starting a new venture?
9. Why might an owner decide to sell an existing business? Are there any reasons that might be viewed negatively by a potential buyer?
10. What are some of the nonquantitative factors that might affect the selling price of a business?

You Make the Call

Situation 1

After five tries, Morris and Ellen finally succeeded as co-preneurs. The first four put bread on the table, but not much more for them and their five children. The fifth venture was a printing company specializing in designing and producing promotional brochures. It turned out to be in the right place at the right time and grew into the largest producer in their region.

Managing the businesses and raising the children took a toll. At one time or another, each of their children joined the family firm, and at one time or another, each was fired. Two children returned to the family business after working for other firms and learning that their parents were not that different from other business owners. Their oldest son was a good technician but invariably failed in any projects he took on independently. The younger son was recognized by employees and customers as skilled both in management and in interpersonal communication. Unfortunately, he had a felony conviction for drug trafficking and was prohibited from driving motor vehicles.

Morris recently suffered a heart attack and realized that he cannot continue forever. He and Ellen have to make a decision about the future of the business. A complicating factor is that they are in a declining industry, one in which electronic production is rapidly replacing paper.

Question 1 What advice do you have for Morris and Ellen?

Question 2 What recommendations do you have for preparing children to lead changes in a company?

Situation 2

After completing his engineering degree, Phil had numerous job offers at high salaries. He accepted a position with a well-established manufacturing company and quickly moved up the ranks. Then, he was recruited to be part of the top management team of a construction company. Life has been good, but Phil has been thinking that he'd really like to run his own business. He's established a strong reputation for both his technical and his leadership skills. He has been speaking with business brokers and with some owners who he feels might be willing to negotiate a sale, but nothing has felt right so far.

Question 1 Why do you think Phil is thinking about business ownership after the success he has achieved when working for other companies? Why do you think he wants to buy instead of start a business?

Question 2 What questions do you think Phil should ask of a seller if he finds a business that he likes?

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Experiential Exercises

1. Find a fellow student who has grown up in a family business. Ask about the attitudes that person's parents have expressed about their child's future with the company. Submit a one-page report describing the direct and indirect ways that the family members communicated their expectations to one another.
2. Locate a business broker who will agree to be interviewed. How does that broker calculate the value of the businesses that are being offered for sale?

Chapter 5 Case

Please see Appendix A for the Chapter 5 Case Study.

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Chapter 6

Visualizing Your Dream: The Business Model and the Business Plan

Looking Ahead

Learning Objectives

The primary purpose of the Visualizing Your Dream chapter is to help you (1) develop a business model that can reduce uncertainty when starting a venture, and (2) write and execute a business plan. By studying this chapter, you should be able to . . .

6-1 Explain the meaning of the term *business model* and how a business model can be used in starting and growing a new venture.

6-2 Describe how a lean start-up can be used to reduce risk when starting a new venture.

6-3 Explain the meaning of the term *business plan* and the purpose and form of a business plan.

6-4 Describe the preferred content and format for a comprehensive business plan.

6-5 Offer practical advice for writing a business plan.

6-6 Explain how to present a business plan to prospective investors.

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Spotlight on Small Business

Maternova

maternova.net

Meg Wirth founded Maternova in 2009 as a mission-driven, for-profit organization. The firm researches, reviews, and sells innovative, proven obstetric and newborn technologies to private hospitals, governments, NGOs, and health-care professionals around the world.

According to the World Health Organization (WHO), approximately 1,000 women die every day from preventable causes linked to pregnancy and childbirth. Wirth founded Maternova to accelerate access to life-saving maternity and birth-care innovations, especially in low-income, rural areas in developing countries.

The company adopted a two-pronged approach to driving revenue: (1) the aggregation and sales of select low-tech medical devices in a pioneering e-commerce marketplace, and (2) an innovative open-source platform where health-care workers can connect globally.

Looking for capital to fund this new enterprise, Wirth and her small team entered business plan competitions and joined two start-up incubators in hopes of gaining visibility and needed cash. This approach served as part of the team's overall bootstrapping strategy. (Note that many universities and colleges with business and entrepreneurship programs sponsor annual business plan competitions. Also, some businesses and organizations outside of higher education offer opportunities with sizable cash prizes.)

With a clear mission and strategic focus, the Maternova team turned to online business-planning software *LivePlan,* which they credit for helping develop their business model into a winning business plan.

Source: Written by Sherisa Cruikshank, former senior content strategist, Palo Alto Software, April 4, 2018.

When you mention an idea for a new business to a friend who's a business owner, they say, "You'll need to prepare a business plan or, maybe even better, create a business model."

While you have heard about writing a business plan, the term *business model* is new to you. You believe strongly in your idea, but spending hours crafting formal documents is not exactly your idea of fun, and you wonder if it is absolutely necessary. After all, you know an entrepreneur who started and successfully grew a company based on an idea developed on the back of a napkin over dinner. And isn't it true that the founders of such notable companies as Microsoft, Dell, *Rolling Stone* magazine, and Calvin Klein all started their businesses without business plans?

So, should you spend time developing a business model or writing a business plan? This chapter will help you understand what you need to know to answer that question. To begin, consider the following basic distinction between a business model and a business plan:

- A *business model* should be used when forming a new venture, where there is so much uncertainty and risk that you have limited, if any, verifiable evidence as to the potential viability of the opportunity.
- A *business plan*, on the other hand, is particularly useful for guiding the company's management team and its employees in executing your vision for the new company, and it is essential when trying to raise money from outside lenders and investors.

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6-1 Explain the meaning of the term business model and how a *business model* can be used in starting and growing a new venture.

6-1 The Business Model and the Entrepreneur

If you asked a group of business leaders to describe a business model, you would get a wide variety of answers. So let's begin by clarifying what we mean by the term *business model*.

6-1a What Is a Business Model?

Simply stated, a **business model** explains in a systematic and structured way how a company, or any organization for that matter, creates, delivers, and captures value. It helps the entrepreneur to anticipate the financial outcomes of the firm's strategic decisions and activities that determine a company's profits and cash flows.

When existing firms develop a business model, they frequently revise or adapt an existing model. A start-up, on the other hand, must create or discover a business model, which means there is greater uncertainty in the process. In fact, some would argue that with a start-up, you might not know what business you are in for the first several years.

As we will explain, developing a business model can provide the best evidence as to whether a business concept can be translated into a viable, profitable business, while at the same time addressing some of the risks of starting a new business. But it is also important to understand that businesses do not operate in isolation. The eventual success or failure of a business model depends in part on how it interacts with the business models of competitors.

Some business models are easy to understand. A firm produces a product and/or service and sells it to customers. If sales exceed expenses, the company makes a profit. Other models are less straightforward. For instance, television broadcasting is part of a complex network of distributors, content creators, advertisers, and viewers. How the eventual profits and cash flows are created and shared depends on a number of competing factors, which are not always clear at the outset.

E-commerce has given rise to new business models. Consider auctions, one of the oldest ways of setting prices for such things as agricultural commodities and antiques. Today, the Internet has popularized the auction model and broadened its use to a wide array of goods and services.

6-1b Creating a Business Model

To demonstrate the process of creating a business model, we will use what is called the **Business Model Canvas**, developed by Alex Osterwalder.[1] The Business Model Canvas focuses on a firm's core characteristics and allows you to test your model assumptions, or hypotheses, in the marketplace. You can then change, pivot, or abandon your idea before large amounts of time and money are deployed.

Benefits of the Business Model Canvas include (1) a customer focus, (2) the highlighting of important interconnections in the model, (3) the facilitation of communications among team members regarding your value proposition, (4) flexibility, and (5) simplicity (it uses only a single piece of paper or a whiteboard).

Exhibit 6.1 shows a graphical representation of the Business Model Canvas, which consists of nine different "building blocks." We have divided the nine building blocks into two groups, as follows:

- Five blocks related to customers (outlined in red).
- Four blocks related to the infrastructure needed to support your value proposition to customers (outlined in blue).

Let's first look at the group of building blocks in Exhibit 6.1 that help the entrepreneur understand prospective customers.

business model
A structured analysis of how a firm plans to create, deliver, and capture value, focusing on the financial outcomes of strategic decisions and activities that will determine profits and cash flows.

Business Model Canvas
A strategic tool that focuses on a firm's core characteristics and allows an entrepreneur to test new ideas before time and money are deployed.

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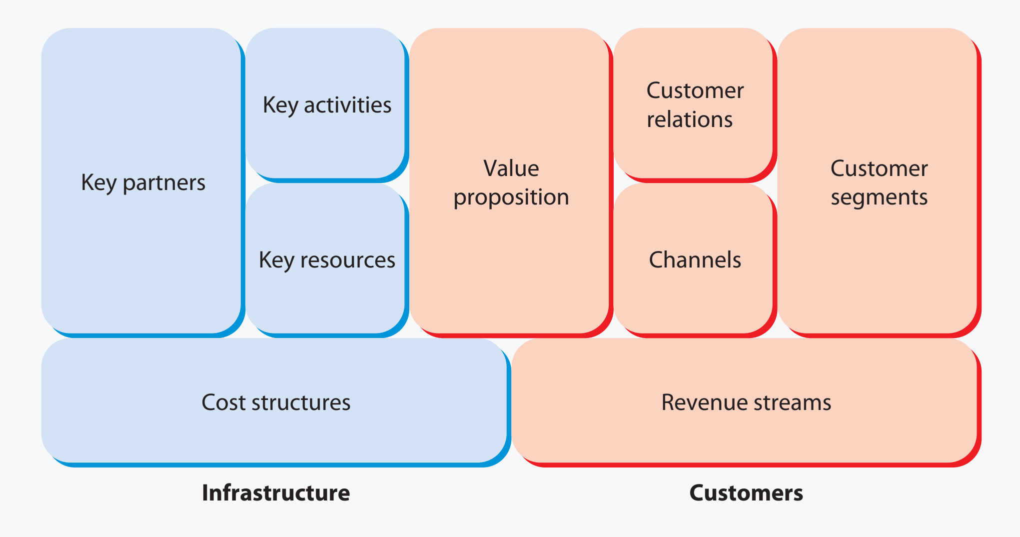
Exhibit 6.1 The Business Model Canvas



Focusing on Customers

The building blocks in Exhibit 6.1 that focus on customers include (1) your value proposition, (2) customer relations, (3) customer segments, (4) channels, and (5) revenue streams.

Value Proposition. A **value proposition** is a statement of how a company creates value for its customers compared to its competitors. It provides the basis for the company's competitive advantage. It lets others know exactly what you will do for your customers that no other company currently does for them. Your value proposition will answer why customers will buy from your company and what problems you will solve for them. Common examples include newness, high performance, ability to customize, design, brand or status, price, cost reduction, and convenience.[2]

Customer Relations. Customer relations refer to how you will acquire, keep, and grow the customer base. Here, you should describe the full "customer journey," such as how customers will find out about you, the interactions you will have with them on a regular basis, and how you will get customers to increase their spending. This description should include advertising, providing excellent customer service, and communicating through e-mails and newsletters.

Customer Segments. Customer segments describe who your customers will be. Remember, you exist to serve your customers. Some businesses serve only one customer segment, while others serve more than one segment. Google, for example, serves advertisers as well as people conducting searches. In both the customer relations and the customer segments building blocks, you need to assess your value proposition relative to competitors and determine if you will be able to provide better value to your customers than your competitors are.

Channels. Channels explain how your product or service will be sold to your customers. You can have your own methods of distribution or use partners' channels. When deciding what channels to use, you must determine how your customers want to be reached. Your channels may include the stores you will own, the sales force you will employ, and a company website. Partner channels may include wholesalers or affiliate partners, for example.

value proposition
A statement of how a company creates value, which provides the basis for the firm's competitive advantage.

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Revenue Streams. A **revenue stream** identifies the nature and types of a company's sources of revenue. The following are common types of revenue streams:

- *Volume or unit-based:* Customers pay a fixed price per unit in exchange for a product or service.
- *Subscription / membership:* Customers pay a fixed amount at regular intervals, prior to receiving a product or service.
- *Advertising-based:* Customers pay based on cost per impression, cost per click, or cost per acquisition.
- *Licensing revenue:* Customers pay a one-time licensing fee to be able to use or resell the product or service.

Revenue streams can also be classified in the following ways:

- *Single stream:* Revenues come from a single product or service.
- *Multiple streams:* Revenues come from a combination of multiple products and services.
- *Interdependent streams:* Revenues derive from selling one or more products (such as printers) or services to generate revenues from other products (such as printer cartridges) or services.
- *Loss leader:* One or several revenue streams are sold at a loss to create sales in a profitable revenue stream.

When forecasting revenue streams, you must find the answers to key questions that can provide the rationale for future sales estimates. A list of relevant questions to consider is shown in Exhibit 6.2. (Note that you may already have the answers to some of these questions based on the work you did with earlier customer-focused building blocks.) When completing this section of the Business Model Canvas, be sure to continue to think about the strategy that will capture the most value, both for the customers and for the business.

Having now completed our discussion of the five building blocks related to a firm's customers, we will next consider the building blocks that help to create the infrastructure needed to support your value proposition.

Exhibit 6.2 **Examples of Questions to Ask When Forecasting Revenue Streams**

1. Who are your most likely customers?
2. How are they different from the general population?
3. What events will trigger the need or desire for your type of product or service?
4. When will these events occur? Can they be predicted?
5. How will customers make decisions on whether to buy your product or service?
6. What will be the key decision factors?
7. How will your product or service compare to that of the competition on these key factors?
8. Will these differences be meaningful to the customer?
9. Are these differences known to the customer?
10. How can your product or service be exposed to your most likely potential customers?

revenue stream
A component of the business model that identifies the nature and types of a company's sources of revenue.

Creating the Infrastructure

Returning to the Business Model Canvas shown in Exhibit 6.1, we now want to focus on the remaining four building blocks (outlined in blue) that deal with a company's

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infrastructure. It is vitally important that an entrepreneur knows what activities and relationships are important in creating value. Otherwise, the business will not be sustainable. As shown in the exhibit, these four building blocks include (1) key partners, (2) key activities, (3) key resources, and (4) cost structures.

Key Partners. Having key partners is essential to making the right activities happen and to acquiring key resources. In short, these partners make things happen that you cannot execute on your own.

Key Activities. Key activities relate directly to the firm's value proposition. Spending time on other activities will not add value for customers or the business.

Key Resources. **Key resources** are the inputs a firm uses to produce, sell, distribute, and maintain a product or service. They are required to achieve positive cash flows and profits and, as such, are the most important strategic assets you have.

In general, four types of key resources exist: financial, physical, intellectual, and human. Financial resources include the amount of investment in hard assets, such as equipment and buildings, as well as the amount of working capital in the form of cash, accounts receivable, and inventory. Physical resources are the tangible assets themselves. Critical resources also include any intellectual property needed to achieve the business's success and, of course, its key employees, suppliers, and investors.

Cost Structures. **Cost structures** result from the activities that affect a firm's (1) cost of producing one unit of product or service, and (2) operating expenses, such as payroll, selling activities, administrative costs, and marketing expenses. In other words, you want to know what activities drive these expenses, which can vary with either time or volume of sales. You then need to classify these costs and expenses as follows:

- *Fixed costs:* Costs that do not vary at all with volume, such as rent expenses.
- *Variable costs:* Expenses that vary directly and proportionately with changes in volume, such as sales commissions.
- *Semi-variable costs:* These expenses include both variable costs and fixed costs. They vary in the direction of, but not proportionately with, changes in the volume of sales, such as certain types of payrolls that change as a firm becomes larger but do not vary proportionately with changes to sales volume.

These costs need to be aligned with the firm's value proposition. So developing key resources, activities, and partnerships will help you to understand the most important costs and expenses required to serve your customers.

Finally, while not explicitly included in the Business Model Canvas, entrepreneurs should contemplate possible **business model risk**—that is, they should anticipate changes that can affect the level of risk in a given business model. It is not enough to have a business model that provides a competitive advantage given the present circumstances. Consideration also must be given as to how the model will be affected by changing circumstances. In other words, an entrepreneur must continually be anticipating what can go wrong with the firm's business model and what can be done if it does.

By now, it should be clear: *the Business Model Canvas is about achieving the right value proposition and doing so profitably.*

A final thought: consider showing the Business Model Canvas on a white board. Place sticky notes in the different building blocks to capture your ideas (hypotheses). Each time you think of a better idea or change one part of a building block, you can replace the sticky note with a new one. The more you develop your business model, the more effective it will be.[3]

key resources
A component of the business model that provides estimates of the inputs required for a particular product or service in order to achieve positive profits and cash flows.

cost structures
A component of the business model that provides a framework for estimating a firm's cost of goods sold and operating expenses.

business model risk
A component of the business model that identifies risks in the model and how the model can adjust to them.

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6-2 Describe how a lean start-up can be used to reduce risk when starting a new venture.

6-2 Think Lean Start-up

As a way to test the hypotheses in a business model, we will now look at a related concept, the lean start-up. The **lean start-up** was popularized by Eric Ries[4] and Steve Blank, who believe that the process of starting a new venture can be made less risky. A technique that lies at the heart of the lean start-up is called the build-measure-learn feedback loop. (You'll learn more about this in Chapter 7.)

Instead of extensive time spent writing a business plan at the beginning of a venture, Ries and Blank recommend an iterative process that builds on listening closely to customers. Begin small, try out your product or service in the market, and then make changes based on what you learn from customers.

Ries contends that if you don't learn quickly about your core assumptions through inexpensive data-driven experiments, writing a traditional business plan is a waste of time. The method favors experimentation, where the focus is on getting customer feedback quickly, even before the product is "perfected," or what Ries and Blank call a *minimum viable product*. Blank puts it this way:[5]

> Start-ups are not smaller versions of large companies. They do not unfold in accordance with master plans. The ones that ultimately succeed go quickly from failure to failure, all the while adapting, iterating on, and improving their initial ideas as they continually learn from customers.

Ries and Blank argue against engaging in months of planning and research. Instead, they say, accept that all you have at the beginning are untested hypotheses. Spending time with prospective customers, vendors, and other key partners in the venture provides a foundation in the search for a sustainable and profitable business model.

lean start-up
An iterative process to reduce risk in a new venture.

pivoting
Refocusing or recreating a start-up if the initial concept turns out to be flawed.

For example, Ries and Blank encourage discussions about product features, pricing, distribution channels, and customer acquisition strategies, which the entrepreneur then uses to revise their assumptions. Next, the entrepreneur starts the cycle over again, testing redesigned products and making small adjustments (*iterations*) or more major changes by **pivoting** to new hypotheses. Once a sustainable business model is proven, the entrepreneur can begin to focus on writing a plan and building the business.

We will now turn our attention from developing a business model to writing a business plan.

6-3 Explain the meaning of the term *business plan* and the purpose and form of a business plan.

6-3 The Purpose and Form of a Business Plan

A business plan can provide a framework for launching a new venture or guidelines for operating an established business. We'll begin this section on writing business plans by providing a definition of the term *business plan*.

6-3a What Is a Business Plan?

A **business plan** can be described as a document that outlines the basic concept underlying a business—specifically, what problem will be solved—and describes how the entrepreneur will execute the plan to solve the problem. The plan should lay out the basic idea for the venture and include descriptions of where an entrepreneur is now, where they want to go, and how they intend to get there.

business plan
A document that outlines the basic concept underlying a business and describes how that concept will be realized.

But, as discussed in Chapter 1, your personal aspirations and motivations deserve careful thought. *If the business does not align with your personal goals, you are not likely to succeed, and you certainly will not enjoy the journey.*

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There is no one correct formula for preparing a business plan. Opportunities are so diverse in size as well as growth potential that no single plan will work in all situations. But at a minimum, every business plan should include the following three key elements:[6]

1. A logical statement of a business problem and your solution to that problem.
2. A significant amount of hard evidence, based in part on your business model.
3. Candor about the risks, gaps, and assumptions that might be proved wrong.

6-3b Who Cares about the Business Plan?

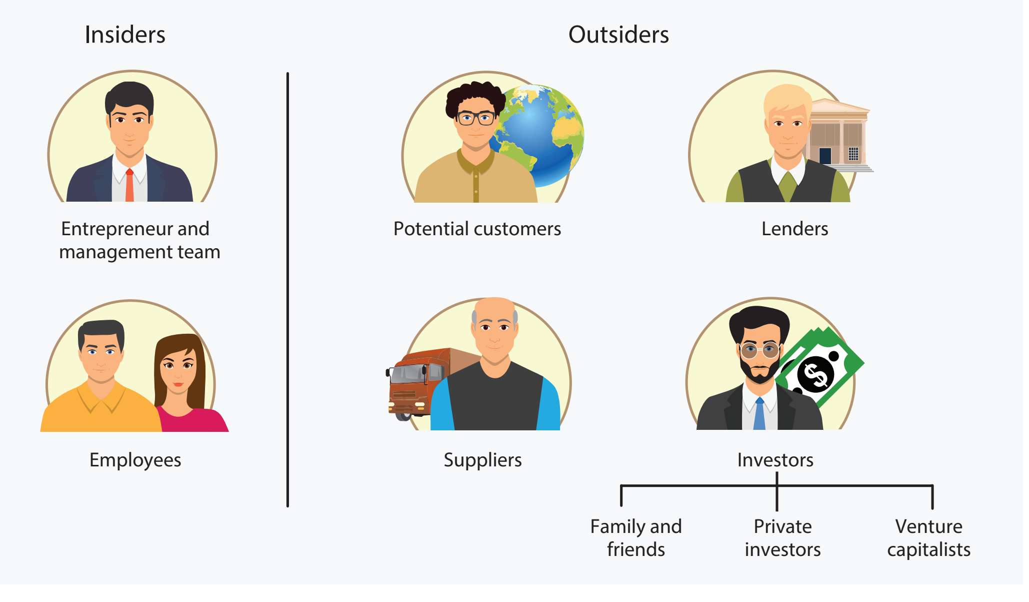
A business plan can be a helpful tool to use with two important groups: company *insiders,* who can use it for direction, and *outsiders,* who may help the company achieve its goals. Exhibit 6.3 provides an overview of those who might have an interest in a business plan for a proposed venture.

Company insiders are the internal users of the plan: the entrepreneur and the firm's management, along with its employees. The business plan provides a framework that helps the entrepreneur and the management team focus on the important issues and activities in executing the plan. And it helps the entrepreneur communicate their vision to current and prospective employees of the firm.

The business plan can also be helpful with outsiders. To make the company successful, the entrepreneur must convince outsiders—potential customers, suppliers, lenders, and investors—to partner with the firm. Why should they do business with your start-up, rather than with an established firm? They need evidence that you will be around in the future. Professor Amar Bhidé at Tufts University explains:[7]

> Some entrepreneurs may have an innate capability to outperform their rivals, acquire managerial skills, and thus build a flourishing business. But it is difficult for customers (and others) to identify founders with these innate capabilities.

Exhibit 6.3 **Users of Business Plans**



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6-3c Execution Matters

Given what we know about companies that were started without business plans, having a plan is clearly not an absolute prerequisite for success. But this simply tells us that *the business plan is not the business*. In other words, execution matters!

Some entrepreneurs spend days, if not weeks, writing a 60-page business plan with another 50 pages of appendices but are not effective at executing the plan. In such cases, writing a business plan accomplished little, if anything. Only if you *effectively execute* the business plan does it have a chance of making a difference.

Thus, an entrepreneur must find the right balance between planning and becoming operational. No matter how well your plan has been thought out, unexpected events will happen. One of the key attributes of a successful entrepreneurial team is adaptability, regardless of what the business plan says to do. Boxer Mike Tyson once commented, "Everybody has a plan until they get punched in the face." Starting a business can be a bit like a prize fight.[8] You can plan, but then you must adapt to the obstacles that will surely arise.

Also consider that a lender or other investor might demand to see a business plan before investing in your venture. Shouldn't you require the same before investing your personal savings or, even more important, your family's savings?

Finally, if you want to capture the full potential of an opportunity and make a difference in lives, planning is the rule, not the exception. But building an exceptional company requires thoughtful planning and then execution. Deciding what you want the business to be and to accomplish is vital and deserves considerable thought. Above all, plan with intention, which comes from having to justify your beliefs and assumptions about your new venture.

6-3d What Form Will the Business Plan Take?

For most entrepreneurs, the issue is not *whether* to plan but *when* and *how* to engage in effective planning, given the situation. Different situations lead to different needs—and to different levels of planning. In addition to deciding when to plan, an entrepreneur must choose the form that the planning will take. Preparing a plan requires time and money, two resources that are always in short supply. The entrepreneur has two basic choices when it comes to writing a business plan: the *short plan* or the *comprehensive plan*.

The Short Plan

As noted earlier, extensive planning may be of limited value when there is a great amount of uncertainty in the environment or when timing is a critical factor in capturing an opportunity. A **short plan** is an abbreviated form of the traditional business plan that addresses only the most important issues in a firm's success, including the following:

- The problem that needs to be solved for customers
- The business strategy that will be used to solve the problem
- The business model
- The measures that will be used to gauge success
- Milestones to be met
- The tasks and responsibilities of the management team

short plan
An abbreviated business plan that presents only the most important issues and projections for the business.

A short plan can also be used when trying to attract investors to the business. Although some investors will want to read a comprehensive business plan before deciding about the investment, others will want to see an abbreviated presentation to learn whether the business idea sparks their interest. The short plan might include a

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Living the Dream

Jania and Desmin Daniels Believe in Writing a Business Plan

At Rose Petals Cafe & Lounge in the Germantown neighborhood of Philadelphia, co-founders Jania and Desmin Daniels are dedicated to creating unique and delicious food.

"I'm Puerto Rican and my husband's African-American, so we formulate a dinner menu that merges those things," Jania says of their menu, which is inspired by a fusion of cultures. They also feature an extensive breakfast menu, with creative offerings like catfish and cornbread waffles.

Jania's experience managing a food court establishment fueled her belief that writing a business plan should be an early step in starting a business. She says it helped them organize all their thoughts and ideas about Rose Petals Cafe, but it also made it easy to structure and share financial information with potential lenders and investors.

Business planning shouldn't be a one-time exercise to create a document that you'll never use again after you secure a loan or investment. The real power is in using it as a tool to stay on top of your financial metrics and to respond to challenges and opportunities as they arise.

"It is such a working document. You're always tweaking your concept and your idea," Jania says.

When there are curveballs, it helps to go back to your plan and think things through, the Danielses found. They used their business plan as a tool to guide their decision to open the cafe in a different neighborhood than they had originally planned. It helped them to understand how their location would affect their potential for success and to identify potential competition from the outset.

Source: Adapted from "Building a Future, Honoring the Past: The Story of Rose Petals Cafe," https://www.liveplan.com/blog/2015/01/building-future-honoring-past-story-rose-petals-cafe, accessed February 16, 2021.

15- to 30-minute oral presentation consisting of 10 to 15 PowerPoint slides, or what is called a *pitch* (discussed more fully later in the chapter).

The Comprehensive Plan

When entrepreneurs and investors speak of a business plan, they are usually referring to a **comprehensive plan**, a complete business plan that provides an in-depth analysis of the critical factors that will determine a firm's success or failure, along with the underlying assumptions. Such a plan is especially beneficial when you are facing significant change in the business or the external environment (such as changing demographics, new legislation, or developing industry trends). It can also be helpful in explaining a complex business situation to investors.

A comprehensive business plan should consider the following key factors (presented graphically in Exhibit 6.4):

1. The *opportunity* should reflect the potential and the attractiveness of the market and industry.
2. *Critical resources* include not only money, but also human assets (suppliers, accountants, lawyers, investors, etc.), intellectual property, and hard assets (accounts receivable, inventories, buildings, etc.). An entrepreneur should think of ways to minimize the resources necessary for start-up.
3. The *entrepreneurial team* must possess integrity, as well as breadth and depth of experience.
4. The *financing structure*—how a firm is financed (i.e., debt versus equity) and how the ownership percentage is shared by the founders and investors—will

comprehensive plan
A complete business plan that provides an in-depth analysis of the critical factors that will determine a firm's success or failure, along with all the underlying assumptions.

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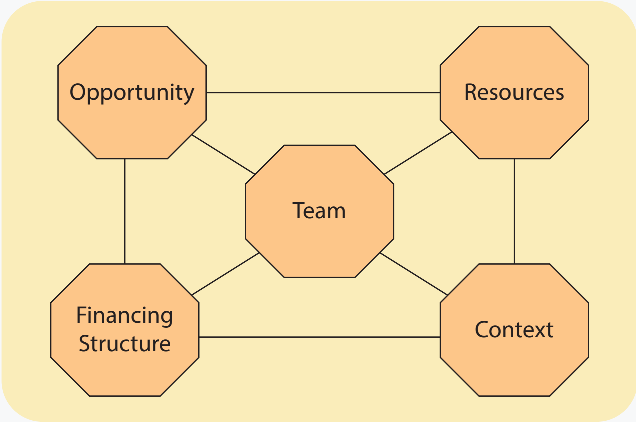
Exhibit 6.4 Key Factors for Success



have a significant impact on an entrepreneur's incentive to work hard. The goal is to find a win-win deal.

5. The *context* (or external factors) of an opportunity includes the regulatory environment, interest rates, demographic trends, inflation, and other factors that inevitably change but cannot be controlled by the entrepreneur.

Thus, the business plan will need to demonstrate that the entrepreneur has pulled together the right opportunity, the right resources, the right people, and the right financing structure, all within the right context. Admittedly, there will always be uncertainties and ambiguities; the unanticipated is bound to happen. But by making decisions about these key factors, you can be sure that you are dealing with the important issues, and this will help you in determining the appropriate content to include in the plan.

6-4 Describe the preferred content and format for a comprehensive business plan.

6-4 Preparing a Business Plan: Content, Format, and Quality

If a feasibility analysis (see Chapter 3) and/or your business model suggests that a business concept has merit, it is time to begin the process of writing a business plan. In writing the plan, two issues are of primary concern: (1) the content and format of the plan, and (2) the quality of the written presentation.

There is no single format to be followed in writing a business plan. However, investors usually like to see the plan in a format that is familiar to them. Presenting a business plan with a unique format could be a mistake.

Exhibit 6.5 summarizes the major sections common to most business plans. A brief overview of each of these sections follows.[9] (Chapters 7 through 13 take an in-depth look at each section of the business plan.)

6-4a Cover Page

The cover page should contain the following information:

- Company name, address, phone number, social media sites, and website.
- Company slogan and logo.

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- Name of contact person (preferably the president) with mailing address, phone number, and e-mail address.
- Date on which the business plan was prepared.
- If the plan is being given to investors, a disclaimer that the plan is being provided on a confidential basis to qualified investors only and is not to be reproduced without permission.
- Number of the copy (to help keep track of how many copies have been given out).

Exhibit 6.5 Abbreviated Business Plan Outline

Section Heading	Information Provided
Cover Page	Company name, logo, slogan, contact information, copy number, date prepared, and disclaimer (if needed)
Table of Contents	Listing of the key sections of the business plan
Executive Summary	One- to three-page overview of the significant points, intended to motivate the reader to continue reading
Company Description	Company objectives, the nature of the business, its primary product or service, its current status (startup, buyout, or expansion) and history (if applicable), and the legal form of organization
Industry, Target Customer, and Competitor Analysis	Key characteristics of the industry, including the different segments, and the niche where you plan to compete
Product/Service Plan	Justification for why people will buy the product or service, based on its unique features
Marketing Plan	Marketing strategy, including the methods of identifying and attracting customers, selling approach, type of sales force, distribution channels, types of sales promotions and advertising, and credit and pricing policies
Operations and Development Plan	Operating or manufacturing methods, operating facilities (location, space, and equipment), quality-control methods, procedures to control inventory and operations, sources of supply, and purchasing procedures
Management Team	Description of the management team, outside investors and/or directors, and plans for recruiting and training employees
Critical Risks	Any known inherent risks in the venture
Offering	How much capital the entrepreneur needs and how the money will be used (section used to attract investors)
Exit Strategy	Ways an investor—and the entrepreneur—may be able to harvest their business investment
Financial Plan	Contemplated sources of financing; any historical financial statements, if available; pro forma financial statements for three to five years, including income statements, balance sheets, cash flow statements, and cash budgets
Appendix of Supporting Documents	Various supplementary materials and attachments to expand the reader's understanding of the plan

6-4b Table of Contents

The table of contents provides a sequential listing of the sections of the plan, with page numbers. This allows the reader to spot-read the plan (a common practice) rather than reading it in its entirety.

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6-4c Executive Summary (Overview)

The **executive summary**, or **overview**, is a crucial section of the business plan as it helps to catch the reader's attention. At the very outset, it must (1) convey a clear and concise picture of the proposed venture and (2) create a sense of excitement regarding its prospects.

Although the executive summary is placed at the beginning of the business plan, it provides an overview of the entire plan and should be written last. In no more than three (preferably two) pages, the executive summary should include the following subsections:

- A description of the opportunity
- An explanation of the business concept
- An industry overview
- The target market
- The competitive advantage you hope to achieve in the market
- The economics of the opportunity
- The management team
- The amount and purpose of the money being requested (the "offering"), if you are seeking financing

Depending on the situation and the preference of the entrepreneur, the executive summary may be in the form of a synopsis or a narrative. A *synopsis* briefly covers all aspects of the business plan, giving each topic relatively equal treatment. It relates, in abbreviated fashion, the conclusions of each section of the completed business plan. Although it is easy to prepare, the synopsis can be rather dry reading for the prospective investor.

A *narrative*, on the other hand, tells a story, so it can convey greater excitement than the synopsis. When deciding whether to use a narrative, consider that it works best for the following types of businesses:

- Those breaking new ground with a new product, service, or operational techniques.
- Those with one dominant advantage, such as holding an important patent or being run by a well-known entrepreneur.
- Those with interesting or impressive backgrounds or histories.

6-4d Company Description

The company description informs the reader of the type of business being proposed, the firm's objectives, where the firm is located, and whether it will serve a local or international market. If the business is already in existence, its history should be included.

In writing this section, the entrepreneur should answer the following questions:

1. When and where is the business to be started?
2. What is the history (if any) of the company?
3. What are the firm's objectives?
4. What changes have been made in structure and/or ownership?
5. In what stage of development is the firm—for example, seed stage or full product line?

executive summary (overview)
A section of the business plan that conveys a clear and concise overall picture of the proposed venture and creates interest in the venture.

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6. What has been achieved to date?
7. What is the firm's competitive advantage or distinctive competence?
8. What are the basic nature and activities of the business?
9. What is its primary product or service?
10. What customers will be served?
11. What is the firm's form of organization—sole proprietorship, partnership, limited liability company, corporation, or some other form?
12. What are the current and projected economic states of the industry?
13. How do the owners expect to exit the business? Do they intend to sell to another company or an investment group? Do they plan to be a publicly traded company, or to transfer ownership to the next generation of the family?

6-4e Industry, Target Customer, and Competitor Analysis

The primary purpose of this section is to present the opportunity and demonstrate why there is a significant market to be served. You should describe the broader industry in which you will be competing, including industry size, growth rate, fundamental trends, and major players. Then, identify the different segments of the industry, and describe the niche in which you plan to participate. It is tempting to begin describing your own company at this point. Instead, you should provide the context of the opportunity and demonstrate that a market segment is being underserved. There will be an opportunity later to introduce your product or service.

The next step is to describe your target customers in terms of demographics and psychological variables, such as their values, their attitudes, and even their fears. The more clearly you can identify your customer, the more likely it is there will be demand for your product or service. Finally, knowing who your customer is will serve as the basis for understanding who your competitors are. You should analyze competitors in terms of product or service attributes that they offer or are failing to provide.

6-4f Product/Service Plan

The **product/service plan** describes the products and/or services to be offered to the firm's customers. Now is the time to make a convincing presentation of your company's competitive advantage—explain, for example, how your product or service is superior to, less expensive than, or takes less time to manufacture or perform than what is currently available or how it fills a gap in the market.

In the case of a physical product, try to provide a working model or prototype. Investors will naturally show the greatest interest in products that have been developed and proven to be functional. Any innovative features should be identified, and any patent protections should be explained. (Chapter 15 discusses this topic more fully.) Additionally, explain your growth strategy for the product and/or service, as growth is a primary determinant of a firm's value. If relevant, describe secondary target markets that the firm will pursue.

product/service plan
A section of the business plan that describes the product and/or service to be provided and explains its merits.

marketing plan
A section of the business plan that describes how the firm will reach, service, and keep customers within a given market.

6-4g Marketing Plan

The **marketing plan** is the basis for describing the firm's marketing strategy. In other words, how will you entice customers to make them begin and continue using your

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product or service? Remember, you must have a compelling value proposition, as discussed earlier in the chapter.

This section should include the following topics:

- Methods of identifying and attracting customers
- Credit and pricing strategies
- The selling approach
- The type of sales force
- Distribution channels

Chapter 7 provides in-depth coverage of the marketing plan.

6-4h Operations and Development Plan

The **operations and development plan** offers information on how the product will be produced or the service provided. Here, you will explain how the firm's operations will create value for the customer.

This section discusses items such as the following:

- Location and facilities
- The choice between in-house production and outsourcing to minimize costs—never plan to outsource anything that contributes to your competitive advantage
- The proposed approach to ensuring quality, controlling inventory, and obtaining raw materials

Chapters 9 and 21 further discuss the issues to be addressed in the operations and development plan.

6-4i Management Team Section

Prospective investors look for well-managed companies. Of all the factors they consider, the quality of the management team is paramount. Some investors say that they would rather have an "A" management team and a "B" product or service than a "B" team and an "A" product or service. But it can also be said that the right management in the wrong market is likely headed for failure. For success, you must have a good team working in a growth market.

The **management team section** should detail the proposed venture's organizational structure and the backgrounds of those who will fill its key positions. Ideally, a well-balanced management team—one that includes financial and marketing expertise, as well as production experience and innovative talent—will already be in place. Managerial experience in related enterprises and in other start-up situations is particularly valuable. It might also include outside investors and/or directors, as well as plans for recruiting and training employees.

The factors involved in preparing the management team section are discussed in greater detail in Chapter 8.

operations and development plan
A section of the business plan that offers information on how a product will be produced or a service provided, including descriptions of the firm's facilities, labor, raw materials, and processing requirements.

management team section
A section of the business plan that describes a new firm's organizational structure and the backgrounds of its key employees.

critical risks section
A section of the business plan that identifies the potential risks that may be encountered by an investor.

6-4j Critical Risks Section

The business plan is intended to tell a story of success, but there are always risks associated with starting a new venture. Thus, the plan would be incomplete if it did not determine the risks inherent in the venture. The **critical risks section** identifies

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the potential pitfalls that may be encountered by an investor. Common risks include a lack of market acceptance (customers don't buy the product as anticipated), competitor retaliation, longer time period and higher expenses than expected to start and grow the business, inadequate financing, and government regulations.

Understanding critical risks is especially important for technology companies, where a new product or service must be significantly better than those currently available in order to overcome the inertia that many customers experience when faced with changing to a new technology. Intellectual property, such as patents and trade secrets, must be acquired—and defended, in some cases.

6-4k Offering

If the entrepreneur is seeking capital from investors, an **offering** should be included in the plan to indicate clearly how much money is needed and when. It is helpful to convey this information in a *sources and uses table* that indicates the type of financing being requested (debt or equity) and how the funds will be used. For example, for a firm needing $500,000, including any money borrowed and the founder's investment, the sources and uses table for the first year might appear as follows:

Sources:	
Bank debt	$100,000
Equity:	
New investors	300,000
Founders	100,000
Total sources	$500,000
Uses:	
Product development	$125,000
Personnel costs	75,000
Working capital:	
Cash	20,000
Accounts receivable	100,000
Inventory	80,000
Machinery	100,000
Total uses	$500,000

If equity is being requested, the entrepreneur will need to decide how much ownership of the business they are willing to give up. Typically, the amount of money being raised should carry the firm for 12 to 18 months—enough time to reach some milestones. Then, if all goes well, it will be easier and less costly to raise more money later. These issues will be explained in greater detail in Chapters 11 and 12.

6-4l Exit Strategy

If a firm is using the business plan to raise equity financing, investors will want to know the possible options for cashing out of their investment. This should be provided in the **exit strategy section**. Most equity investors will not invest in a start-up or early-stage business if they are not reasonably confident that they can recover their principal investment, plus a nice return on the investment, within 5 to 10 years.

In Chapter 13, we will explain the issue of crafting an exit strategy, or what we call the *harvest*.

offering
A section of the business plan that indicates to an investor how much money is needed, and when and how the money will be used.

exit strategy section
A section of the business plan that focuses on options for cashing out of the investment.

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6-4m Financial Plan

The **financial plan** presents financial forecasts as pro forma statements. This section of the business plan should show that the proposed business can be self-supporting and, ultimately, profitable.

Entrepreneurs need to be honest with themselves and fully consider a company's financial outlook when writing the financial plan. According to Rudy Garza, a venture capitalist in Austin, Texas:[10]

> While I may not have much confidence in the entrepreneur's financial forecasts, the financial plan helps me understand the entrepreneur's thought processes about the sustainability and profitability of the opportunity. That is very important in my estimation.

Pro forma statements, which are projections of the company's financial statements, should be presented for between three and five years, and ideally include:

- Balance sheets
- Income statements
- Statements of cash flows on an annual basis
- Cash budgets on a monthly basis for the first year and on a quarterly basis for the second and third years

While every financial statement is important, the pro forma statements of cash flows deserve special attention. A business can be profitable but still fail if it does not produce positive cash flows.

6-4n Appendix of Supporting Documents

The appendix should contain various supplementary materials and attachments to expand the reader's understanding of the plan. These supporting documents should include any items referenced in the text of the business plan, such as the following:

- Résumés of key investors and owners/managers
- Photographs of products, production facilities, and office buildings
- Professional references
- Marketing research (primary) studies
- Pertinent published (secondary) research
- Signed contracts of sale

The fact that the appendix of supporting documents appears at the end of the plan does not mean that it is of secondary importance. The reader needs to understand the assumptions underlying the premises set forth in the plan. And nothing is more important to a prospective investor than the qualifications of the management team.

Each chapter in this section (Part 3) of the book, except for Chapter 10, ends with a special set of exercises to walk you through the process of writing a business plan. These exercises consist of questions to be thoughtfully considered and answered. They are entitled "The Business Plan: Laying the Foundation" because they deal with issues important to starting a new venture and provide guidelines for preparing the different sections of a business plan.

financial plan
A section of the business plan that projects the company's financial position based on well-substantiated assumptions and explains how the figures have been determined.

pro forma statements
Projections of a company's financial statements for between three to five years, including balance sheets, income statements, statements of cash flows, and cash budgets.

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6-5 Writing a Business Plan

6-5 Offer practical advice for writing a business plan.

An effective written presentation ultimately depends on the quality of the underlying business opportunity. As we said earlier, *the plan is not the business*. A poorly conceived new venture idea cannot be rescued by a good presentation. However, a good concept may be destroyed by a presentation that fails to communicate it effectively.

Let's take a look at how you can avoid some of the most common mistakes when writing a business plan.

6-5a Analyze the Market Thoroughly

In analyzing the market for your product or service, you must know who your customers will be and what they want. This information should come not just from market research, but also from talking directly to customers. With this in mind, you need to determine the answers to the following questions:

- What is your target market?
- How large is the target market?
- What problems concern the target market?
- Are any of these problems greater than the one you're addressing?
- How does your product or service fix the problem?
- Who will buy your product or service?
- How much are they willing to pay for it?
- Why do they need it?
- Why would they buy from you?

As we have already said, your presentation should be based on *evidence*. Nowhere in the business plan is it more important to provide hard evidence to support your claims than when presenting your analysis of the market. It is here that a well-tested business model pays dividends.

6-5b Recognize Your Competition

Understand that everyone has competitors. Saying "We have no competition" is almost certain to make readers of your plan doubt almost everything else you say. You must show in your plan where your business will fit in the market and what your competitors' strengths and weaknesses are. If possible, include estimates of their market shares and profit levels.

6-5c Provide Solid Evidence for Any Claims

Factual support must be supplied for any claims or assurances made. In short, the plan must be believable. A prime temptation is to present page after page of detailed computer-generated financial projections suggesting—intentionally or unintentionally—that the entrepreneur can predict with accuracy what will happen. Experienced investors know this is not the case. They want to know what is behind the numbers, as this allows them to see whether the entrepreneur understands the key factors that will drive success or failure.

6-5d Think Like an Investor

Many small firms do not seek outside capital, except in the form of bank loans. But whether or not you are preparing a business plan in order to seek outside

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financing, you would benefit from understanding the world as an investor sees it—that is, you should think as an investor thinks.

Some investors believe that you should think like an investor and act like an entrepreneur. In this way, you bring to the analysis both the energy of the entrepreneur and the discipline of an investor. At the most basic level, prospective investors have two primary goals:

1. Maximizing potential return on an investment by maximizing their share of the cash flows to be received from the investment.
2. Minimizing the risk they are taking. (While investors in early-stage companies are undeniably risk takers, they look for ways to shift risk to others, usually to the entrepreneur.)

If you forget these two basic truths, you will not be able to understand much else about how investors think.

6-5e Identify Potential Fatal Flaws

One difficult aspect of writing a business plan is effectively dealing with problems or weaknesses—and every business has them. An entrepreneur, wanting to make a good impression, may become so infatuated with an opportunity that they cannot see potential fatal flaws.

For instance, an entrepreneur might fail to ask, "What is the possible impact of new technology, e-commerce, or changes in consumer demand on the proposed venture?" If there are weaknesses in the plan, the investors will find them. At that point, an investor's question will be "What else haven't you told me?" The best way to handle weaknesses properly is to consider thoroughly all potential issues, to be open and straightforward about those issues, and to have an action plan that effectively addresses any problems. To put it another way, *integrity matters*.

6-5f Pay Attention to Details

Paying attention to the details may seem minor to you but likely is not to others who read the plan to determine whether they want to be associated with the firm. The following suggestions will help you to attend to the "little things":

1. *Use good grammar*. Nothing turns off a reader faster than a poorly written business plan. Find a good editor, and then review and revise, revise, revise.
2. *Limit the presentation to a reasonable length*. The goal is not to write a long business plan, but to write a good business plan.
3. *Go for an attractive, professional appearance*. To add interest and aid readers' comprehension, make liberal but effective use of visual aids, such as graphs, exhibits, and tabular summaries.
4. *Describe your product or service in lay terms*. Entrepreneurs with a technical background tend to use jargon that is not easily understood by individuals who are unfamiliar with the technology or the industry. Don't make this mistake!

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Living the Dream

Writing a Sweet Business Plan

SOURCE: YUCOCO CHOCOLATE/TWITTER, INC.

Chocolate is the one of the most popular gifts throughout the world. The list of occasions for giving chocolate is long, which is what Sophie Frost, Tom Travers, and Nick Ward realized before they founded Yucoco, a start-up that helps customers create their own unique chocolates.

Yucoco allows customers to design and personalize their own delicious, handmade chocolate bar through the company's website, Yucoco.com. Offering more than 100 different toppings, gift cards, and personalized packaging, the company provides customers with over a billion possible combinations. Yucoco currently uses a business model that is purely e-commerce. Although its product is unique to the market, the company has potential competitors, ranging from other chocolate companies to online florists and online gift companies.

Before diving into their product line, Frost, Travers, and Ward made constructing the business plan of their organization a priority. The trio believed it was vital that they build a case that convinced not only themselves, but also everyone else, that their handmade chocolate idea was an opportunity worth exploring. They quickly discovered that a massive amount of support and advice for composing business plans is available, if you look in the right location.

Frost feels that it is very important for a business plan to be credible. For Yucoco, the team found that referencing overall industry and market trends helped to build their case. As Frost says, "It's important to not let writing the business plan become a chore—identify what the things are that get you excited, that make the business different and exciting, and detail and explore them as much as possible." Had it not been for their compelling business plan, Yucoco would not have received its original funding of £10,000 from Virgin Start-Up.

Throughout the course of cultivating their business, Frost, Travers, and Ward have learned the importance of writing and developing a strong business plan. According to Frost, "It is the best way of turning an idea into a potential business and has been invaluable in getting Yucoco off the ground."

Sources: Alison Coleman, "State-Funded Start-up Capital for UK's Savviest Entrepreneurs," April 16, 2014, https://www.forbes.com/sites/alisoncoleman/2014/04/16/state-funded-start-up-capital-for-uks-savviest-entrepreneurs/?sh=2f7bd66d7553, accessed May 8, 2021; and "Virgin Start-Up: Yucoco |Virgin Start-up Loans—Support and Advice to Start Your Own Business," June 14, 2016, https://www.virginstart-up.org/how-to/virgin-start-up-yucoco, accessed May 8, 2021.

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If you choose to ignore these recommendations, the business plan will detract from the opportunity itself, and you may lose the chance to capture it.

6-6 Explain how to present a business plan to prospective investors.

6-6 Pitching to Investors

In addition to having a well-written business model and a business plan, an entrepreneur seeking capital from investors may be asked to give an oral presentation to the investors, or what is called a **pitch**. This is the time to spark investors' interest in the business. Frequently, the entrepreneur is given 15 to 20 minutes to present their PowerPoint presentation, followed by about the same amount of time for questions and answers.

Christopher Mirabile, who is a frequent investor in start-ups, emphasizes the importance of thinking like an investor. He classifies entrepreneurs into three groups:[11]

> Competent entrepreneurs can explain their company in terms of what the product does. Good entrepreneurs can explain their company in terms of their customer and their market. Funded entrepreneurs can pitch their company in terms that an investor can relate to.

Mirabile continues by explaining that most entrepreneurs have difficulty putting their story together from an investor's perspective. They can speak elegantly about the product, the customer, and possibly the market. However, they lack the intuition and experience to present the opportunity in a way that lets the investor know if it's a good investment.

What investors want to know is relatively straightforward, as is the order in which they want to see the topics in the pitch. Also, the essential topics that need to be covered are the same for most businesses. We suggest that you consider preparing 12 PowerPoint slides to accompany your presentation:[12]

1. Identify the problem to be solved.
2. Introduce your solution to the problem.
3. Discuss your beginning traction for getting sales.
4. Identify your target market.
5. Explain the costs of acquiring customers within that market.
6. Discuss how you will create value and gain a competitive advantage.
7. Describe the basics of the revenue stream.
8. Provide financial projections, along with your assumptions.
9. Describe and promote the management team.
10. Identify your funding needs and explain how you will use investors' money.
11. Describe possible exit strategies—how the investors may be able to cash out.
12. To conclude, remind investors why your product/service and team are so great.

Guy Kawasaki, the founder of Garage Technology Ventures and the author of *The Art of the Start*, offers what he calls his 10/20/30 rule:[13]

- Have only 10 presentation slides,
- Limit the presentation to 20 minutes, and
- Use a 30-point font in your slides.

As Kawasaki explains, the purpose of the pitch is not to close the deal with the investors. Instead, the objective is to get to the next stage of due diligence. The pitch is not the end; it is only the beginning.

pitch
An oral presentation of the business plan to investors, intended to spark their interest.

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6-1. Explain the meaning of the term *business model* and how a business model can be used in starting and growing a new venture.

- A business model explains in a systematic and structured way how an organization creates, delivers, and captures value. It helps the entrepreneur to anticipate the financial outcomes of the firm's strategic decisions and activities that determine a company's profits and cash flows.
- Developing a business model can provide the best evidence as to whether a business concept can be translated into a viable, profitable business.
- The Business Model Canvas focuses on a firm's core characteristics and allows you to test your model assumptions, or hypotheses, in the marketplace. You can then easily change, pivot, or abandon your idea before large amounts of time and money are deployed.
- The nine building blocks of the Business Model Canvas are (1) value proposition, (2) customer relations, (3) customer segments, (4) channels, (5) revenue streams, (6) key partners, (7) key activities, (8) key resources, and (9) cost structures.
- Entrepreneurs should also consider business model risk, anticipating changes that can affect the risk level in a given business model.

6-2. Describe how a lean start-up can be used to reduce risk when starting a new venture.

- The lean start-up is an iterative process that builds on listening closely to customers. Begin small, try out your product or service in the market, and then make changes based on what you learn from customers.
- Creating a minimum viable product and then making small adjustments or more major changes by pivoting to new hypotheses let an entrepreneur prove a sustainable business model before focusing on writing a plan and building the business.

6-3. Explain the meaning of the term *business plan* and the purpose and form of a business plan.

- A business plan is a document that outlines the basic concept underlying a business—specifically, what problem will be solved—and describes how the entrepreneur will execute the plan to solve the problem. It should lay out the basic idea for the venture and include descriptions of where an entrepreneur is now, where they want to go, and how they intend to get there.
- At a minimum, every business plan should include these three key elements: (1) a logical statement of a business problem and your solution to that problem, (2) a significant amount of hard evidence, based in part on your business model, and (3) candor about the risks, gaps, and assumptions that might be proved wrong.
- Two important groups are users of business plans: (1) company insiders, who use the plan as a framework to focus on important issues and activities, and (2) outsiders, who use it to determine whether they will partner with the firm.
- The business plan is not the business. Only if you effectively execute the business plan does it have a chance of making a difference. An entrepreneur must find the right balance between planning and becoming operational.
- There are two basic choices when it comes to writing a business plan: (1) the short plan, which discusses only the most important issues in the firm's success, and (2) the comprehensive plan, which provides an in-depth analysis of the critical factors that will determine success or failure, along with the underlying assumptions.

6-4. Describe the preferred content and format for a comprehensive business plan.

- There is no single format to be followed in writing a business plan. However, investors usually like to see the plan in a format that is familiar to them. Presenting a business plan with a unique format could be a mistake.
- Key sections of a business plan are the (1) cover page, (2) table of contents, (3) executive summary (overview), (4) company description, (5) industry, target customer, and competitor analysis, (6) product/service plan, (7) marketing plan, (8) operations and development plan, (9) management team section, (10) critical risks section, (11) offering, (12) exit strategy, (13) financial plan, and (14) appendix of supporting documents.

6-5. Offer practical advice for writing a business plan.

- Analyze the market thoroughly.
- Recognize your competition.

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- Provide solid evidence for any claims you are making.
- Think like an investor.
- Identify potential fatal flaws.
- Pay attention to the details.

6-6. Explain how to present a business plan to prospective investors.

- In addition to having a developed business model and a business plan, an entrepreneur seeking capital from investors may be asked to give an oral presentation to investors, or what is called a pitch. This is the time to spark investors' interest in the business.
- What investors want to know is relatively straightforward, as is the order in which they want to see the topics in the pitch. The essential topics that need to be covered are the same for most businesses.
- Guy Kawasaki's 10/20/30 rule provides guidelines for the pitch: Have only 10 presentation slides, limit the presentation to 20 minutes, and use a 30-point font in your slides.

Key Terms

Discussion Questions

1. Describe the major sections to be included in the Business Model Canvas.
2. Why and when should you use the Business Model Canvas?
3. Explain some of the benefits of the Business Model Canvas.
4. Describe the different types of revenue streams.
5. Explain the concept of business model risk and why it is important for an entrepreneur to take this into consideration.
6. Describe the concept of a lean start-up and how it can help reduce risk in the early stages of a new venture.
7. Why might you write a business plan? When might it not be necessary or even advisable to write a plan?
8. Describe the major sections to be included in a business plan.
9. What are the two types of business plans? In what situation would you use each type of plan?
10. What are some effective ways to avoid making mistakes when writing a business plan?
11. Describe the concept of a pitch and how it might be effectively executed.

You Make the Call

Situation 1

You want to start an online clothing store and need information about the size of the market for the marketing section of your business plan. From an online search, you found that Americans spent $18.3 billion online for apparel, accessories, and footwear last year and that the forecast for their spending on these items in the coming year is $22.1 billion. You have also researched publicly traded apparel companies, like Gap, to discover trends in online sales for these firms.

Question 1 Why is your research thus far inadequate for what you need to know?

Question 2 Do you think it will be difficult to find all the information you need?

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Question 3 What else might you do to find the necessary information?

Situation 2

You recently visited with a friend who knew you had taken a small business course when you attended college. During your visit, she made the comment, "I plan to open a business this summer. I won't be applying for a bank loan to fund this company, so I don't have a business plan. Do I need one?"

Question 1 What would you need to know to answer her question?

Question 2 If she decides to write a business plan, what advice would you give her?

Situation 3

Shannon Holloway and Cate Davis decided to start a new business to manufacture healthy and delicious drinks. They believed that their location, close to high-quality water, would give them a competitive edge. Although Holloway and Davis had never worked together, Holloway had 17 years of experience in the soft drink industry. Davis had recently sold her firm and had funds to help finance the venture. However, the partners needed to raise additional money from outside investors. They spent almost 18 months developing their business plan. The first paragraph of their executive summary reflected their excitement:

> The contemporary beverage market is the result of a spectacular boom in demand for drinks with nutritional value from environmentally safe ingredients and waters that come from deep, clear springs free of chemicals and pollutants. Argon Beverage Corporation will produce and market a full line of sparkling fruit drinks, flavored waters, and sports drinks that are of the highest quality and purity. These drinks have the same delicious taste appeal as soft drinks while using the most healthful fruit juices, natural sugars, and the purest spring water, the hallmark of the contemporary drink market.

With the help of a well-developed plan, the partners were successful in raising the necessary capital to begin their business. They leased facilities and started production. However, after almost two years, the plan's goals were not being met. There were cost overruns, and profits were not up to expectations.

Question 1 What problems might have contributed to the firm's poor performance?

Question 2 Although several problems were encountered in implementing the business plan, the primary reason for the low profits turned out to be embezzlement. Holloway was diverting company resources for personal use, even using some of the construction materials purchased by the company to build a house. What could Davis have done to avoid this situation? What are her options after the fact?

Experiential Exercises

1. A former chef wants to start a business to supply temporary kitchen help (such as chefs, sauce cooks, bakers, and meat cutters) to restaurants in need of staff during busy periods. Prepare a one-page report explaining which section or sections of the business plan would be most crucial to this new business and why.
2. Suppose that you wish to start a tutoring service for college students in elementary accounting courses. List the benefits you would realize from preparing a written business plan.
3. Interview a person who has started a business within the past five years. Prepare a report describing the extent to which the entrepreneur engaged in preliminary planning and his or her views about the value of business plans.

Business Plan

LAYING THE FOUNDATION

Part 3 (Chapters 6 through 13) deals with issues that are important in starting a new venture. This chapter presented an overview of the business plan and its preparation. Chapters 7 through 13 focus on major segments of the business plan, such as the marketing plan, the organizational plan, the location plan, the financial plan, and the exit plan, or what we call the harvest. After you have carefully studied these chapters, you will have the knowledge you need to prepare a business plan.

Since applying what you study facilitates learning, we have included, at the end of each chapter in Part 3 (except Chapter 10), a list of important questions that need to be addressed in preparing a particular segment of a business plan. This chapter's questions relate to writing a description of your new venture.

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Company Description Questions

Now that you have learned the main concepts of business plan preparation, you can begin the process of creating a business plan by writing a general company description. In thinking about the key issues in starting a new business, respond to the following questions:

1. When and where is the business to start?
2. What is the background (or history, if applicable) of the company?
3. What are the company's objectives?
4. What changes have been made in structure and/or ownership (if applicable)?
5. In what stage of development is the company?
6. What has been achieved to date?
7. What is the company's distinctive competence?
8. What is the basic nature and activity of the business?
9. What is its primary product and/or service?
10. What customers will be served?
11. What is the company's form of organization?
12. What are the current and projected economic states of the industry?
13. Does the company intend to become a publicly traded company or an acquisition candidate, or do the owners want to transfer ownership to the next generation of the family?

Chapter 6 Case

Please see Appendix A for the Chapter 6 Case Study.

Endnotes

1. See Alexander Osterwalder and Yves Pigneur, *Business Model Generation* (Hoboken, NJ: John Wiley & Sons, 2010).
2. Osterwalder also has a canvas for developing a value proposition. See Alexander Osterwalder, *Value Proposition Canvas* (Hoboken, NJ: John Wiley & Sons, 2014).
3. For further discussion of the Business Model Canvas, check out the following webinars: "How Can You Describe Your Business Model?" https://www.youtube.com/watch?app=desktop&v=QoAOzMTLP5s&t=1s, accessed May 8, 2021; "How to Design, Test and Build Business Models," https://www.youtube.com/watch?v=RzkdJiax6Tw, accessed May 8, 2021; and "Business Model Canvas Explained with Examples," https://www.youtube.com/watch?v=CakUeC1sCSs, accessed May 8, 2021.
4. For Ries's presentation of the lean start-up, see Eric Ries, *The Lean Start-Up: How Today's Entrepreneurs Use Continuous Innovation to Create Radically Successful Businesses* (New York: Crown Business, 2011). See also "An Introduction to Lean Planning," http://www.liveplan.com/blog/2014/11/an-introduction-to-lean-planning, accessed March 12, 2021.
5. Ries, *op. cit.,* p. 54.
6. These three elements are described in John Mullins, *The New Business Road Test* (London: Financial Times Prentice Hall, 2014).
7. Amar Bhidé, *The Origin and Evolution of New Businesses* (New York: Oxford University Press, 2000), p. 53.
8. Taken from San Hogg, "Pull No Punches," *Entrepreneur*, July 2012, p. 74.
9. Portions of the content in this section draw on Andrew Zacharakis, Stephen Spinelli, and Jeffry A. Timmons, *Business Plans That Work* (New York: McGraw-Hill, 2011).
10. Personal conversation with Rudy Garza, November 2, 2016.
11. Christopher Mirabile, "What's Your Story? Pitch Deck Flow," Angel Capital Association, January 21, 2015, http://www.angelcapitalassociation.org/blog/whats-your-story-pitch-deck-flow, accessed May 8, 2021.
12. Adapted from articles by Caroline Cummings, formerly with Palo Alto Software. For a more in-depth description, see Caroline Cummings, "How to Successfully Pitch Your Business Idea to Investors," https://articles.bplans.com/how-to-pitch-to-investors-in-10-minutes-and-get-funded/, accessed August 23, 2021.
13. Guy Kawasaki, *The Art of the Start* (London: Portfolio, 2004). See also https://www.youtube.com/watch?v=liQLdRk0Ziw, accessed May 8, 2021.

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Chapter 7

The Marketing Plan

Learning Objectives

The Marketing Plan chapter provides an overview of how marketing principles may be applied in managing a small business. By studying this chapter, you should be able to . . .

7-1 Describe small business marketing.

7-2 Identify the components of a formal marketing plan.

7-3 Discuss market segmentation and its related strategies.

7-4 Describe strategies for finding customers.

7-5 Explain the importance of forecasting sales.

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Spotlight on Small Business

Barry Moltz

barrymoltz.com

According to his website, "Barry Moltz gets company owners growing again who have not yet reached their potential." He offers advice and mentoring on multiple business functions, but the first two functions he lists are marketing and sales. How and why did he acquire expertise in those skills, and how does he go about getting others to use his services?

As Moltz describes it, his learning process derived from living through both failures and successes. His experiences taught him that a small business owner must have a systematic marketing approach. While that sounds like a simple business philosophy, coming up with the approach and making it work demand an entrepreneur's complete focus.

Like many college graduates, Moltz went to work in corporate America—in his case, with IBM. His IBM credentials enabled him to move on to an executive-level position with a digital-communications company. He followed that by co-founding three ventures. One of those ventures failed. In another, he was fired by his teammates. He grew and sold the third business.

Moltz reports that there was no marketing plan for selling the Internet-based business. It was an occasion when "timing was everything." The late 1990s were considered the time of the dot-com bubble, with "dot-com" being shorthand for an Internet-based business. Many companies had ".com" in their domain address. Investors were viewing companies on the Internet as having huge growth potential, without much concern for their business model. Moltz and his partners were approached with an offer they felt they could not refuse and closed the deal.

Moltz's next venture did not involve raising capital and hiring employees. He became an adviser to others who want to build their own ventures. Drawing on his extensive experience in creating and managing businesses, as well as leading an angel investor group (a group of individuals who put their money into small companies with growth potential), he introduced himself as the small business expert who gets businesses unstuck.

When starting out, Moltz had the complementary goals of acquiring consulting clients and being in demand on the speaking circuit. He needed a way to market himself. So, he wrote a book! *You Need to Be a Little Crazy: The Truth about Starting and Growing Your Own Business* was based on his own hits and misses as an entrepreneur. The book was followed by a radio show, social media, email marketing, and customer relationship management follow-ups. He developed a weekly, action-packed routine to sell his services. The result? The funnel that was channeling customers to him quickly filled.

Moltz helps his clients determine what their brand is, then works with them on plans to market that brand. He emphasizes that it is ultimately a matter of execution. The plan won't get you to your goal if you don't take action. He spells this out in his latest book, *ChangeMasters: How to Make the Changes You Know You Need to Make*, which has a 2022 publication date. Moltz argues that trying to make major changes in your business overnight is not the way to accomplish your goals. Rather, he advises making small changes when working toward what your business should become, recognizing that some adjustments will be necessary along the way.

Sources: barrymoltz.com, accessed May 11, 2021; Barry Moltz and Rieva Lesonsky, *Small Business Hacks: 100 Shortcuts to Success*, Melbourne, FL: Motivational Press, 2017; and personal communication with Barry Moltz, May 18, 2021.

Barry Moltz did not wake up one morning to discover he was a small business expert. Many experiences—both good and bad—contributed to his education and his ultimate success. Through his books, speeches, and coaching, he tries to lessen the number of trials and errors that others may go through. He wants prospective business owners to know that there are reasons to do their homework and develop plans. No one perfectly predicts the future, but planning a marketing strategy can help avoid mistakes and save money in finding customers and convincing them to buy from your company.

One of the first lessons that business owners must learn is that marketing a product or service involves more than simply selling it. If you want to be a successful business

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owner, you need to put yourself in the shoes of your customers and figure out why customers buy what they do. In other words, you need a marketing plan.

In this chapter, we introduce the components of a well-written marketing plan. First, we'll consider a few basic questions about marketing:

- What is marketing for a small business owner?
- What are the components of an effective marketing orientation?
- How do you make sure you are offering value to your customers?

7-1 What Is Small Business Marketing?

7-1 Describe small business marketing.

Marketing consists of those activities that direct the creation, development, and delivery of value from a business to its customers. This definition emphasizes the benefits that customers will gain from a product or service.

In Chapter 6, we introduced you to business plans and business models. When designing a business model, you think of benefits as value propositions—your best guess as to what the customer will value in your product or service. You may have to run a number of tests before you discover what customers will view as the benefit that they get from your business relative to what they get from your competitors.

The value to customers may occur at three levels: core product/service, actual product/service, and augmented product/service. The **core product/service** is the fundamental benefit or solution sought by customers. The **actual product/service** is the basic physical product and/or service that delivers that benefit. The **augmented product/service** is the basic product and/or service plus any extra or unsolicited benefits to the consumer that may prompt a purchase. In the case of a pair of shoes, for example, the core product is basic protection for the feet; the actual product is the shoes themselves. The augmented product might be increased running speed, greater comfort, or making a fashion statement. Do the shoes offer style, prestige, or social identity?

A business owner must understand that the marketing process has a much broader scope than simply selling a product or service, or just advertising. Marketing consists of many activities, some of which occur even before a product is produced and made ready for distribution and sale. Although small companies may not have the resources available to their large competitors, they cannot ignore marketing activities and must develop strategies to meet the needs of customers. Advances in online applications and social media are providing new and more cost-efficient means for small businesses to compete.

Keep in mind that having a marketing plan does not mean that you will avoid mistakes, but it can drastically reduce the number of errors by forcing you to think through available options, given the resources you have.

marketing
Activities that direct the creation, development, and delivery of value from a business to its customers.

core product/service
The fundamental benefit or solution sought by customers.

actual product/service
The basic physical product and/or service that delivers the fundamental benefit or solution.

augmented product/service
The basic product and/or service plus any extra or unsolicited benefits to the consumer that may prompt a purchase.

7-1a Having a Marketing Orientation Makes a Difference

Decades ago, business educators came to the realization that everything begins and ends with the customer. Strategies for identifying and meeting the needs of customers should drive all aspects of an enterprise. This became known as a marketing orientation.

However, not all owners receive a business education before launching their ventures. Many run their operations with different orientations, often reflecting the owner's prior education and experience. We frequently see one of three different approaches used: a production, a sales, or a consumer approach, with the first two being used most often. Production and sales approaches are associated with the experience and aptitudes of entrepreneurs who may have a manufacturing or technology-based background, or who may have had a career in sales.

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A *production approach* emphasizes the product as the single most important part of the business. The firm concentrates resources on developing the product in the most efficient manner, while promotion, distribution, and other marketing activities are given less attention. This is the classic "build-a-better-mousetrap" approach. But do customers understand what makes your mousetrap special, or do they even know about your product? On the other hand, a *sales approach* deemphasizes production efficiencies and customer preferences in favor of a focus on "pushing product." Achieving sales goals becomes the firm's highest priority.

In contrast to the production and sales approaches, a firm adopting a *consumer approach* fits the marketing orientation, believing that everything, including production and sales, centers on consumers and their needs. As you learned in Chapter 6, your job is to devise a value proposition that satisfies your targeted customer segments.

7-1b Choosing a Consumer Approach

Focusing on the consumer is put into practice by applying a two-stage process that underlies all marketing efforts: (1) identifying customer needs, and (2) determining a value proposition that satisfies those needs. This simple formula is easy to understand but difficult to implement, given the competitive nature of most markets. But this is what it takes for a company to be successful in the long term. We strongly recommend that all new businesses begin by identifying customer segments for which their product or service provides value. Customer satisfaction is not a means to achieving a goal—it *is* the goal!

We can find many examples of both production and sales approaches that generate short-term success. However, a consumer approach not only recognizes production efficiency goals and professional selling but also adds concern for customer satisfaction. This requires the company to define the value customers will gain from the products and services offered.

Once a small firm makes a commitment to offering value to a customer segment, it is ready to develop a marketing strategy to support this goal. Activities involved in creating a marketing strategy include taking the steps necessary to locate and describe potential customers—a process called **market analysis**. Other marketing activities encompass product and/or service, pricing, promotion, and distribution (place), which combine to form the **marketing mix**.

7-2 Identify the components of a formal marketing plan.

7-2 The Formal Marketing Plan

If a feasibility study (described in Chapter 3) indicates that the venture idea is a viable opportunity, an entrepreneur is ready to prepare the formal marketing plan. Each business venture is different, so each marketing plan must be unique. A cloned version of a plan created by someone else should be avoided. Exhibit 7.1 depicts the major components of a marketing plan. These components are discussed further in Chapters 14 through 18.

market analysis
The process of locating and describing potential customers.

marketing mix
The combination of product and/or service, pricing, promotion, and distribution (place) activities.

7-2a Goals

You've probably heard the cliché "If you don't know where you are going, any path will get you there." It may seem obvious that anyone starting a business would have a goal, but some goals can guide you and others may just mislead you. Many entrepreneurs launch their ventures with the goal of making money, or selling a new product they

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Exhibit 7.1 The Marketing Plan

have developed, or being independent and not working for someone else. How do you measure such goals and know if you have succeeded? As soon as you legally register your business, have you met your independence goal? When you make your first sale, does that satisfy your goals of making money and selling your product? Do you really know if you will be around next week and able to pay your bills?

Goals can have different timelines. You may want to make your first sale or land your first account in the next two weeks. You might set a goal of breaking even by generating enough revenue to cover your fixed and variable expenses within 18 to 24 months. Maybe you would like to position your company for sale to provide you with financial security in ten years. Once you know where you are going, you can work backwards on your timeline and spell out the steps that will help you to reach that goal.

7-2b Value Propositions

Value propositions are essential to your marketing plan. What will you offer that will make a customer want to do business with you? Why should they choose you over a competitor? Remember that a value proposition is a hypothesis, a guess about what a customer wants from your product or service. You may have to experiment with multiple value propositions before you find the one(s) that will enable your business to survive and prosper. Your marketing plan will lay out the ways you will determine what value you will offer to customer segments, how you will communicate to customers that you have something that benefits them, and how you will build relationships to retain and add to your customer base.

7-2c Competition

It is truly amazing how many times prospective entrepreneurs have told us there are no competitors for their product or service or for the type of business they intend to manage. There are always competitors. You propose to solve a problem for your customers when you open your business. You see their pain, and you have a solution. But somehow they have been able to live without you up until now. They are finding plenty of ways to spend their money. You are now asking them to channel to you the dollars that they are presently spending with someone else. Why should they do that?

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What is it about your value proposition that is going to cause customers to buy from you as opposed to all their other choices?

Existing competitors should be studied carefully. The more you know about their key management personnel, the better you can anticipate the actions they will take. A brief discussion of competitors' overall strengths and weaknesses should be a part of the competition section of the marketing plan. Related products currently being marketed or tested by competitors should be noted. The entrepreneur should also assess the likelihood that any of these firms will enter the targeted market. Performing a SWOT analysis at this point is always a good idea (see Chapter 3). It is important that your company has a clear understanding of its *strengths*, its *weaknesses*, available market *opportunities*, and *threats* from competitors as well as from changes in the company's operating environment (social, technological, economic, political, and other environmental variables).

A SWOT analysis only has value if you use the information that comes out of it. It should tell you the following:

1. Where your business stands relative to the competition.
2. How competitors are likely to react when you change or try a new marketing tactic.
3. What actions you might take when you cannot overcome a weakness or avoid a threat.

7-2d Customer Segments

A critical section of the marketing plan describes the market the entrepreneur is targeting. There may be millions of people who could do business with you, but not all of them will. Some match up with your competitors better than with you. You must identify the customer segments that are the best fit for your value propositions. A **customer profile** describes the key demographic and psychological characteristics of the customers you consider most likely to be qualified purchasers of your products or services. This is where you start testing your hypotheses about whether your value propositions are sufficiently attractive to customer segments to get them to buy.

If a business owner envisions several target markets, each segment must have a corresponding customer profile. Likewise, different target markets may call for a corresponding number of related marketing strategies. Typically, however, a new venture will initially concentrate on a select few target markets—or even just one. Attempting to reach all potential customers would be way too costly for a small business.

7-2e Marketing Strategy

The information on marketing strategy forms the most detailed section of the marketing plan and, in many respects, is subject to the closest scrutiny from potential investors. Marketing strategy plots the course of the marketing actions that will make or break the owner's vision.

The marketing mix of the "4 Ps" highlights the areas that a company's marketing strategy should address:

1. *Product* decisions that will transform the basic product or service idea into value for the customer.
2. *Place* (distribution) activities that will determine the delivery of the product to customers.

customer profile
A description of potential customers in a target market.

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3. *Pricing* decisions that will set an acceptable exchange value on the total product or service.
4. *Promotional* activities that will communicate the necessary information to target markets.

The limited resources of small businesses have a direct bearing on the emphasis given to each of these areas. Additionally, a service business will not have the same distribution problems as a product business, and the promotional challenges facing a retail store will be quite different from those faced by a manufacturer. Despite these differences, we can offer a generalized format for presenting strategies in a marketing plan for those who will carry out those strategies.

The Product/Service Section

The product/service section of the marketing plan includes the name of the product and/or service and the name of the business and why those names were selected. Any legal protection that has been obtained for the names should be described. It is also important to explain the logic behind the name selection. An entrepreneur's family name, if used for certain products or services, can sometimes make a positive contribution to sales. Think about all the advertisements you have seen by companies that label themselves "family businesses." They want you to feel that their family members are committed to do what they say they will do and that you can trust them.

A good name is simple, memorable, and descriptive of the benefit provided by the product or service. (We discuss this in more depth in Chapter 15.) Whatever the logic behind the choice of names, the selection should be defended and the names registered with the appropriate agencies so that they are protected. Remember our discussion of trade names and trademarks in Chapter 4, though. Choosing a name has legal implications, so protection is not automatic. Sometimes, names selected for a business or a product or service may be challenged, even many years later, particularly if they haven't been registered. A small business that changes its name or the name of a key product or service may find that legal costs, advertising, packaging, and other materials become prohibitively expensive.

In the marketing plan, other components of the total product, such as the packaging, might be presented via photos, drawings, or other representations. It may be desirable to use professional packaging consultants to develop these tools. Customer service plans such as warranties and repair policies also need to be discussed in this section. All of these elements of the marketing strategy should be tied directly to customer satisfaction. (Chapter 14 further examines the importance of creating and maintaining good customer relationships.)

Another legal issue that many small business owners face relates to the unique features of their products or services. These features affect the reasons that customers buy your product and why someone might invest in your company. To protect these special features, companies obtain patents, trademarks, and copyrights, which are used to differentiate products and images from those of competitors and to prevent rivals from stealing a competitive advantage.

Rather than patenting their products or technologies, some enterprises prefer to maintain trade secrets. We all have heard the stories of the secret Coca-Cola formula and of KFC's mysterious 11 herbs and spices. These trade secrets fall under the term *intellectual property*. Many companies build their marketing strategies around their intellectual property, promoting the idea that only they can offer a particular benefit to customers.

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Living the Dream

Promoting a Blissful Product

Your first marketing strategy is likely to change as your company grows and prospers. You may begin with a lot of personal effort to get your first customers. Imagine how difficult this can be when you are not only introducing a new product, but also creating a new product category! Every day, we are exposed to product promotions on television, the Internet, signs and billboards, and any number of other media. You immediately recognize the names and logos of established products and companies. When no one has ever heard of your product, though, you must find a way of capturing prospective customers' attention that is different from the approaches used by competitors in your industry.

Jen Batchelor felt that people should be able to enjoy Happy Hour without the possible negative effects of alcohol. She developed blends of adaptogens, botanics, and nootropics and co-founded Kin Euphorics. Her beverages are designed for "All bliss, no booze." Examples of adaptogens include Rhodiola rosea (roseroot), Ganoderma lucidum (reishi mushroom), and Crocus sativus (saffron). According to the company's website, adaptogens strengthen the adrenal system and moderate stress responses. They are presumed to be sources of antioxidants and anti-inflammatory agents, helping to prevent cellular damage. Botanics are plants, herbs, and spices used to improve health, treat symptoms, and prevent disease. Passionflower, hibiscus, ginger, clove, and cinnamon are all botanics. Nootropic supplements are intended to improve memory, creativity, and motivation in healthy individuals. Examples include L-serine, L-tyrosine, and L-theanine. Different combinations of ingredients are marketed as alternatives to such alcoholic drinks as aperitifs (High Rhode) and nightcaps (Dream Light).

Batchelor did not just mix a drink and try to sell it. She started with a 12-month plan to develop minimum viable products and run taste tests. She was sure that she recognized a problem but knew her solution had to be something people really wanted and would be sustainable. Batchelor and her associates ran over 3,500 taste tests. Satisfied with the results, she began going after customers. She explains one successful attempt this way:

> I wanted to get my nonalcoholic beverages in front of a big industry player. So I cased out a couple of places I knew he frequented and chatted up bartenders there, convincing them to carry my product for a week and use my cocktail napkins as a promo. Everywhere he went, he was being offered Kin drinks or seeing my logo at his favorite venues. A week later, I asked two warm leads to introduce me within 24 hours of each other, and then I emailed him myself, as if I was experiencing the same serendipity he was. In the end, he suggested we meet immediately, I got the deal, and he became a mentor.

A lot of energy can be spent getting those early customers. The start-up team for Kin Euphorics knew their plan needed to evolve into a more cost-efficient means for acquiring customers. Although Batchelor acknowledges that she made mistakes along the way, she emphasizes that having a growth strategy focused on efficiencies was critical for achieving goals. She avoided the temptation to introduce a large number of products so that Kin could concentrate on making each new one successful in the market, focusing on customer satisfaction in the recognition that it is cheaper to retain a customer than to find a new one.

Although Kin products are sold on the company's website, expansion has concentrated on wholesale distribution and restaurants in major cities. Challenges remain regarding the lack of scientific support for benefits from some of the ingredients of the drinks. Batchelor remains optimistic, however, pointing out that the natural ingredients have been accepted in the marketplace for decades.

Sources: https://www.kineuphorics.com/, accessed July 3, 2021; Bristol Farms, "Meet the Founder: Jen Batchelor of Kin Euphorics," https://www.bristolfarms.com/blog/2021/06/meet-the-founders-kin-euphorics/, accessed July 3, 2021; "Get That First Meeting," *Entrepreneur*, April-May 2020, p. 18; and "'Confidence Gets Checks Signed'—Why This Founder Wants You to Have a 3-Year Plan for Your Business," https://www.createcultivate.com/blog/jen-batchelor-founder-kin-interview, accessed July 4, 2021.

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Place—The Distribution Section

Quite often, new ventures use established intermediaries to handle the distribution of their product. This strategy reduces the investment necessary for launch and helps the new company get its products to customers faster. How those intermediaries will be persuaded to carry the new product should be explained in the distribution section of the marketing plan. This section may address supply chain issues, licensing, importing or exporting, and any other subjects playing significant roles in the channel of distribution.

Some retail ventures require fixed locations; others need mobile stores. For many, the Internet is their location, but they may rely on others in a distribution chain to transport and/or store merchandise. Layouts and configurations of retail outlets should be described in this section of the marketing plan. Examples of questions to be addressed include the following:

- Will the customer get the product by regular mail or by express delivery?
- Will the service be provided from the entrepreneur's home or office or from the location of a licensed representative?
- How long will it take between order placement and actual delivery?

When a new firm's method of product delivery is exporting, the distribution section must discuss the relevant laws and regulations governing that activity. Knowledge of exchange rates between currencies and distribution options must be reflected in the material discussed in this section. Distribution concepts are explained in greater detail in Chapter 15, and exporting is discussed in Chapter 18.

The Pricing Section

At a minimum, the price of a product or service must cover the cost of bringing it to customers. Therefore, the pricing section must calculate production, distribution, and marketing costs. Of course, there are exceptions to every rule, such as giving products away in order to convince customers that they are worth paying for in the future or using "loss leaders" to attract customers who will discover other products for which they will pay full price. Naturally, forecasting methods used for analysis in this section should be consistent with those used in preparing the market analysis section. Start-up companies are becoming more concerned about **customer acquisition costs**, the amount spent to attract each new customer who makes a purchase from the company. This amount is calculated by dividing the total fixed costs of the business by the actual or projected number of customers. In this way, readers of the marketing plan get a better picture of how efficiently the business is operating, instead of just looking at a sum of expenses at the bottom of an income statement.

Break-even computations, which indicate the points at which revenues and costs are equal, should be included for alternative pricing. However, setting a price based exclusively on break-even analysis is not advisable, as it ignores some important factors. If entrepreneurs can find a truly unique niche, they may be able to charge premium prices—at least, in the short run. There's no perfect way of doing it, but the objective is to determine what purchasers are willing to pay for the product or service, then work backward to make sure that it can be produced and distributed in a way that allows the business to make a profit.

Competitors should be studied to learn what they are charging. To break into a market, an entrepreneur will usually have to price a new product or service within a reasonable range of the competition's price. Many new business owners think their best strategy is to underprice the competition in order to gain market acceptance and boost sales.

customer acquisition costs
The amount spent to attract each new customer who makes a purchase from the company.

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Keep in mind, however, that existing competitors probably have more resources than you do. If they consider your business to be a threat and engage you in a price war, they can probably outlast you. In addition, do you really want your customers to come to you only because you sell a cheaper product or service? That's no way to build loyalty. You will lose those customers to the next company that prices its product or service lower than you do. Chapter 16 examines break-even analysis and pricing strategy in more depth.

The Promotion Section

The promotion section of the marketing plan should describe the business owner's approach to creating customer awareness of the product or service and explain why customers will be motivated to buy. Technological advances are having a huge impact on how firms promote themselves and their products, and how customers obtain information about the products and services that they choose to purchase. On the positive side for small businesses, many new options have reduced the costs of promotion and extended their reach. However, the need for promotion is enormous and frequently overwhelming, making it difficult for a small enterprise to gain customers' attention.

Even with new technology, personal selling (i.e., person-to-person selling) and advertising will continue to be important. You will read more about personal selling and advertising in Chapter 17. If personal selling is appropriate, the promotion section of your plan should outline how many salespeople will be employed and how they will be compensated. It should also mention the proposed system for training the sales force. If advertising is to be used, a list of the specific media to be employed should be included and advertising themes described. If you will be using the services of an advertising agency, the name and credentials of the agency should be provided, as well as a brief mention of successful campaigns supervised by the agency.

Barry Moltz (see the Spotlight feature for this chapter) acknowledges the importance of the 4 Ps of marketing but advises small business owners to be sure to also have a unique selling proposition (USP). According to Moltz, the first step is to learn why customers do business with you. The focus of the marketing should be on the benefits those customers feel they receive, not on features of the product. You want to know what the USPs of your competitors are. Check out their physical locations, websites, social platforms, and marketing messages. Where do you stand in comparison? And be passionate about your product or service and your company. Emotion can help you connect with customers and win their loyalty.

7-2f Metrics

Each component of the marketing plan should specify metrics to help determine whether you are on track to accomplish your goals. **Metrics** are measurements that tie specific and repeatable actions to observable results.[1] Metrics may be used to help your business get back on track, but they can also signal that it may be time to change your goals. The word *pivot* crops up in this book from time to time and is a popular term with entrepreneurs and investors to highlight when it is necessary to take the business in a new direction, either because you find you cannot reach your goal or because you have discovered a new and better opportunity. Metrics should not lock you into a single path of action.

In reviewing what you have learned so far about the marketing plan, you will find several situations where we recommend metrics. Typical categories where business owners specify metrics include the following:

metrics
Measurements that tie specific and repeatable actions to observable results.

- Time—When goals should be accomplished, including target dates for stages of progress.
- Cost—How much is budgeted for the goal.

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- Quality—How products or services compare with those of competitors in their ability to satisfy customer requirements and expectations.
- Quantity—How much can be produced within time, cost, and other constraints.

One word of caution: Metrics can become dysfunctional when applied incorrectly. Sometimes, this is due to misperceptions, but misperceptions have real implications. Make sure that employees who are responsible for specific action goals view the metrics being used as:[2]

- Relevant and controllable by those who are being measured.
- Readily accessible by all who are being measured.
- Regularly reviewed and discussed.
- Free of anything resembling "fixing the blame" or "finger-pointing."

As we turn toward a discussion of target markets for launching and growing a venture, we will continue to address quantitative measures. Measurement is essential for feedback in the lean start-up approach.

7-3 Understanding Potential Target Markets

7-3 Discuss market segmentation and its related strategies.

The marketing plan should guide the entrepreneur toward analyzing the market to identify customer segments. That demands a proper understanding of the term *market*, which means different things to different people. It may refer to a physical location where buying and selling take place ("They went to the market"), or it may be used to describe selling efforts ("We must market this product aggressively"). Still another meaning is the one we emphasize in this chapter: A **market** is a group of customers or potential customers who have purchasing power and unsatisfied needs. Note carefully the three ingredients in this definition of a market:

1. A market must have buying units, or *customers*. These units may be individuals or business entities.
2. Customers in a market must have *purchasing power*. Those who lack money and/or credit do not constitute a viable market because no transactions can occur.
3. A market must contain buying units with *unsatisfied needs*. Customers, for instance, will not buy unless they are motivated to do so—and motivation can occur only when a customer recognizes their unsatisfied needs.

In light of our definition of a market, determining market potential is the process of locating and investigating buying units that have both purchasing power and needs that can be satisfied with the product or service that is being offered.

7-3a Market Segmentation and Its Variables

In Chapter 3, cost- and differentiation-based strategies are described as they apply to marketplaces that are relatively homogeneous, or uniform, in nature. As discussed, these strategies can also be used to focus on a market niche within an industry. In his book, *Competitive Advantage*, Michael Porter refers to this type of competitive strategy—in which cost- and differentiation-based advantages are achieved within narrow market segments—as a *focus strategy*.[3]

A focus strategy depends on market segmentation and becomes a consideration in competitive markets. Formally defined, **market segmentation** is the process of dividing

market
A group of customers or potential customers who have purchasing power and unsatisfied needs.

market segmentation
The division of a market into several smaller groups, each with similar needs.

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the total market for a product or service into smaller groups with similar needs, such that each group is likely to respond favorably to a specific marketing strategy.

Barry Moltz (see this chapter's Spotlight feature) thinks business owners should collect data about customers every time they do business with them. Your marketing plan should guide you in your use of the data. How can you tailor promotions and offers to the customers you want to retain? Personalized messages cement relationships. One purpose of the relationships may be to obtain input from customers so that you can better meet their needs and make your business more attractive to prospective new customers.

In order to divide the total market into appropriate segments, an entrepreneur must consider **segmentation variables**, which are parameters that distinguish one form of market behavior from another. Two broad sets of segmentation variables that represent the major dimensions of a market are benefit variables and demographic variables. Both types of variables are needed to implement marketing strategies and sales forecasting.

- **Benefit variables** are used to identify segments of a market based on the benefits sought by customers, thereby highlighting the customers' unsatisfied needs.
- **Demographic variables** focus on certain characteristics that describe customers, their purchasing power, their consumption patterns, and other factors. These characteristics include age, marital status, gender, occupation, and income.

7-3b Marketing Strategies Based on Segmentation Considerations

Several types of marketing strategies are based on segmentation efforts. The three types of strategies discussed here are the unsegmented approach, the multisegment approach, and the single-segment approach. Few companies engage in all three approaches simultaneously. Small businesses often lack the resources that these strategies tend to require. But, for some, a marketing strategy based on segmentation considerations is the best route to take.

The Unsegmented Strategy

When a business defines the total market as its target, it is following an **unsegmented strategy** (also known as *mass marketing*). This strategy can sometimes be successful, but it assumes that all customers desire the same basic benefit from the product or service. This may hold true for water but certainly does not hold true for shoes, which satisfy numerous needs through a wide range of styles, prices, colors, and sizes. With an unsegmented strategy, a firm develops a single marketing mix—one combination of product, price, promotion, and place. Its competitive advantage must be derived from either a cost- or a differentiation-based advantage.

The Multisegment Strategy

With a view of the market that recognizes individual segments with different preferences, a firm is in a better position to tailor marketing mixes to various segments. If a firm determines that two or more market segments have the potential to be profitable and then develops a unique marketing mix for each segment, it is following a **multisegment strategy**. Clothing stores may market to both adults and children (demographic segments). A group of banks may offer services in multiple states (geographic segments). A company that owns several restaurant chains may have discovered that some customers choose a restaurant based on price, while others are loyal to a brand (behavioral segments).

segmentation variables
The parameters used to distinguish one form of market behavior from another.

benefit variables
Specific characteristics that distinguish market segments according to the benefits sought by customers.

demographic variables
Specific characteristics that describe customers, their purchasing power, their consumption patterns, and other factors.

unsegmented strategy
A strategy that defines the total market as the target market; also known as *mass marketing*.

multisegment strategy
A strategy that recognizes different preferences of individual market segments and develops a unique marketing mix for each.

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The Single-Segment Strategy

When a firm recognizes that several distinct market segments exist but chooses to concentrate on reaching only the most potentially profitable segment, it is following a **single-segment strategy**. Once again, a competitive advantage is achieved through a cost- or differentiation-based strategy.

The single-segment approach is probably the wisest strategy for small businesses to use during initial marketing efforts. It allows a small firm to specialize and make better use of its limited resources. Then, once its reputation has been established, the firm will find it easier to enter new markets.

7-4 Finding Customers

7-4 Describe strategies for finding customers.

Once you have analyzed market segments, it makes sense to plan the specific steps that lead to finding the right customers for the business. Many small business owners base their marketing plans on intuition or on their personal, limited experiences and observations. To improve your odds of success, you will want to learn as much as you can about your customers and how you may be able to meet their needs.

Small business owners are often encouraged to conduct formal marketing research, but we suggest caution. **Marketing research** may be defined as the gathering, processing, interpreting, and reporting of market information. If you have not taken extensive coursework in marketing research and have actually engaged in the practice, you can easily mislead yourself with the results you obtain and make bad decisions.

A small business typically conducts less marketing research than a big business does, partly because of the expense involved but also because the entrepreneur often does not understand the basic research process. Therefore, our discussion of marketing research focuses on the more widely used and practical techniques that entrepreneurs can employ as they analyze potential target markets and make preparations to develop their marketing plans.

Think about what you really need to know as you become a business owner. You want to have a product or service that a customer will buy. The customer must feel that you are solving a problem for them, making life better for them, or in some way giving them a reason to channel money to your company that could have been used for something else. That means you need to know who that customer is and if there are enough of those customers to make your business profitable. You want to find out what models and tools you can use to find customers and determine if your value proposition will turn them into *your* customers.

In Chapter 6, you read about the Business Model Canvas and the lean start-up approach. In recent years, both have been found effective in finding customers and testing whether your value proposition matches the customer segments you are targeting. We will now examine procedures for applying these strategies.

7-4a Matching Value Propositions to Customer Segments

As explained in Chapter 6, the Business Model Canvas contains nine blocks,[4] each of which may be applicable to preparing a marketing plan. With our focus on finding customers, we look specifically at the value proposition and customer segments blocks:[5]

- *Value propositions* are based on products and/or services that create value for a customer segment.
- *Customer segments* are groups of people and/or organizations that a business wants to reach and create value for with a dedicated value proposition.

single-segment strategy
A strategy that recognizes the existence of several distinct market segments but focuses on only the most profitable segment.

marketing research
The gathering, processing, interpreting, and reporting of market information.

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Value propositions and customer segments support each other. You may have come up with an idea for a product or service, and the requirement for starting or growing your business is to find the right customer for it. Alternatively, you may have discovered a problem that a customer is having, and you are looking for the product or service that meets the customer's needs. The first value proposition you offer to a customer is just a guess. You run tests of your product idea, adjusting the product or finding a different customer segment until you find a match.

The dilemma for the small business owner is to discover what customers need and then find ways of meeting those needs. To learn more about the customer segment that you are targeting, follow the advice of Steve Blank and "get out of the building!"[6] Once you get out of the building, your job is to talk to and listen to customers.

Blank has been influential in popularizing both the Business Model Canvas and the lean start-up method. His contention is that it is essential for business owners to find existing and prospective customers and talk to them. Let the customers articulate what they need to solve a problem or to improve conditions that they are facing. Entrepreneurs cannot assume that they understand customer needs. They have to first listen to and learn from customers, and then test their ability to formulate a value proposition.

Do not fall into typical market research errors by asking the wrong questions or misinterpreting what people are telling you. One of the traps business owners encounter is having customers tell them what the customer thinks the owner wants to hear. There is nothing for you down that path. Here are some recommendations for learning how your value propositions may match customer segments:[7]

- Start locating potential customers through Linkedin, company websites, personal networks, etc.
- Plan your questions, but be flexible enough to alter them based on what people tell you.
- Try to talk to both users and decision makers.
- Listen to what customers are demanding.
- Don't try to sell; just be a good listener.
- Talk to experts in the field.
- Be ready to share prototypes (but be sure that you have protected your intellectual property first).
- Summarize for the customer what you think you heard, and be ready to make corrections.

Don't think one or two interviews with customers will tell you what you need to know. Most marketing experts want you to talk to at least 100 customers to learn what trends may be buried in their comments. You should be testing what you hear along the way. What changes need to be made to your value proposition to meet the needs of your desired customer segments?

Even when you find a match between your value propositions and your customer segments, you are not done. The world keeps changing. New competitors enter the market. Technologies become obsolete and are replaced by alternatives. The economic environment is volatile, and costs may go up for your products or services. Any number of disruptions may occur in the social and legal environments in which you are operating. Your marketing plan must recognize the changes that impact your customer segments.

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Living the Dream

Building a Strong Network

Do you need another reason to write a marketing plan? Simple. You don't know everything. Preparing a marketing plan puts you on the path to gain knowledge that may make all the difference in getting your venture off the ground. That was key for Lauren Schute Wang when she decided to start her own business. After graduating from Georgia State University with a marketing degree, she spent a decade working on brand development for large corporations.

In 2014, Wang came up with a solution to a problem she had been experiencing for years--she hated using tampons. So, Wang developed alternative products: discs, cups, wipes, and more. Before she launched her own enterprise, though, she wanted to fill some of the knowledge gaps she knew she had.

> When I first had the idea for Flex, I made a list of all of the things I didn't know how to do: regulatory, supply chain, fundraising, etc. I then created an email list of all my contacts and started a monthly email where I told people about my mission and vision, and included one specific ask, usually for a meeting with someone with one of these specialties. It was shocking to see how quickly I connected with experts in all the areas I was seeking help with. Five years later, I still work with several people whom I met during that time.

The Flex Company opened for business in 2015. The lightbulb moment for the launch resulted from two strangers from other parts of the United States calling her to place orders for products they had only heard about through the grapevine that Wang had initiated through her emails. Originally, Wang felt it was counterintuitive to tell people about her ideas. It turned out that her networking led her to early users, employees, and investment capital.

It took Flex less than a year to reach $4 million in sales. Three years into the business, Wang reported that Flex had more than doubled its revenue each year following its launch. She attributes much of the growth to gaining access to retail outlets, including Target, which she does not consider to be a place where her products just sit on a shelf. Wang sees education as essential to her marketing efforts, collecting data to find ways to improve service to customers. And the information she gathers makes her a strategic partner for Target. The Target data have become important metrics in determining customer acquisition costs for Flex.

Wang and her team believe their future success will be a function of their purpose, vision, and mission:

- Purpose: We're working to create a world where every woman loves her body.
- Vision: Our vision is to reimagine and deliver life-changing period products everywhere.
- Mission: The Flex Company's mission is to create body-positive and life-changing experiences through the products that we make and the conversations we spark.

For Lauren Schute Wang, customers will determine the direction of the future products that Flex will offer.

Sources: "Experience Period Freedom," https://flexfits.com/, accessed July 5, 2021; "Lauren Schulte Wang," https://www.crunchbase.com/person/lauren-schulte, accessed July 5, 2021; Beth Gillette, "Goodbye Tampons: Lauren Schulte Is Changing the Way You Have a Period," https://theeverygirl.com/lauren-schulte-the-flex-company/, accessed July 5, 2021; "Get That First Meeting," *Entrepreneur*, April-May 2000, p. 18; and Lauren Schulte Wang, "Choose Love over Fear: How We Grew to $4M in Under 1 Year," https://medium.com/@laurenschulte/choose-love-over-fear-how-we-grew-to-4m-in-under-1-year-ee9608197773, accessed July 5, 2021.

7-4b Continuously Improving the Marketing Plan through Feedback

The next tool for ensuring that you are satisfying the needs of your customers is part of the lean start-up approach (see Chapter 6). Designed by Eric Ries, the approach can reduce risks, time, and costs in getting a product to market.[8] One technique that Ries

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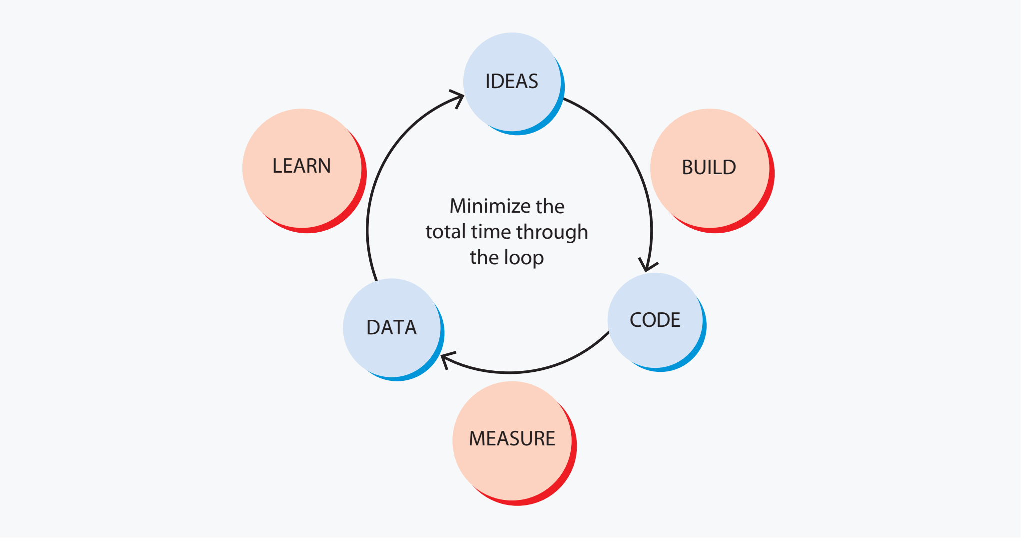
places at the core of the lean start-up method is especially beneficial to the marketing plan by continuously adjusting to changes in customer segments. The Build-Measure-Learn Feedback Loop, shown in Exhibit 7.2, guides you in testing your idea and your product or service to find solutions for targeted customers and making adjustments as you discover better ways of meeting their needs. In this way, you keep your marketing plan alive, revising and improving it as you learn through doing. Let's work our way through the Build-Measure-Learn Feedback Loop.

Ries's model begins with the idea. It may be an idea for a product or service that will be the basis of your new venture. An idea can happen in existing businesses as well. It may be an idea for a product modification or for a new service or product line that you are considering. Ries suggests that you build a version of that idea, but not the perfect version. You are to build a *minimum viable product*, or MVP: "The minimum viable product is that version of a new product which allows a team to collect the maximum amount of validated learning about customers with the least effort."[9] Ries cautions that the last thing you want to do is spend the time and money to create the "perfect product." Invariably, your perfect product will not perfectly fit your customer and will need to be altered in some way. Instead, you want to build just enough to test your assumptions about whether you have something customers are willing to buy.

The word *code* in Exhibit 7.2 comes out of Ries's experience in the software industry, where, once you decide on a software idea and put together an MVP, you start coding. So, if you are in a different industry, you would substitute the appropriate word or phrase for *code* that describes whatever actions you are taking to revise and improve your product as you observe how customers respond. You measure the results of each experiment conducted with your MVP and use the resulting data to revise, revise, revise. This learning process gets you closer and closer to matching your value proposition to the needs of your customer segments. Eventually, your start-up experiment becomes a real business.

Remember, the marketing plan is a living document. It doesn't end when you have gone through the circles in Exhibit 7.2. This feedback loop of continuous learning helps keep your business in tune with your customers as conditions change in the various environments in which you are competing.

Exhibit 7.2 The Build-Measure-Learn Feedback Loop



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7-5 Estimating Market Potential

7-5 Explain the importance of forecasting sales.

A small business can be successful only if sufficient market demand exists for its product or service. A sales forecast is the typical indicator of market adequacy, so it is particularly important to complete this assessment prior to writing the marketing plan. Many types of information are required to gauge market potential. We discuss these information needs as we examine the forecasting process, which will be described in greater detail in Chapter 11.

7-5a The Sales Forecast

A **sales forecast** is a prediction of how much of a product or service can be sold within a given market during a specified time period. The forecast can be stated in terms of dollars and/or units. One sales forecast may cover a period of time that is a year or less, while another may extend over several years. Both short-term and long-term forecasts are needed for a well-constructed marketing plan. Once again, you'll discover how critical it is to take metrics seriously in the planning process.

A sales forecast is an essential component of the marketing plan because it is critical in assessing the feasibility of a new venture. If the market is insufficient, the business is destined for failure. A sales forecast is also useful in other areas of business planning. Production schedules, inventory policies, and personnel decisions all start with a sales forecast. Obviously, a forecast can never be perfect, and entrepreneurs should remember that a forecast can be wrong in either direction, by either underestimating or overestimating potential sales.

7-5b Limitations of Forecasting

For a number of practical reasons, forecasting is used less frequently by small firms than by large firms. First, for any new business, forecasting circumstances are unique. Entrepreneurial inexperience, coupled with a new idea, represents the most difficult forecasting situation. An ongoing business that requires only an updated forecast for its existing product is in the most favorable forecasting position.

The owners of some small firms attempt to keep in touch with industry trends through contacts with appropriate trade associations. The professional members of a trade association are frequently better qualified to engage in sales forecasting. Most libraries have a copy of the *National Trade and Professional Associations Directory*, which lists these groups. Entrepreneurs can also obtain current information about business trends by regularly reading trade publications and magazines focused on small business ownership, such as *Entrepreneur* and *Inc*. Government publications, such as the *Federal Reserve Bulletin*, *Survey of Current Business*, and *Monthly Labor Review*, may also be of general interest. Subscribing to professional forecasting services is another way to obtain forecasts of general business conditions or for specific industries.

For a new business, few things are as important as identifying your market—nothing happens until someone buys something from your company. And if you plan to grow your business, understanding your market is essential. In this chapter, we introduced you to the steps necessary for putting together a marketing plan. The plan will be a living document for you as you manage your business. Every day, you will learn more about your market and how you can meet customer needs. In later chapters, you will see that your marketing strategy impacts many other areas of your venture: It affects how many people you employ and what skills they need, the volume and selection of your inventory, the production processes you use, and many other business functions.

sales forecast
A prediction of how much of a product or service can be sold within a given market during a specified time period.

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7-1. Describe small business marketing.

- Marketing consists of those activities that direct the creation, development, and delivery of value from a business to its customers.
- The value to customers occurs at three levels: (1) the core product/service, (2) the actual product/service, and (3) the augmented product/service.
- Three distinct marketing orientations are the production, sales, and consumer approaches.
- A small business should adopt a consumer approach to marketing, as that approach is most consistent with long-term success.
- Activities involved in creating a marketing strategy include analyzing the market and determining the marketing mix.
- A two-stage process underlies all marketing efforts when focusing on the consumer: identifying customer needs, and determining a value proposition that satisfies those needs.

7-2. Identify the components of a formal marketing plan.

- The formal marketing plan should include sections on goals, the value proposition, the competition, customer segments, marketing strategy, and metrics.
- Goals should provide clear guidelines for the business and be measurable.
- The value proposition expresses your hypothesis regarding why customers will buy from your business.
- A SWOT analysis is helpful in assessing the competition.
- The marketing plan should contain a profile of the customers you consider most likely to be qualified purchasers of your product or service.
- The "4 Ps" of marketing strategy that should be discussed in the marketing plan are (1) product decisions, (2) place (distribution) activities, (3) pricing decisions, and (4) promotional activities.
- Metrics are essential inclusions in marketing plans in order to determine if the plan is achieving business goals.

7-3. Discuss market segmentation and its related strategies.

- A market is a group of customers or potential customers with purchasing power and unsatisfied needs.
- A focus strategy relies on market segmentation, which is the process of dividing the total market for a product or service into smaller groups with similar needs, such that each group is likely to respond favorably to a specific marketing strategy.
- Broad segmentation variables that represent major dimensions of a market are benefit variables and demographic variables.
- Three types of market segmentation strategies are (1) the unsegmented approach, (2) the multisegment approach, and (3) the single-segment approach.
- The unsegmented strategy—when a business defines the total market as its target—is also known as mass marketing.
- A firm that determines that two or more market segments have the potential to be profitable and then develops a unique marketing mix for each segment is following a multisegment strategy.
- A firm that follows a single-segment strategy recognizes that several distinct market segments exist but chooses to concentrate on reaching only the segment that promises the greatest profitability.

7-4. Describe strategies for finding customers.

- Research is necessary for the preparation of a meaningful marketing plan, but business owners should question their own skills in gathering and interpreting information.
- The Business Model Canvas and the lean start-up approach both offer techniques for developing strategies to find customers.
- The value proposition and customer segments blocks of the Business Model Canvas provide starting points for testing ideas against market responsiveness.
- Conditions for running a business never stay constant, so the Build-Measure-Learn Feedback Loop in the lean start-up approach is an important tool for continuing to find and retain customers.

7-5. Explain the importance of forecasting sales.

- A sales forecast is an estimate of how much of a product or service can be sold within a given market during a specified time period.

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- Both short-term and long-term forecasts are needed for a well-constructed marketing plan.
- A sales forecast is an essential component of the marketing plan because it is critical in assessing the feasibility of a new venture.
- Small business owners may attempt to keep in touch with industry trends through contacts with appropriate trade associations, by regularly reading trade and government publications and magazines focused on small business ownership, and by subscribing to professional forecasting services.

Key Terms

actual product/service p. 165
augmented product/service p. 165
benefit variables p. 174
core product/service p. 165
customer acquisition costs p. 171
customer profile p. 168
demographic variables p. 174
market p. 173
market analysis p. 166
marketing p. 165
marketing mix p. 166
marketing research p. 175
market segmentation p. 173
metrics p. 172
multisegment strategy p. 174
sales forecast p. 179
segmentation variables p. 174
single-segment strategy p. 175
unsegmented strategy p. 174

Discussion Questions

1. What do you think would be different about marketing products and services for a small business as opposed to managing the marketing function in a large corporation?
2. If you had opened a restaurant before the COVID-19 pandemic, what might have affected your marketing plan once lockdowns began? What do you feel you would have had to change to survive?
3. Do markets always need to be segmented? Why or why not? What might be some differences in market segmentation for small companies versus large companies?
4. Think of a small business that you have bought products or services from. If you were writing its value proposition, what would it be?
5. Why are sales forecasts needed?

You Make the Call

Situation 1

When Michael Maher, Barrett Purdum, and Mike Armenta cofounded Taylor Stitch, a custom shirt manufacturer and retailer in San Francisco, they were confident that they could make the business a success by building on their skills in designing, manufacturing, and marketing. They moved forward with eyes wide open. They were aware that there were skills they did not possess, skills that might make or break the venture as they tried to get it off the ground. It was obvious to them that the business would have to have an online presence, but none of them had any education or experience in developing and maintaining an online marketing campaign. They decided they needed a partner and chose Shopify, a company that helps companies set up online stores. It sells or configures domain names, sets up and hosts websites, provides shopping cart features enabling customers to browse and buy, and offers other e-commerce products and consulting services. The owners of Taylor Stitch now sell products on their own website and also through those of other retailers, including Huckberry, Stylight, Backcountry, and more.

Sources: http://www.taylorstitch.com, accessed July 6, 2021; and https://open.spotify.com/episode/67dOhLEwp55YoJGV8jvNu2, accessed July 6, 2021.

Question 1 Where would you fit the preparation of a website for Taylor Stitch in their marketing plan? Why?

Question 2 What metrics would you recommend to the owners of Taylor Stitch to help them determine if they are achieving their marketing goals?

Situation 2

The Woodside Hotel chain is a second-generation business in Northern California. The current manager, Greg Alden, earned his MBA at UCLA's Anderson School of Management. Alden and his family have positioned their chain in the luxury hotel category. That means they must take customer reviews seriously. Alden

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keeps an eye on hotel rankings on Yelp, TripAdvisor, Expedia, and other relevant rating sites. But monitoring all those services can be seriously time consuming. Alden found a better way to monitor how satisfied customers were and what they were communicating about hotels they visited by contracting with Revinate. Revinate provides a software platform for hotels and other companies in the hospitality industry. The platform allows Alden to track online reviews and to use social media to learn what travelers want. He can spot trends and act on criticisms immediately, bringing customers back and attracting new ones. The Internet has taken "word-of-mouth" advertising to a whole new level.

Sources: Gwen Moran, "Chatter Master," *Entrepreneur*, December 2012, p. 62; Woodside Hotel Group, https://www.woodsidehotelgroup.com/our-story/why-stay-with-us, accessed July 7, 2021; and http://www.revinate.com, accessed July 7, 2021.

Question 1 In addition to monitoring where your company is ranked in comparison with competitors, what other metrics do you think you might want to examine if you were in the hotel industry?

Question 2 Do you report your experiences with businesses on any social networks? Why or why not?

Experiential Exercises

1. Find a local small business that has co-founders and interview them separately. Did they have a marketing plan when they started? What would they do differently if they could go back and start over? How do their answers compare?
2. Check out some websites of small businesses to determine what their value propositions are. Do the websites tell you why the companies are unique, or do they seem to resemble other businesses you know about in their industry?
3. Visit a retail store that you like in your community. Take a good look at the customers entering and leaving the store. Do they have anything in common—age, gender, clothing choices, individuals versus family groups, etc.? What conclusions can you draw about the market segment(s) served by that store?

Business Plan

LAYING THE FOUNDATION

As part of laying the foundation for your own business plan, respond to the following questions regarding the marketing plan, marketing research, market segmentation, and sales forecasting.

Marketing Plan Questions

1. How will you identify prospective customers?
2. What is the customer profile for your product or service?
3. Who is your competition?
4. Have you conducted a SWOT analysis?
5. What geographic area will you serve?
6. What are the distinguishing characteristics of your product or service?
7. What steps have already been taken to develop your product or service?
8. What do you plan to name your product or service?
9. Will there be a warranty?
10. How will you set the price for your product or service?
11. What type of distribution plan will you use?
12. Will you export to other countries?
13. What type of selling effort will you use?
14. What special selling skills will be required?
15. What types of advertising and sales promotion will you use?
16. Can you use the Internet to promote your company and product or service?

Marketing Research Questions

1. What research questions do you need answers to?
2. What types of research should be conducted to collect the information you need?
3. How much will this research cost?
4. What sources of secondary data will address your informational needs?
5. What sources of relevant data are available in your local library?
6. What sources of outside professional assistance would you consider using to help with marketing research?

Market Segmentation Questions

1. Will you focus on a limited market within the industry?
2. What segmentation variables will you use to define your target market?

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3. If you determine that several distinct market segments exist, will you concentrate on just one segment?

Sales Forecasting Questions

1. How do you plan to forecast sales for your product or service?
2. What sources of forecasting assistance have you consulted?
3. What sales forecasting techniques are most appropriate to your needs?
4. What is the sales forecast for your product or service?
5. How reliable is your sales forecast?

Chapter 7 Case

Please see Appendix A for the Chapter 7 Case Study.

Endnotes

1. Ash Maurya, "3 Rules to Actionable Metrics in a Lean Startup," https://blog.leanstack.com/3-rules-to-actionable-metrics-in-a-lean-startup/, accessed June 13, 2021; and Eric Ries, *The Lean Startup: How Today's Entrepreneurs Use Continuous Innovation to Create Radically Successful Businesses* (New York: Crown Business, 2011).
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4. Alexander Osterwalder and Yves Pigneur, *Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers* (Hoboken, NJ: Wiley, 2010); and "Build an Invincible Company," https://www.strategyzer.com/, accessed June 9, 2021.
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7. Osterwalder et al., *op. cit.*
8. Ries, *op. cit.*
9. *Ibid.*

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Chapter 8

The Organizational Plan: Teams, Legal Structures, Alliances, and Directors

Looking Ahead

Learning Objectives

The Organizational Plan chapter describes what to look for in a management team, how to choose among the various legal forms of organization for your business, and how to effectively use strategic alliances and boards of directors. By studying this chapter, you should be able to . . .

8-1 Describe the characteristics and value of a strong management team.

8-2 Explain the common legal forms of organization used by small businesses.

8-3 Identify factors to consider in choosing among the primary legal forms of organization.

8-4 Discuss the unique features and restrictions of six specialized organizational forms.

8-5 Understand the nature of strategic alliances and their uses in small businesses.

8-6 Describe the effective use of boards of directors and advisory boards.

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Spotlight on Small Business

Bubbakoo's Burritos

https://www.bubbakoos.com

When launching a start-up, few things are more important than having the right people along for the journey. And these individuals need to be in positions to which they are well-suited if the business is to grow and be successful. One example of a business that has thrived as a result of its strong management team is Bubbakoo's Burritos.

Paul Altero and Bill Hart founded the New Jersey–based restaurant chain in 2008. But it was Altero who first came up with the idea while writing a business plan for a course he was taking at the University of Delaware. He used the name Bubbakoo's Burritos for the assignment, and the name stuck.

After college, Altero worked at a variety of businesses and eventually found his way to the well-known burger chain Johnny Rockets, where he met Hart. The two worked together for 10 years, including later stints at Chipotle that led to the rekindling of Altero's burrito dream. After giving it much thought, Altero and Hart left their positions to open the first Bubbakoo's Burritos restaurant. To make sure their burrito eatery would provide a unique experience, the start-up team decided they would allow diners to build their own burrito, a concept that was unheard of at the time.

In launching his restaurant business, Altero built on lessons learned when he worked for a time at Nordstrom, a company that has a sharp focus on providing amazing customer service. He designed Bubbakoo's to deliver a superb dining experience and unique product-customization options. The eatery apparently hit the mark with consumers, as the business gained traction very quickly. In 2009, the company opened a second location and kept up the pace after that, opening a new restaurant each year for the next several years.

Altero and Hart turned to a franchising model in 2015, which allowed them to expand even faster. By 2017, they had locations throughout the eastern half of New Jersey. This grew to more than 60 locations spread across eight states by the end of 2020. Over the years, Bubbakoo's Burritos has worked hard to build strong customer loyalty, and now the company is benefiting tremendously from it.

But a company can only be as great as its management team, and Bubbakoo's Burritos is definitely led by a competent crew. For example, cofounder Bill Hart now has 30 years of operational experience in the food industry under his belt. Altero has been able to turn his attention to brand development because he knows that Hart has put an operational system in place that can support the brand's growth. But this is not the sum total of the venture's leadership. A supporting cast of management talent has been added over the years, and this has contributed greatly to the venture's success.

Bubbakoo's Burritos is clearly in good hands—and it shows in the impressive expansion of the venture over its relatively brief history. While other companies may casually assert, "Our people make all the difference," Bubbakoo's Burritos has evidence to show that this is true. But it goes beyond raw knowledge and years of experience. Because the members of the team were carefully selected, they also function very effectively as a group—and that's what it takes to succeed. For example, in addition to growing the business, the executives that run the company have shown that they are able to settle their differences quickly and smoothly. They often step in as tiebreakers, which ends disagreements efficiently and allows more time and energy to be focused on the business and its strategy. These are all hallmarks of a high-functioning management team.

Sources: https://www.bubbakoos.com/ourstory, accessed February 13, 2021; "6 Ways for Cofounders to Settle Disagreements," *Entrepreneur,* Vol. 48, No. 2 (March 2020), pp. 16–17; and Dahlia Ghabour, "Build-Your-Own Burrito Chain Opens Its First Kentucky Location in Louisville," *Louisville Courier Journal*, January 19, 2021, https://www.courier-journal.com/story/life/food/2021/01/19/bubbakoos-burritos-fast-casual-c-hain-opens-first-louisville-location/4214540001, accessed February 13, 2021.

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Popular notions aside, most successful entrepreneurs do not operate as "Lone Rangers" in the start-up world. In fact, it seems that an increasing number of new ventures—including the one featured in the opening Spotlight to this chapter—are being led by talented and effective *teams* of entrepreneurs. This adjustment may be required to handle the increasing complexity of running a business and to share the expanding workload involved in getting a start-up off the ground.

To be sure, plenty of solo entrepreneurs are starting new (and successful) businesses, but evidence is mounting to reveal that team-founded ventures tend to outperform their single-founder counterparts. Entrepreneurship experts Stephen Spinelli and Robert Adams emphasize this point:[1]

> Owning and running the whole show effectively puts a ceiling on growth. . . . It is extremely difficult to grow a higher-potential venture by working single-handedly. Higher-potential entrepreneurs build a team, an organization, and a company.

Unfortunately, team leadership in a small enterprise all too often presents its share of heartaches, especially when partners are hastily chosen, work and reward relationships are unclear, and formal agreements are poorly conceived. The high hopes of partnership and camaraderie in business can easily be dashed on the rocks of real life. People are imperfect, after all, so working closely with others is bound to lead to a certain amount of disappointment. However, in all but the simplest of businesses, the entrepreneur's personal talents often need to be supplemented with the experience and abilities of other individuals. A venture's prospects typically are most promising when its leadership is composed of competent, resourceful, and tenacious individuals who are committed to doing their best and can get along because they trust one another and share the same values.[2] With that in mind, it is important for an entrepreneur to identify and attract a strong management team. An organizational plan that provides for effective leadership is appealing to both potential investors and prospective managerial personnel.

In this chapter, we also discuss the selection of an appropriate ownership structure, often called a legal form of organization. The direction of the business will be powerfully shaped by an entrepreneur's decision to organize as a sole proprietorship, a partnership, a corporation, or one of the other available forms. The organizational form should match the needs of the business, but getting it right can be a challenge. Also included in the organizational plan are strategic alliances, which are becoming increasingly popular among small businesses and can be vitally important to their performance. Finally, we describe the role of boards of directors or advisory boards for small businesses and provide insights on how to make the most of them.

All of these elements of a small business should be carefully considered in the organizational plan. The quality of an entrepreneur's decisions on these issues can greatly enhance the performance of the company—or doom it to failure. We will show you how to navigate the potentially dangerous waters of planning for these facets of the business and guide you toward improved odds for success.

8-1 Describe the characteristics and value of a strong management team.

8-1 Building a Management Team

management team
Managers and other key persons who give a company its general direction.

If a firm is extremely small, the founder will probably be the key manager and perhaps the only manager. In most firms, however, others share leadership roles with the owner, which creates opportunities to leverage their combined networks and resources for the good of the company. In general, we view the **management team** as consisting of individuals with supervisory responsibilities, as well as nonsupervisory personnel who

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play key roles in the business.[3] For example, members of a management team might include a financial manager who supervises a small office staff and another person who directs the marketing effort.

If you should find that you don't have your "dream team" in place when you are just getting started, understand that the team arrangement does not have to be permanent. Although it can be difficult to do, sometimes you have to respectfully and appropriately let individuals go when they cannot or will not effectively support the business. New members can be added to the team as the need arises.[4]

Strong management can make the best of a good business idea by securing the resources needed to make it work. Of course, even a highly competent management team cannot rescue a firm that is based on a weak business concept or that lacks adequate resources. However, the importance of strong management to start-ups is evident in the attitudes of prospective investors, who consider the quality of a new venture's management to be one of the most important factors in decisions to invest. In other words, investors know that enterprises typically perform poorly if they are guided by weak or incapable managers.

One reason that a management team often can bring greater strength to a venture than an individual entrepreneur can is that a team can provide a diversity of talent to meet various managerial needs. This can be especially helpful to start-ups built on new technologies that must manage a broad range of factors. In addition, a team can provide greater assurance of continuity, since the departure of one member of a team is less devastating to a business than the departure of a single owner.

The competence required in a management team depends on the type of venture and the nature of its operations. For example, a software development firm and a restaurant require very different types of business experience. Similarly, service firms and retail businesses tend to be less complicated to launch and operate, which may explain why solo entrepreneurs lean toward these kinds of start-ups. Whatever the business, a small firm needs managers with an appropriate combination of education, experience, and skills. The qualifications of an applicant for a key position should complement those of members already on the team.

In many cases, a start-up owner stacks the management team with family and friends, rather than seeking balanced expertise. This has a definite upside. The owner knows these people well and trusts them, they often work for less compensation (despite the elevated risk of joining a new venture), and they are more likely to make personal sacrifices to keep the business alive. The downside is that the team can quickly become very homogeneous, lack complementary strengths, entertain feelings of entitlement, and carry the baggage of family dysfunction into the enterprise. All of these factors—the negative and the positive—should be taken into consideration when hiring family and friends.

8-1a Achieving Balance

Not all members of a management team need competence in all areas—the key is balance. It is important that you bring on others who are as competent as you are, just not about the same things. For example, if one member has expertise in finance, another should have an adequate marketing background. Recent research shows that it's helpful to pair the depth of knowledge of highly specialized experts with big-picture thinkers who are better able to "connect the dots" of the business and its opportunities.[5] Further, the venture most likely will need someone who can supervise employees effectively. This diversity in perspectives and work styles is what enables the completion of complex tasks. But studies have found that it can also lead to significant conflict, which can squeeze all the energy and enthusiasm out of a venture.[6]

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Even when entrepreneurs recognize the need for team members with varying expertise, they frequently look for qualities that reflect their own personalities and management styles. Interpersonal compatibility and cooperation among team members are necessary for effective collaboration, and cohesive teams tend to perform better.[7] However, research and experience suggest that a functionally diverse and balanced team will be more likely to cover all the business bases, giving the company a competitive edge—especially when softer relational issues of fit and compatibility are also worked out.[8]

To ensure balance, a management team should comprise both competent insiders and outside specialists. For example, a small firm will benefit greatly by developing working relationships with a commercial bank, a law firm, and an accounting firm. (A number of outside sources of managerial assistance are identified and discussed in Chapter 19.) In addition to providing counsel and guidance to the management team, an active board of directors or an advisory board (discussed later in this chapter) can also help connect the venture with external sources of expertise and assistance. It is simply a matter of tapping into board members' existing networks of business relationships. The value of a good board, in this regard, cannot be overstated.

8-1b The Solo Start-up Is Still an Option

Despite the advantages of forming a team to start a business, evidence reveals that the number of small business owners who are choosing to go it alone has increased significantly in recent years.[9] And emerging technologies make this option increasingly manageable today. Business support services that used to cost thousands of dollars are now available online for free or for a small monthly charge, and hiring help from around the world can require nothing more than a few mouse clicks. These tools can replace the assistance that might otherwise be available only by taking on a skilled business partner or expanding the management team.

As a former enrollment director at Dartmouth College, Harvey Manger-Weil found a way to launch his SAT/ACT preparation service, The College Wizard, without the hassles that come from having a physical location, partners, or other fixed features. As a solo business owner, he has been able to keep up with the company's rapid growth by systematizing, automating, and outsourcing everything that can be managed externally—especially repetitive tasks.[10]

An expanding assortment of available devices, services, and platforms can make everyday functions much more manageable. Productivity tools now exist to keep you organized and facilitate your work. These can greatly free up your time, allowing you to work *on* your business rather than *in* it.[11]

In the final analysis, teams can achieve great things and may, at times, be necessary. But they're not for everyone, as indicated by an analysis showing that 46 percent of ventures that raised more than $10 million in start-up investment had solo founders.[12] Taking on a partner or adding to the management team means giving up the freedom to make your own decisions, being dependent on others to get things done, and pursuing a dream that others may not fully share. In other words, the price can be steep, and many entrepreneurs are unwilling to pay it.

8-1c Expanding Social Networks

Whether starting with a team or choosing to go it alone, it's often not *what* you know but *who* you know that matters. Management team members help the venture obtain investment and technology resources. But they can also connect the enterprise with a social network that provides access to a wide range of resources beyond the reach of individual team members.

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Living the Dream

When the Start-Up Game Is Best Played as a Team Sport

When forming a management team, planning for balance among the various members is crucial. When everyone works together so that each person's strengths are lined up with their specific role in the venture, the team's overall performance is likely to be high. Figuring this out takes a great deal of thought and planning, but cloud-storage pioneer Backblaze seems to have pulled it off. Its management team is clearly as well balanced as it is talented.

Backblaze was founded in 2007 by five people and began as a provider of online backup services. The business solved the problem of lost data after hard-drive damage. The concept behind the business is simple: Move chunks of data to the venture's data center, let it sit there, and then just be sure not to lose it.

With services priced at only $6 a month or $60 a year for unlimited automatic data backup, the company's rates are among the cheapest available. How is it able to pull this off? The founders decided to cut costs by building their own data servers, since depending on Amazon or Dell for such services would have led to significantly higher prices.

Backblaze's software is also exceptionally easy to use, and it can be run on either Windows or Mac OS. The service has been very well received by customers. By the time 2020 rolled around, the company had grown to have 133 employees and was making more than $40 million in revenue—an increase of 40 percent over the previous year. With operations in more than 175 countries, Backblaze has serviced over 50 billion files and has stored more than 1 exabyte of customer data.

Brian Wilson is the IT genius behind the venture. He had made the decision to retire at the ripe old age of 39 after cashing out of a previous business that he also had started. But after seven months of motorcycle rides, ski trips, and other leisure pursuits, he was starting to get the itch to create something big again. The inspiration for his next act was soon to come.

Wilson's entrepreneurial restart followed a call from his close friend Lise. "It's all gone!" she seethed. "My computer crashed. I lost everything! Can you help me get my data back?" Wilson instinctively asked if she had a backup. "Brian," she huffed, "I don't need a lecture. I need my data!" Sometime after hanging up, he realized that his friend's digital disaster was not an unusual case and therefore represented what could be a high-potential business opportunity. Desperate for something more constructive to do with his life, he decided to start a new venture that would address the need.

No one can be great at everything, even someone of Wilson's exceptional talent. He realized early on that it would be necessary to recruit a team of entrepreneurial players to join him in the venture if Backblaze were ever to become a success. For example, it was abundantly clear to Wilson that graphics and drawing were not his forte. So, he recruited Casey Jones, his longtime designer, to create the website and logo as a side project. Jones convinced Wilson to add him to the start-up team as a full-time member.

Wilson then brought on Billy Ng, an engineer who was practical, smart, and had the skills needed to write the back-end software and to develop it quickly. Wilson's next draft, to "develop the impeccable security and battle-ready infrastructure that a company handling lots of personal data would need," didn't work out. The individual soon quit over a disagreement about pricing for the service.

It obviously pays to have a rich network of gifted friends and former associates when starting a business. Wilson soon was able to hire Tim Nufire, who had a brain for security. And he owned a house against which they could borrow much needed cash to help get Backblaze off the ground. But there was still a gap at the top of the new venture: Backblaze needed a capable CEO to run everything. For this role, Wilson turned to Gleb Budman, a Berkeley MBA and the only "marketing guy" that Wilson had ever truly come to respect and appreciate. Once Budman was in place, the start-up team was set.

The carefully selected players complemented one another very well, which gave the company a good running start at success. Because they saw the great potential of what they hoped to build together, these individuals were willing to make tremendous sacrifices. For example, they all took huge pay cuts, choosing to live on very meager pay and a steady diet of ramen noodles and cheap pizza while they pursued their entrepreneurial dream.

Wilson and his colleagues were able to build a multimillion-dollar business, due in significant measure to the superb balance of talent and skills shared between the founders—and their hard work and commitment, of course. The business has had its share of bumps and bruises along the way, but the members of

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the start-up team have supported each other, and the business continues to grow. To ensure that diverse perspectives are a part of the company's decision making, the senior leadership team is racially and gender mixed. With management now guided by a three-person board of directors (two of whom are women), Backblaze has the leadership it needs to pilot the company into a prosperous future.

Source: "Backblaze Is a World Leader in Computer Backup and Cloud Storage," https://www.backblaze.com/company/about.html, accessed April 15, 2021; Burt Helm, "The (Little) Company That Saved the World (Online)," *Inc.*, Vol. 42, No. 1 (March/April 2020), pp. 71–79; and Thorin Klosowski, "The Best Online Cloud Backup Service," March 30, 2021, https://www.nytimes.com/wirecutter/reviews/best-online-backup-service, accessed April 15, 2021.

A **social network** is the web of relationships that a person has with other people, including friends from college, former employees and business associates, and contacts through community organizations and religious groups. But it doesn't end there. A friend from college may not have what you need, but they may know someone who does. It is often said that business is all about relationships, a principle that is not lost on successful entrepreneurs. And as well-connected people are added to the management team, the power of social networks is expanded tremendously.

What does an entrepreneur need from their network? That all depends on the situation. Small business owners in the process of launching a start-up use their networks to take advantage of the following benefits:

- To access valuable information, or to get advice about pressing problems or situations.
- To gain introductions to other people who may be able to help them.
- To obtain money, business services, physical facilities, and equipment.
- To enhance the reputation and credibility of the brand they are promoting.

Clearly, a healthy system of personal relationships can help a venture access the knowledge and resources it needs to get established and grow. One entrepreneurship writer likened networking to "raiding the fridge"[13] since it puts the small business owner in touch with those who might have something they need, such as automated warehouse space, Web design expertise, or an introduction to a high-potential client.

Beyond providing access to resources, social networks can be especially helpful in communicating legitimacy and jump-starting sales. Reputable firms may hesitate to do business with a company that doesn't have a demonstrated track record for reliable delivery or high-quality products or services. But influential advocates can use their pull to help a small business acquire one or more high-profile customers, for example, which may persuade others to give a relatively unknown company a shot at their business, too. For an entrepreneur, having a healthy social network and a management team with useful connections can be critical in establishing a solid reputation.

Some small business owners are tapping into the expanding universe of social media tools to attract customers, connect with peers, and share advice about common problems. Undisputed heavyweights, such as Facebook, Instagram, LinkedIn, and Twitter, as well as a host of newer platforms (sporting creative names like Buffer, Everypost, Hootsuite, Sprout Social, and Sprinklr), offer tools created for media management.[14] Small business owners are finding that they can use these platforms to build an active and robust social network to increase their **social capital**, which we refer to as the advantage created by an individual's connections within a network of social relationships. However, this advantage doesn't develop overnight or by accident. It takes years to build social capital, and the building blocks that support it are well known—being reliable as a friend, being fair in your dealings, and being true to your word.

social network
An interconnected system of relationships with other people.

social capital
The advantage created by an individual's connections within a social network.

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The principle of reciprocation can be extremely helpful in adding to whatever social capital you already have. In his popular book on influence, Robert Cialdini defines **reciprocation** as a subtle but powerful sense of obligation, deeply embedded in every society, to repay in kind what another person has done for us or provided to us.[15] In general, people naturally feel that they should return favors. You can easily prime the pump of social capital by being the first to lend a hand and then watch those you assist come to your rescue when you run up against a challenge and ask for help. You don't have to fake it; just slow down a bit, and take a genuine interest in the needs of your friends and acquaintances. And helping others doesn't have to be costly. In today's information economy, passing along an important bit of news or insight is easy and free—but it can be as good as gold! So, think ahead, and reach out to help where you can. Your social capital is sure to increase, binding friends and contacts to you and providing a solid foundation for building a business.

8-2 Common Legal Forms of Organization

8-2 Explain the common legal forms of organization used by small businesses.

When launching a new business, an entrepreneur must decide whether joining a start-up team or going it alone is right for them. But that is only the start of the important decisions they must make. For example, they also need to select a legal form of organization, which will determine who the actual owners of the business are. The most basic options are the sole proprietorship, partnership, and C corporation. More specialized forms of organization exist, but many small businesses find one of these common forms suitable for their needs. After outlining the primary options, we look first at some criteria for choosing among them and then introduce a number of specialized forms (refer to Exhibit 8.1) that offer their own unique features and advantages.

8-2a The Sole Proprietorship Option

A **sole proprietorship**, the most basic business form, is a company owned by one person. An individual proprietor has title to all business assets and is subject to the claims of creditors. They receive all of the firm's profits but must also assume all losses, bear all risks, and pay all debts. Although this form certainly is not right for everyone, forming a sole proprietorship is nonetheless the simplest and cheapest way to start operation. Most states do not even require such companies to have a business license. Because of the ease of start-up, the majority of small businesses (73 percent)[16] adopt this legal structure (refer to Exhibit 8.2).

In a sole proprietorship, an owner is free from interference by partners, shareholders, and directors. However, a sole proprietorship lacks some of the advantages of other legal forms. For example, the owner bears **unlimited liability**, which means that their personal assets can be taken by business creditors if the enterprise fails. For this reason, the sole proprietorship form is usually the practical choice only for very small businesses. In addition, sole proprietors are not employees of the business and cannot benefit from the advantage of many tax-free fringe benefits, such as insurance and hospitalization plans, which corporations often provide to their employees.

The death of the owner terminates the legal existence of a sole proprietorship. Thus, the possibility of the owner's death may cloud relationships between a business and its creditors and employees. It is important that the owner have a will, because the assets of the business minus its liabilities will belong to their heirs. In a will, a sole proprietor can give an executor legal authorization to run the business for the heirs until they can take it over or it can be sold.

reciprocation
A powerful sense of obligation to repay in kind what another has done for or provided to us.

sole proprietorship
A business owned by one person, who bears unlimited liability for the enterprise.

unlimited liability
Liability on the part of an owner that extends beyond the owner's investment in the business.

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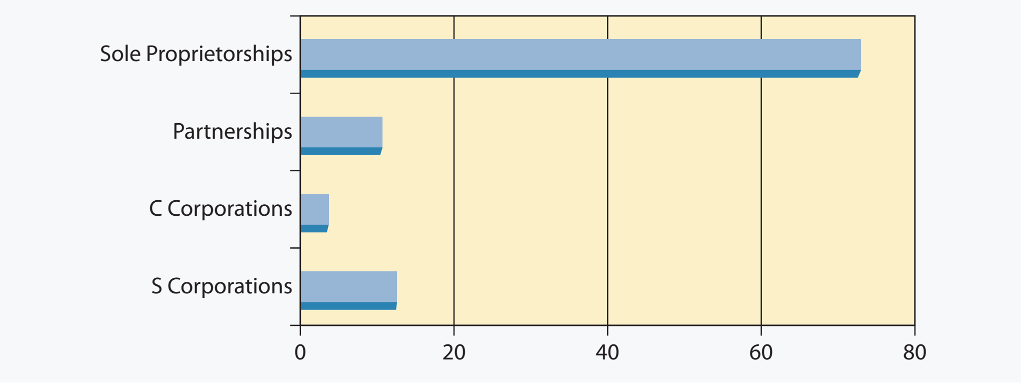
Exhibit 8.1 Legal Forms of Organization for Small Businesses

Exhibit 8.2 Percentage of Small Businesses by Legal Form of Organization



Sources: Internal Revenue Service, "Table 1A: Calendar Year Projections [for 2022] of Individual Returns by Major Processing Categories for the United States," https://www.irs.gov/pub/irs-pdf/p6187.pdf, accessed March 26, 2021; and Internal Revenue Service, "Table 1: Fiscal Year Projections [for 2022] of the Number of Returns to Be Filed with the IRS, 2020–2027," https://www.irs.gov/pub/irs-soi/p6292.pdf, accessed March 26, 2021.

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Also of concern is the possible incapacity of the sole proprietor. If they were badly hurt in an accident and hospitalized for an extended period, the business could be ruined. A sole proprietor can guard against this contingency by giving a competent person legal power of attorney to carry on in such situations.

In some cases, circumstances argue against selecting the sole proprietorship option. If the nature of a business involves exposure to legal liability—for example, the manufacture of a potentially hazardous product or the operation of a child-care facility—an organizational form that provides greater protection against personal liability is likely to be a better choice. For most companies, however, various forms of insurance are available to deal with the risks of a sole proprietorship, as well as those related to partnerships. Liability insurance and other forms of protection are discussed further in Chapter 23.

8-2b The Partnership Option

A **partnership** is a legal entity formed by two or more co-owners to operate a business for profit. Because of a partnership's voluntary nature, owners can set it up quickly, avoiding many of the legal requirements involved in creating a corporation. A partnership pools the managerial talents and capital of those joining together as business partners. As in a sole proprietorship, however, the owners share unlimited liability.

Operating a business as a partnership has benefits, but it is also fraught with potential problems, enough that many experts discourage the use of this form of organization to run a business. Nonetheless, the benefits of partnerships are clear and include, among others:

- Sharing the workload, as well as the emotional and financial burdens of the enterprise.
- Gaining management talent that might otherwise break the budget.
- Adding companionship and mutual motivation to life in a small business.

However, many believe that the personal conflicts common in partnerships more than offset the benefits, and partners often fall short of one another's expectations. Of course, decision making is more complicated in partnerships because leadership is shared, and owners must also share their equity position in the business, which naturally dilutes the control of each partner. While some of the difficulties of partnerships are financial in nature, most are relational—for example, coping with a partner's dishonesty or dealing with differing priorities. Partnerships clearly have both worrisome and redeeming qualities. Therefore, *a partnership should be formed only if it appears to be the best option after considering all features of the enterprise*.

Choosing a Partner

Any person capable of contracting may legally become a business partner. Individuals may become partners without contributing capital or having a claim to assets if the decision is made to close the business down. Such persons are partners only with regard to management and profits. The formation of a partnership involves consideration not only of legal issues but also of personal and managerial factors. A strong partnership requires partners who are honest, healthy, capable, and compatible. The following suggestions may help entrepreneurs make the most of this form of organization:

- *Choose your partner carefully*. Partnerships are like marriages—they work best when you pick the right partner. Identifying a promising partner is just a start. You also need to be sure that your goals, values, and work habits are

partnership
A legal entity formed by two or more co-owners to operate a business for profit.

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compatible and that your skills are complementary before committing to the deal. Above all, team up with a person you can trust, since the actions of your partner can legally bind you, even if a decision is made without your knowledge or consent.[17]

- *Be open, but cautious, about partnerships with friends*. Valued relationships can take a quick turn for the worse when a business deal gets rocky. A Dr. Jekyll friend can sometimes transform into a Mr. Hyde business associate when money enters the picture.
- *Test-drive the relationship, if possible*. Try more limited forms of business collaboration before jumping in with both feet. For example, you can cooperate on a small project or share a booth at a trade show and observe the behavior, style, and work habits of your prospective partner. This allows you to assess their strengths and weaknesses before committing to a long-term relationship.
- *Create a shared vision for the business*. Partners must be on the same page when it comes to forming the business concept they hope to develop together. This takes time, patience, and a lot of conversation. Other specific matters you should discuss before joining forces include the expectations of all partners (contributions of time, money, expertise, etc.), planned division of work, anticipated vacation time, and the sharing of profits and losses.
- *Prepare for the worst*. Keep in mind that more than half of all partnerships fail. That is why most experts recommend having an exit strategy for the partnership from the beginning. What looks like a good business arrangement at the outset can quickly fall apart when market conditions shift, a partner becomes involved in another business venture, or personal circumstances change. The birth of a child, a sudden divorce, or the unexpected death of a spouse can alter everything. If it becomes necessary, exiting a partnership is far more difficult when plans for such an unfortunate outcome were not considered early on.

Failure to take suggestions like these seriously can derail efforts to build an effective working relationship or doom an otherwise workable partnership to an unnecessary or painful demise.

Rights and Duties of Partners

An oral partnership agreement is legal and binding, but memory is always less than perfect. In his book, *Legal Guide for Starting and Running a Small Business*, author and practicing business attorney Fred S. Steingold strongly recommends that partners sign a written **partnership agreement** to avoid problems later on.[18] This document, which explicitly spells out the partners' rights and duties, should be drawn up before the venture is launched. Though the partners may choose to have an attorney draft the agreement in order to ensure that all important features are included, many other sources of assistance also are available to provide guidance through this process. One such resource is another book by Steingold, *Legal Forms for Starting and Running a Small Business*,[19] which provides a lengthy outline and description of a proper agreement.

Unless the articles of the partnership agreement specify otherwise, a partner is generally recognized as having certain implicit rights. For example, partners share profits or losses equally, unless they have agreed to a different ratio. But these rights are also balanced against serious liabilities. In a general partnership, each party bears **joint and several liability**. Although the precise definition of this rule varies a bit from state to state,[20] it can mean that a business decision by one partner binds all other partners.

partnership agreement
A document that states explicitly the rights and duties of partners.

joint and several liability
The liability of each partner resulting from any one partner's ability to legally bind the other partners.

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This is true even if they were not consulted in advance, didn't approve the agreement or contract in question, or didn't even know about it! As with a sole proprietorship, the unlimited personal liability of the partners can be terrifying. The assets of the business are at risk, of course, but so are the personal assets of the partners, including their homes, cars, and bank accounts. Good faith, together with reasonable care in the exercise of managerial duties, is required of all partners in the business.


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Unfortunately, complications can arise even if partners have been careful to match their expectations at the start of the partnership and the arrangement has been formalized through a partnership agreement. When problems emerge, partners should move quickly to try to resolve the underlying issues. If they cannot do so, they should consider hiring a business mediator. Working with a mediator can be expensive, but the dissolution of the partnership is likely to be far more costly.

Termination of a Partnership

Death, incapacity, or withdrawal of a partner ends a partnership and requires liquidation or reorganization of the business. Liquidation often results in substantial losses to all partners, but it may be legally necessary. A partnership represents a close personal relationship of the parties that cannot be maintained against the desire of any one of them.

When one partner dies, loss due to liquidation may be avoided if the partnership agreement stipulates that surviving partners can continue the business after buying the decedent's interest. This option can be facilitated by having each partner carry life insurance that names the other partners as beneficiaries.

Partnerships sometimes have immediate concerns to address when a partner decides to leave the business, especially if the departure is unexpected. It is not uncommon for the departing colleague to start a competing company, often with the intention of taking talented employees and important clients with them. When this happens, it is crucial that the remaining partner(s) move quickly to avoid serious losses. For example, a sound response plan could include taking the following measures:

1. Cut off the departing partner's access to bank accounts, physical facilities, and company assets to avoid loss or damage to equipment critical to the business.
2. Quickly assess that partner's role in the enterprise, and take steps to fill their shoes to get the business back to normal as soon as possible.
3. Once these very pressing matters are under control, sort out any legal issues that remain, such as abiding by any signed exit agreements.

With time and often a lot of hard work, the partnership can usually regain its footing. But the horror stories that surface of partnerships that go bad underscore just how fragile such relationships can be—and how important it is to have a rapid-response plan when things go wrong.

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8-2c The C Corporation Option

In 1819, Chief Justice John Marshall of the United States Supreme Court defined a **corporation** as "an artificial being, invisible, intangible, and existing only in contemplation of the law." With these words, the Supreme Court recognized the corporation as a **legal entity**, meaning that it can file suit and be sued, hold and sell property, and engage in business operations that are stipulated in the corporate charter. In other words, a corporation is a separate entity from the individuals who own it, which means that the corporation, not its owners, is liable for the debts of the business. This arrangement has profound and far-reaching implications for risk taking and business formation. The ordinary corporation—often called a **C corporation** to distinguish it from more specialized forms—is discussed in this section.

The Corporate Charter

To form a corporation, one or more persons must apply to the secretary of state (at the state level) for permission to incorporate. After completing preliminary steps, including payment of an incorporation fee, the written application (which should be prepared by an attorney) is approved by the secretary of state and becomes the **corporate charter**. This document—sometimes called *articles of incorporation* or *certificate of incorporation*—shows that the corporation exists.

A corporation's charter should be brief, in accordance with state law, and broad in its statement of the firm's powers. Details should be left to the *corporate bylaws*, which outline the basic rules for ongoing formalities and decisions of corporate life, including the following:

- The size of the board of directors.
- The duties and responsibilities of directors and officers.
- The scheduling of regular meetings of the directors and shareholders.
- The means of calling for a special meeting of these groups.
- Procedures for exercising voting rights.
- Restrictions on the transfer of corporate stock.

Rights and Status of Stockholders

Ownership in a corporation is evidenced by shares of stock owned by a stockholder. An ownership interest does not confer a legal right to act for the firm or to share in its management. It does, however, provide the stockholder with the right to receive dividends in proportion to the shares of stock owned, but only when the dividends are properly declared by the firm. Ownership of stock typically carries a **preemptive right**, or the right to buy new shares in proportion to the number of shares already owned before new stock is offered for public sale.

The legal status of stockholders is fundamental, of course, but it may be overemphasized. In many small corporations, the owners typically serve both as directors and as managing officers. The person who owns all or most of the stock can control a business as effectively as if it were a sole proprietorship. Thus, this form of organization can work well for individual and family-owned businesses, where maintaining control of the firm is important.

Limited Liability of Stockholders

For most stockholders, their limited liability is a major advantage of the corporate form of organization. Their financial liability is restricted to the amount of money

corporation
A business organization that exists as a legal entity and provides limited liability to its owners.

legal entity
A business organization that is recognized by law as having a separate legal existence.

C corporation
An ordinary corporation, taxed by the federal government as a separate legal entity.

corporate charter
A document that establishes a corporation's existence; also called *articles of incorporation* or *certificate of incorporation*.

preemptive right
The right of stockholders to buy new shares of stock before they are offered to the public.

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they invest in the business. Creditors cannot require them to sell personal assets to pay the corporation's debts. However, a bank that makes a loan to a small firm may insist that the owners assume personal liability for that debt. If the corporation is unable to repay the loan, the banker can then look to the owners' personal assets to recover the amount of the loan. In this case, the corporate advantage of limited liability is lost.

Why would owners agree to personally guarantee a firm's debt? Simply put, they may have no choice if they want the money. Most bankers are unwilling to loan money to an entrepreneur who is not prepared to put their own personal assets at risk.

Death or Withdrawal of Stockholders

Unlike a partnership interest, ownership in a corporation is readily transferable. An exchange of shares of stock is sufficient to transfer an ownership interest to a different individual.

Stock shares of large corporations are exchanged continually without noticeable effect on the operation of the business. For a small firm, however, a change of owners, though legally similar, can involve numerous complications. For example, finding a buyer for the stock of a small company may prove difficult. Also, a minority stockholder in a small firm is vulnerable. If two of three equal shareholders in a small business sold their stock to an outsider, the remaining shareholder would then be at the mercy of that outsider.

The death of a majority stockholder can have unfortunate repercussions in a small firm. An heir, the executor, or a purchaser of the stock might well insist on direct control, with possible adverse effects for other stockholders. Preventing problems of this nature is crucial. Legal arrangements should be made at the outset to provide for management continuity by surviving stockholders and fair treatment of a stockholder's heirs. As in the case of a partnership, taking out life insurance ahead of time can ensure the ability to buy out a deceased stockholder's interest.

Maintaining Corporate Status

If it wishes to retain its standing as a separate legal entity, a corporation must take the following actions:

- Hold annual meetings of both the shareholders and the board of directors.
- Record minutes to document the major decisions of shareholders and directors.
- Maintain bank accounts that are separate from owners' bank accounts.
- Keep detailed financial records.
- File a separate income tax return for the business.

8-3 Considerations in Choosing an Organizational Form

8-3 Identify factors to consider in choosing among the primary legal forms of organization.

Choosing a legal form for a new business deserves careful attention because of the various, sometimes conflicting features of each organizational option. Depending on a company's particular circumstances, the tax advantages of one form, for example, may offset the limited liability advantages of another form. Some trade-offs may be necessary. Ideally, an experienced attorney or knowledgeable accountant should be consulted for guidance in selecting the most appropriate form of organization.

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Exhibit 8.3 **Comparison of Basic Legal Forms of Organization**

Form of Organization	Initial Organizational Requirements and Costs	Liability of Owners	Continuity of Business
Sole proprietorship	Minimum requirements; generally no registration or filing fee	Unlimited liability	Dissolved upon proprietor's death
General partnership	Minimum requirements; generally no registration or filing fee; written partner-ship agreement not legally required but strongly suggested	Unlimited liability	Unless partnership agreement specifies differently, dissolved upon withdrawal or death of partner
C corporation	Most expensive and greatest require-ments; filing fees; compliance with state regulations for corporations	Liability limited to investment in company	Continuity of business unaffected by shareholder withdrawal or death
Form of organization preferred	Proprietorship or partnership	C corporation	C corporation

Some entrepreneurship experts insist that the two most basic forms of business—sole proprietorship and partnership—should *never* be adopted. While these forms clearly have drawbacks, they are still workable for many small business owners. And, fortunately, there is another basic form to consider—the C corporation. Exhibit 8.3 summarizes the main considerations in selecting one of these three primary forms of ownership.

8-3a Initial Organizational Requirements and Costs

Organizational requirements and costs rise as the formality of the organization increases. That is, a sole proprietorship is typically less complex and less expensive to form than a partnership, and a partnership is less complex and less expensive to form than a corporation. In view of the relatively modest costs, however, this consideration is of minimal importance in the long run.

8-3b Liability of Owners

Liability risks are among the most important factors to consider when selecting an organizational form. As discussed earlier, a sole proprietorship and a partnership have the built-in disadvantage of unlimited liability for the owners. With these forms of organization, there is no distinction between the firm's assets and the owners' personal assets. In contrast, setting up a corporation limits the owners' liability to their investment in the business.

Two cautions are in order regarding liability and organizational forms. First, incorporation will not protect a firm's owners from liability if it is used to perpetuate a fraud, skirt a law, or commit some other wrongful act. In such cases, the courts may decide that there is no legal separation between the owners and the corporate entity, a concept known as **piercing the corporate veil**. For example, protection from financial liability may be jeopardized in the following cases:

- The company is bankrupt, but its owners knowingly take on debt.
- The board of directors does not meet as required by law or observe other corporate formalities.
- Business and personal accounts are not kept separate, and company funds are used to pay an owner's personal expenses.

piercing the corporate veil
A situation in which a court concludes that incorporation has been used to perpetuate a fraud, skirt a law, or commit some wrongful act, and it removes liability protection from the corporate entity.

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Exhibit 8.3 Comparison of Basic Legal Forms of Organization (Continued)

Transferability of Ownership	Management Control	Attractiveness for Raising Capital	Income Taxes
May transfer ownership of company name and assets	Absolute management freedom	Limited to proprietor's personal capital	Income from the business taxed as personal income to the proprietor, though at a reduced rate under some conditions
Requires the consent of all partners	Majority vote of partners required for control	Limited to partners' ability and desire to contribute capital	Income from the business taxed as personal income to the partners, though at a reduced rate under some conditions
Is easily transferred by transferring shares of stock	Shareholders have final control, but usually board of directors controls company policies	Usually the most attractive form for raising capital	The C corporation is taxed on its income, and the stockholder is taxed if and when dividends are received
Depends on the circumstances	Depends on the circumstances	C corporation	Depends on the circumstances

Legal action is taken most often against smaller, privately held business entities and "sham corporations" that are set up with the specific goal of deceiving others.[21] Of course, some forms of organization offer no shield against liability in the first place.

Second, no form of organization can protect entrepreneurs from *all* forms of liability. If, for example, an owner causes a traffic accident and is declared personally liable for damages or injuries in court, they will have to pay the judgment, even if it means selling personal assets to satisfy the ruling. On the other hand, if an employee caused the accident while on company business, the assets of the business will be at risk, but the personal assets of the owner will be shielded from liability—*but only if the business is organized as a corporation or limited liability company* (which will be discussed later in the chapter). This protection does not extend to the owner(s) of a sole proprietorship or a partnership, whose personal assets would also be at risk.

As indicated previously, most banks and many suppliers require small business owners to sign a personal guarantee before lending money or extending credit to them, regardless of the form of organization. Entrepreneurs have to pay off these obligations if their businesses are unable to, even if doing so requires the use of personal assets. This is the lender's way of trying to ensure that debts are repaid, but it illustrates a practical limitation of organizational forms when it comes to liability protection.

8-3c Continuity of Business

A sole proprietorship is immediately dissolved on the owner's death. Likewise, a partnership is terminated on the death or withdrawal of a partner, unless the partnership agreement states otherwise. A corporation, on the other hand, offers continuity. The status of an individual investor does not affect the corporation's existence.

8-3d Transferability of Ownership

Ownership is transferred most easily in a corporation. The ability to transfer ownership, however, is not necessarily good or bad—it all depends on the owners' preferences. In some businesses, owners may want the option of evaluating any prospective new investors. Under other circumstances, unrestricted transferability may be preferred.

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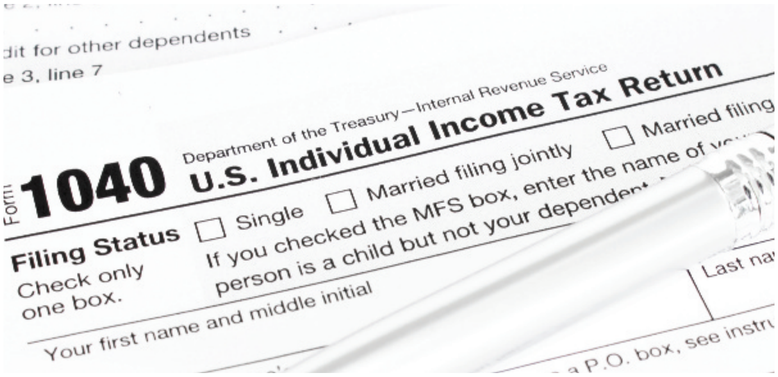

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8-3e Management Control

A sole proprietor has absolute control of the firm. Control within a partnership is normally based on the majority vote, so it follows that an increase in the number of partners reduces each partner's voice in management. Within a corporation, control has two dimensions: (1) the formal control vested in the stockholders who own the majority of the voting common shares, and (2) the functional control exercised by the corporate officers in conducting daily operations. In a small corporation, these two forms of control usually rest with the same individuals.

8-3f Attractiveness for Raising Capital

A corporation has a distinct advantage when raising new equity capital, due to the ease of transferring ownership through the sale of common shares and the flexibility in distributing the shares. In contrast, the unlimited liability of a sole proprietorship and a partnership discourages new investors.

8-3g Income Taxes

Income taxes frequently have a major effect on an owner's selection of a form of organization. To understand the federal income tax system, you must consider this twofold question: Who is responsible for paying taxes, and how is tax liability determined? The three major forms of organization are taxed in different ways:

- *Sole proprietorship.* Self-employed individuals who operate a business as a sole proprietorship report income from the business on their individual federal income tax returns. They are then taxed on that income at the rates set by law for individuals, though income from the business may be taxed at a somewhat lower rate for some business owners, due to recent changes in the tax law.
- *Partnership.* A partnership reports the income it earns to the Internal Revenue Service, but the partnership itself does not pay any taxes. The income is allocated to the partners according to their agreement. The partners each report their own shares of the partnership's income on their personal tax returns and pay any taxes owed. As with sole proprietorships, however, recent changes to the tax code provide deductions to income from the partnership under some conditions.
- *C corporation.* The C corporation, as a separate legal entity, reports its income and pays any taxes related to these profits. The owners (stockholders) of the corporation must report on their personal tax returns any amounts paid to them by the corporation in the form of dividends. (They must also report capital gains or losses, but only at the time they sell their stock in the company.) Keep in mind that dividends are, in essence, taxed twice—first as part of a corporation's earnings and then as part of the owners' personal income.

The IRS's Small Business and Self-Employed Tax Center[22] provides links to tax information regarding the different organizational forms, insights related to important small business topics, and answers to industry-specific questions, as well as forms and publications that will help with tax planning and preparation.

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8-4 Specialized Legal Forms of Organization

8-4 Discuss the unique features and restrictions of six specialized organizational forms.

The majority of small businesses use one of the three major ownership structures just described—the sole proprietorship, partnership, or C corporation. However, other specialized forms of organization are also used by small firms. Six of these alternatives merit further consideration: the limited partnership, the S corporation, the limited liability company, the professional corporation, the nonprofit corporation, and the benefit corporation.

8-4a The Limited Partnership

The **limited partnership** is a special form of partnership involving at least one general partner and one or more limited partners. The **general partner** remains personally liable for the debts of the business, but **limited partners** have limited personal liability as long as they do not take an active role in the management of the partnership. In other words, limited partners risk only the capital they invest in the business. An individual with substantial personal wealth can, therefore, invest money in a limited partnership without exposing their personal assets to liability claims that might arise through activities of the business. If a limited partner becomes active in management, however, their limited liability is lost. To form a limited partnership, partners must file a certificate of limited partnership with the proper state office, as state law governs this form of organization.

8-4b The S Corporation

The designation **S corporation**, or *Subchapter S corporation*, is derived from Subchapter S of the Internal Revenue Code. This organizational form permits a business to retain the limited liability feature of a C corporation while offering a more favorable tax treatment on income. To obtain S corporation status, a corporation must meet certain requirements, including the following:[23]

- The corporation must be domestic.
- The corporation can have no more than 100 stockholders.
- All stockholders must be individuals or certain qualifying estates and trusts.
- Only one class of stock can be outstanding.
- It must not be an ineligible corporation.[24]

An S corporation does not pay income taxes but instead passes taxable income or losses on to the stockholders. This allows stockholders to receive dividends from the corporation without double taxation on the firm's profit (once through a corporate tax and again through a personal tax on received dividends). A competent tax attorney should be consulted before selecting S corporation status, as tax law changes have considerable effect on this form.

8-4c The Limited Liability Company

The **limited liability company** has grown in popularity because it offers the simplicity of a sole proprietorship and the protection of a corporation to shield the personal assets of owners. A limited liability company can have an unlimited number of owners, or "members" (even having a single owner is permitted in most states), and these may include individuals, corporations, other LLCs, and non-U.S. entities.[25] This form

limited partnership
A partnership with at least one general partner and one or more limited partners.

general partner
A partner in a limited partnership who has unlimited personal liability.

limited partners
A partner in a limited partnership who is not active in its management and whose liability is limited to their investment.

S corporation
A type of corporation that offers limited liability to its owners and passes taxable income or losses on to stockholders; also known as a *Subchapter S corporation*.

limited liability company
A form of organization in which owners have limited liability but pay personal income taxes on business profits.

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differs from the C corporation in that it avoids double taxation. Like S corporations, limited liability companies are not taxed but simply pass their income on to their owners, who pay taxes on it as part of their personal income.[26]

According to many attorneys, the limited liability company is usually the best choice for new businesses. Compared to most other forms, it is easier to set up, is more flexible, and offers some significant tax advantages. But a limited liability company isn't always the best way to go. For example, it would be better to choose to organize as a C corporation if you plan to offer stock options to employees since limited liability companies do not have stock and therefore cannot offer such incentives. Or perhaps you hope to go public or sell the business at some time in the future. In this case, a C corporation would, again, be best as it can go public or be sold to another corporation in a tax-free, stock-for-stock exchange. If you are at all unsure about which organizational form is best for your venture, it is wise to seek expert advice from a knowledgeable attorney or accountant. A poor choice at this stage can have very negative long-run consequences for your business.

8-4d The Professional Corporation

Have you noticed the initials PC or PA as part of the corporate name on the letterhead or signage of your doctor, dentist, or attorney? These letters indicate that the practice is set up as a **professional corporation** in order to offer professional services. Although its meaning varies from state to state, the term *professional* usually applies to those individuals whose professions require that they obtain a license before they can practice. This would include doctors, chiropractors, lawyers, accountants, engineers, architects, and other highly trained individuals.

However, unlike other liability-shielding organizational forms, the professional corporation does not protect a practitioner from their own negligence or malpractice. Rather, it shields owners in the practice from one another's liability. In some states, a different business structure called a *limited liability partnership* can serve the same purpose and may have additional advantages. Obviously, the professional corporation applies to a fairly narrow range of enterprises, but it is usually the best option for businesses that fall into that category. In fact, many state laws require this form of organization before a professional practice can operate.

8-4e The Nonprofit Corporation

For some ventures, the most practical form of organization is the **nonprofit corporation**. Most elect to become 501(c)(3) organizations, which are created to serve civic, educational, charitable, or religious purposes. To qualify for 501(c)(3) status, the money-raising concern, fund, or foundation must be a corporation—the IRS will not grant this option to a sole proprietorship or partnership. In the application process, the officers need to submit articles of organization that spell out and limit the range of activities of the enterprise. For a tax exemption to be granted, the organization must pass the **organizational test** ("IRS-speak" for verification that the organization is staying true to the articles filed). A nonprofit corporation must establish a board of directors or trustees to oversee its operations. And if it should dissolve, it is required to transfer its assets to another nonprofit corporation.

There is no question that in some cases nonprofit forms are better than for-profit alternatives. For example, if you hope to seek tax-deductible donations from individuals, foundations, and corporations, then forming as a nonprofit will be necessary. A for-profit business, on the other hand, will have the ability to raise money from private investors, for

professional corporation
A form of corporation that shields owners from one another's liability and is set up for individuals in certain professional practices.

nonprofit corporation
A form of corporation for enterprises established to serve civic, educational, charitable, or religious purposes; not for generation of profits.

organizational test
Verification of whether a nonprofit organization is staying true to its stated purpose.

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which it then grants equity in the venture or promises dividends. This is perhaps the most fundamental difference between the two general forms, but there are others to consider.

In some cases, a hybrid model, which links nonprofit and for-profit entities, is an option for smaller entrepreneurial ventures. Story Pirates is a nonprofit that has been working with thousands of students across the United States since 2004. Starting from a pilot program at a single school in Harlem, New York, the organization's mission has remained the same: "[T]o celebrate the words and ideas of young people and to create confident, literate students equipped with a variety of tools for written, verbal, and artistic self-expression."[27] Its after-school story-writing and drama programs continue to grow in popularity and have now been offered at more than 350 schools from coast to coast. Because of the organization's expansion, the founders had to figure out early on how to handle the rapid growth in ticket sales. Forming a for-profit with the same name was a huge step in the right direction. The two organizations then were able to share the name and content through licensing agreements that allowed them to make the most of various high-potential opportunities that were coming their way.[28]

Hybrid forms come with some hassles that must be managed—such as maintaining separate boards and management teams and being prepared to prove that transactions between entities reflect true market value. But as one writer put it, "You get to have your cake and save the whales, too."[29] What more could a small business owner ask for?

8-4f The Benefit Corporation

Perhaps your entrepreneurial aspirations include more than superb financial performance. If this is the case, the **benefit corporation** may be the best option for what you have in mind. This unique form of organization legally empowers companies to pursue social and environmental goals rather than focusing solely on profits. Stated differently, this structure can help companies "unlock human potential and creativity" as a step toward harnessing "the power of business for the higher purpose of solving society's most challenging problems."[30] A nonprofit called B Lab created the model for this legal structure and has been pressing for its adoption in more and more U.S. states. The organization also offers a process that can lead to what is called B Corp Certification, which most benefit corporations opt to pursue.

The increasing number of enterprises organizing as benefit corporations includes many well-known names, such as Ben & Jerry's, Patagonia, and Warby Parker. But you should know that taking on this organizational form saddles a company with some burdensome obligations, like a binding commitment to altruistic policies, and permits shareholders to sue directors if a company falls short of its stated social mission. So why go down this path? Cindi Bigelow, president and CEO of family-owned Bigelow Tea, explains that it keeps a firm's employees focused on doing "the right thing—and for the right reasons."[31]

Forming as a benefit corporation forces a firm to stay true to its stated mission—even in a down year when investors may pressure management to shift to financial priorities. At the same time, though, the deliberate social emphasis can provide significant advantages, including the following:

- Recruiting and retaining talented employees, many of whom will work for less pay because they believe in the company's social purpose.
- Selling products or services to consumers who support the venture's mission.
- Fending off hostile takeover bids from corporations that care only about profits.

It is important to note, however, that benefit corporations are subject to the same tax treatment as other corporations, so this presents neither an advantage nor a disadvantage for this form of organization.

benefit corporation
A form of corporation that creates a positive social or environmental impact through a binding commitment to its altruistic mission and high standards of legal accountability.

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8-5 Understand the nature of strategic alliances and their uses in small businesses.

8-5 Forming Strategic Alliances

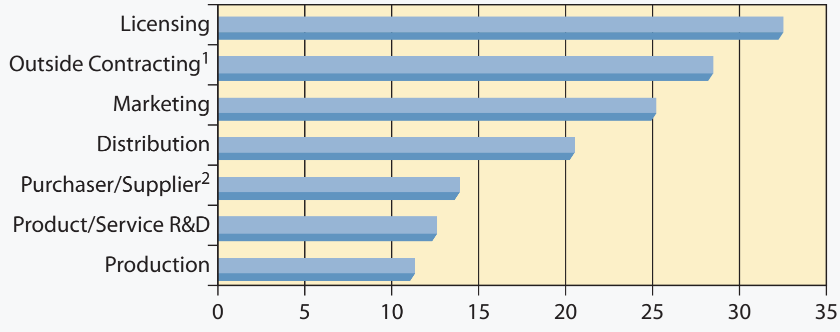
Choosing a legal form of organization wisely can make a big difference to the performance of a small business. But some entrepreneurs find that it is also helpful to join forces with other companies as they build their ventures. This is often referred to as a **strategic alliance**, an organizational relationship that links two or more independent business entities in some common endeavor. Without affecting the independent legal status of the participating business partners, it provides a way for companies to improve their individual effectiveness by sharing certain resources. And these alliances can take many forms, from informal information exchanges to formal equity or contract-based relationships, and everything in between. Many small businesses form alliances that involve licensing, outside contracting, marketing, and distribution. These are shown in Exhibit 8.4, along with other, less common options.

Strategic alliances are increasing in importance to small businesses today, and more entrepreneurs are finding creative ways to use these cooperative strategies to their advantage. In fact, *Forbes* magazine reported that half of the business executives surveyed in 2020 for a major consulting report said they were planning a new strategic alliance or some other form of cooperative strategy within the next year in an effort to drive growth and/or profitability.[32] Given the escalating pace of competition and the rising costs of developing essential capabilities, alliances provide ways for small companies to become more competitive. These can come from accessing another firm's first-rate resources, for example, or by expanding the market range for products or services offered, combining advertising efforts, reaching crucial economies of scale, or sharing risks that might prove crippling if borne by a single small company. Since a competitive advantage often goes to the entrepreneur who is quick to exploit it, many small business owners see strategic alliances as an essential part of their plan for growth. These cooperative strategies represent one way to keep up with the accelerating pace of change in today's business environment. Chapter 18 includes a discussion of strategic alliances as they apply to global enterprises.

8-5a Strategic Alliances with Large Companies

Small business owners often assume that their ventures have nothing to offer larger companies, but the truth is that they can play an essential role in helping corporations

Exhibit 8.4 Most Popular Small Business Alliances by Type



[1] These alliances include only relationships that are long-term in nature.
[2] These alliances include agreements relating to programs, such as just-in-time supply or total quality management that are relatively long-term in nature.

Source: Data developed and provided by the National Federation of Independent Business and sponsored by the American Express Travel Related Services Company, Inc.

strategic alliance
An organizational relationship that links two or more independent business entities in a common endeavor.

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address some of their most pressing challenges. Typically, these alliances are formed to join the complementary skills and expertise of the partnered firms, in order to promote the competitive edge of both (or all) parties. For instance, large manufacturers sometimes team up with innovative small manufacturers in product development efforts, and giant retailers form alliances with smaller suppliers to achieve specific quality requirements and meet demanding delivery schedules. Combining the speed, flexibility, and creative energy of a small business with the industry experience, production capabilities, and market reach of a large corporation can be a winning strategy.

While alliances with large firms can give a tremendous boost to performance, some small businesses discover that bigger isn't always better. The advantages created by joining forces with large firms must be weighed against the risk of being squeezed financially or of running into smothering bureaucratic complications.

Tyson Lawrence's small logistics company, for example, jumped at the chance to form an alliance with a huge national retailer. At first, things seemed very positive as the deal quickly pushed sales up to an impressive $5 million. So Lawrence hired more workers and placed other financial bets on his company's shining future. And that's when the problems started. Sales from the large retailer grew to represent 85 percent of the revenues of Lawrence's small business, and it was squeezing his company for everything it was worth.[33]

> If there were damaged goods, even if the damage wasn't his fault, the retailer forced him to eat the costs. And it was constantly changing terms on him, like lowering what it was paying him for jobs and paying him more irregularly and saying he'd need to give up 2 percent in order to get payments processed faster.

After eventually finding a way out of the partnership, Lawrence vowed never again to be so dependent on one large partner. It took some time, but he was able to get back to $5 million in revenue, only this time that business was spread across 40 clients. As evidence of the wisdom of this move, the venture is projected to grow dramatically in the years ahead.[34]

Forming alliances with prestigious partners may offer a substantial boost to status and market access, but the parties' strategic priorities may not mesh, and a major corporation can wield enormous power over a small, struggling enterprise. Also, some large firms have a track record of misbehavior as partners, and you need to know this *before* entering an alliance with them. It follows that investigating whether the big corporation has been a good, ethical partner for other small companies will help you to make an informed and profitable decision.

8-5b Strategic Alliances with Small Companies

Small businesses can also form strategic alliances with partners that are similar in size, in ways that enhance mutual competitive strength. In fact, entrepreneurs often find that these alliances work out best. These partnerships can be more flexible, dedicated, creative, and understanding of the specific needs of small businesses. In other words, it often takes one to know one!

Striking strategic alliances with other small businesses is extremely common and can be very beneficial. Family-owned Jay's Catering Company offers catering services in Southern California, and as you might guess, weddings are a big part of what they do.[35] To facilitate sales, Jay's holds a tasting event every few months and invites engaged couples to sample its dishes. But it doesn't end there because these couples are in need of other services as well. Knowing this, Jay's also uses these events to promote sales for its strategic alliance partners, including wedding planners, photographers, local

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florists, and other complementary service providers. This allows Jay's to become a "one-stop shop" of sorts, creating greater value for clients and increasing sales, so that all vendors in the alliance end up being winners.[36]

8-5c Setting up and Maintaining Successful Strategic Alliances

An alliance strategy can be powerful for growing companies—it spreads the risk of entering new markets and helps small players with unattractive balance sheets appear stable to the end buyer. It can also provide a fast track to reaching the critical mass required for pre-sale and post-sale support. Entrepreneurs should select strategic partners with a "division of labor" mentality that allows all parties to focus their efforts on what they do best. For example, identifying intersections between product lines and expertise opens up the potential for cross-selling that creates growth opportunities for everyone involved.

Working closely with other companies can also introduce significant hazards. Because alliance partners are in a unique position to learn about your strategy and customer base, they can become competitors overnight. Therefore, it is crucial to select partners with care and to structure contracts to ensure growth, including an "easy out" clause if the alliance does not go well.

While strategic alliances often are not easy to set up, they can be even more difficult to maintain. While many small businesses have been pleased with the results of their strategic alliances, a number of alliances run into trouble and, in time, fail. When setting up alliances, entrepreneurs can take the following steps to improve their chances for success:

- *Establish a healthy network of contacts.* Your network can lead you to still other contacts, and eventually to the one you need. Tap into leads through industry analysts, executive recruiters, public relations agencies, business reporters, and the government.
- *Identify and contact individuals within a firm who are likely to return your call.* "Dialing high" (calling contacts at the level of vice president or higher) works in small or medium-sized firms, but in large firms you may need to call managers or other mid-level employees to get a response.
- *Do your homework, and win points just for being prepared.* You should be able to clearly outline the partner's potential financial benefits from the alliance. If possible, show that your firm can deliver value to the alliance across several fronts.
- *Learn to speak and understand the "language" of your partner.* You will not pick up on subtle messages in conversations with partners unless you know how they communicate. This can eventually make or break the alliance.
- *Make sure that any alliance offer is clearly a win-win opportunity.* Only those agreements that benefit all participating parties will endure.
- *Monitor the progress of the alliance.* This is the only way to ensure that goals and expectations are being met, allowing the partners to make changes as they become necessary.

The goal is to form strategic alliances that are beneficial to all partners and to manage these alliances effectively. A key to successful alliances is understanding the true nature of the relationship. Instead of being between companies, *relationships in strategic alliances are actually built between people.* Cultivating relationships is essential to business success in general, and these relationships can be promoted through an effective board of directors or advisers, the topic to which we turn next.

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8-6 Making the Most of a Board of Directors

8-6 Describe the effective use of boards of directors and advisory boards.

In entrepreneurial firms, the **board of directors** tends to be small (usually five or fewer members)[37] and serves as the governing body for corporate activity. In concept, the stockholders elect the board, which in turn chooses the firm's officers, who manage the enterprise. The directors also set or approve management policies, consider reports on operating results from the officers, and declare any dividends.

All too often, the majority stockholder in a small corporation (usually the entrepreneur) appoints a board of directors only to fulfill a legal requirement (since corporations are required by law to have a board of directors) or as mere window dressing for investors. Such an entrepreneur may select personal friends, relatives, or businesspersons who are too busy to analyze the firm's circumstances and are not inclined to disagree with the owner. Small business owners who take a more constructive approach find an active board to be both practical and beneficial, especially when the members are informed, skeptical, and independent.

Perhaps of greater impact, *The Wall Street Journal* has reported research showing that smaller companies that appoint entrepreneurs to their boards experience increased performance along multiple dimensions.[38] For example, their stock prices surge more than anticipated within days of the announced appointment, their revenue-growth rates tend to be higher, and measures of the long-term value of these firms show clear increases. The reasons for these favorable results may be varied, but the findings suggest that it would be wise to consider such appointments.

8-6a Selection of Directors

An entrepreneur who is attempting to assemble a cooperative and experienced group of directors needs to consider the value of an outside board, one with members whose income does not depend on the firm. The firm's attorney and banker, local management consultants, and other business executives might all be considered as potential directors but usually lack the independence needed to critically review an entrepreneur's plans. Also, in many cases, the owner is already paying for their expertise.

board of directors
The governing body of a corporation, elected by the stockholders.

Objectivity is a particularly valuable contribution of outside directors. They can look at issues more dispassionately than can insiders who are involved in daily decision making. Outside directors, for example, are freer to evaluate and to question a firm's ethical standards. Some operating executives, without the scrutiny of outside directors, may rationalize unethical or illegal behavior as being in the best interest of the company. In a family business, an outside board can help mediate and resolve issues related to leadership succession, in addition to providing more general direction. As outsiders, they can be more detached from potentially explosive emotional differences.

Working with outside board members is not always easy, but an entrepreneur who is advised by the board to make tough decisions may find that those decisions are required to move the business forward. This includes bringing the conversation

BLUESKYIMAGE/SHUTTERSTOCK.COM

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back to issues that are easy to avoid. For instance, directors might call attention to a pressing need to build long-term relationships with an influential banker. Or perhaps they may emphasize the value of converting intentions for the company's future into a formal business plan that can be studied, debated, perfected, and used as a tool to attract crucial resources to the enterprise. Entrepreneurs often spend as much as 20 percent of their time on board-related activities, but the time commitment is worth the cost if the directors are doing their jobs well.

The nature and needs of a business help determine the qualifications required in its directors. For example, a firm that faces an intellectual property problem may benefit greatly from the counsel of a board member with a legal background. Business prominence in the community is not an essential quality for board members, although it may help to give the company credibility and enable it to attract other well-qualified directors. Directors with a broad network of influential business friends and associates can contribute greatly, as long as they are willing to reach out to their contacts on behalf of the company.

After deciding on the qualifications to look for, a business owner must seek suitable candidates as board members. Effective directors are honest and accountable, offer valuable insights based on deep business experience, and enhance the company's credibility with its stakeholders (especially customers and suppliers). Suggestions for such candidates may be obtained from the firm's accountant, attorney, banker, and other associates in the business community. Owners or managers of other small companies (that are not competitors), as well as second- and third-level executives in large companies, are often willing to accept such responsibilities. Before offering candidates positions on the board, however, a business owner would be wise to do some discreet background checking.

8-6b Contributions of Directors

The growing complexity of small businesses, arising in part from globalization, increasing regulatory pressures, hypercompetition, and technological developments, makes the expertise of well-chosen directors especially valuable. As mentioned earlier, outsiders in a family business can play a unique role in helping evaluate family talent and mediating differences among family members. And a strong board of directors can help the entrepreneur look beyond the next few months to make important, long-term strategic decisions. In other words, good directors will be able to help entrepreneurs keep their eyes on the big picture.

By virtue of their backgrounds, directors can fill gaps in the expertise of a management team and monitor its actions. Informal research suggests that boards are more effective if they reflect diverse talents, backgrounds, instincts, and expertise—especially when that experience is relevant to the venture and the directors are focused on the right long-term goals.[39] The board should meet regularly to provide maximum assistance to the chief executive. In board meetings, ideas should be debated, strategies determined, and the pros and cons of policies explored. In this way, the chief executive is informed by the unique perspectives of all the board members. Their combined knowledge makes possible more intelligent decisions on issues crucial to the firm.

By utilizing the experience of directors, the chief executive of a small corporation is in no way giving up active control of its operations. Instead, they are simply drawing on a larger pool of business knowledge. A group will typically make better decisions than will a single individual working alone.

An active board of directors serves management by reviewing major policy decisions. Directors can also advise on external business conditions, suggest business

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cycle adjustments, provide informal advice from time to time on specific problems that arise, and offer access to important personal contacts. With a strong board, a small firm may gain greater credibility with the public, as well as with business and financial communities.

8-6c Compensation of Directors

The compensation paid to board members varies greatly, and some small firms pay no fees at all. If compensation is provided, it is usually offered in the form of an annual retainer, board meeting fees, and pay for committee work. (Directors may serve on committees that evaluate executive compensation, nominate new board members, and oversee the work of the company's auditors.)

Estimates vary, but annual retainers for board work at established small firms typically range from $5,000 to $10,000, and board meeting fees can run from $500 to $2,000 per meeting.[40] These costs to the firm are usually in addition to reimbursements for travel expenses related to board meetings and the financial burden of providing directors and officers liability insurance, which protects board members if they should be sued in the course of carrying out their duties as directors. Sometimes, board members are also given a small percentage of the company's profits as a bonus for their participation, and some cash-strapped businesses may grant them stock (anywhere from 0.5 percent to as much as 2 percent to lure top talent) in lieu of compensation.[41]

The relatively modest compensation offered for the services of well-qualified directors suggests that financial reward is not their primary motivation for serving on a board. In fact, it is not uncommon for some directors to serve for free because of their interest in seeing a new or small business prosper. Reasonable compensation is appropriate, however, if directors are making important contributions to the firm's operations. In any case, it is best to keep in mind that you usually get what you pay for.

8-6d An Alternative: An Advisory Board

Some individuals are reluctant to join a board of directors because outside directors may be held responsible for harmful or illegal company actions, even though they are not directly involved in wrongdoing. Thus, many small companies use an **advisory board** as an alternative to a board of directors. This group functions in much the same way as a board of directors does, except that its actions are only advisory in nature. In other words, it has no legal authority over the owner or the company.

The legal liability of members of an advisory board is not completely clear. However, limiting their compensation and power is thought to lighten, if not eliminate, the personal liability of members. Since its role is advisory in nature, the board also may pose less of a threat to the owner and possibly work more cooperatively than a board of directors.

Without a doubt, a well-selected board of directors or advisers can do a great deal for a small company, but bear in mind that this is only one part of an effective organizational plan. The success of any business depends on the quality of its people, who must also be well organized and skillfully led. That's why having a balanced management team, selecting an organizational form that makes sense for the enterprise and its circumstances, and joining advantageous strategic alliances are all so important. This chapter has touched on each of these topics to help you think through key factors involved in developing a solid organizational plan that will give your business a good running start and help to ensure its long-term success.

advisory board
A group that serves as an alternative to a board of directors, acting only in an advisory capacity.

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8-1. Describe the characteristics and value of a strong management team.

- Prospective investors consider the quality of a new venture's management team to be one of the most important factors in decisions to invest.
- A strong management team nurtures a good business idea and helps provide the necessary resources to make it succeed.
- A management team can provide a diversity of talent to meet various managerial needs.
- To ensure balance, the skills of management team members should complement each other, forming an optimal combination of knowledge, skills, and competencies.
- A small firm can enhance its management by drawing on the expertise of competent insiders and outside specialists.
- Enabled by countless new technologies and free or low-cost online support services, an increasing number of entrepreneurs are still choosing to launch their companies as solo ventures.
- Social media tools can be very helpful in attracting customers, connecting with peers, and sharing advice about common problems, as well as accessing talent for the management team.
- Building social capital through networking and goodwill is extremely helpful in developing a small business.

8-2. Explain the common legal forms of organization used by small businesses.

- The most basic legal forms of organization used by small businesses are the sole proprietorship, partnership, and C corporation.
- Currently, 73 percent of all new businesses are organized as sole proprietorships, 10.7 percent are set up as partnerships, and 3.7 percent are established as C corporations (12.6 percent are formed as S corporations).
- In a sole proprietorship, the owner receives all profits and bears all losses. The principal disadvantage of this form is the owner's unlimited liability.
- In a partnership, which should be established on the basis of a written partnership agreement, success depends on the partners' ability to build and maintain an effective working relationship. The partners share unlimited liability.
- C corporations are particularly attractive because of their limited liability feature. The fact that ownership is easily transferable makes them well suited for combining the capital of numerous owners.

8-3. Identify factors to consider in choosing among the primary legal forms of organization.

- The key factors in choosing an organizational form are the initial organizational requirements and costs, the liability of the owners, the continuity of the business, the transferability of ownership, management control, its attractiveness for raising capital, and income tax considerations.
- Self-employed individuals who operate businesses as sole proprietorships report income from the businesses on their individual tax returns.
- A partnership reports the income it earns to the Internal Revenue Service, but the partnership itself does not pay income taxes. The income is allocated to the owners according to their partnership agreement.
- A C corporation reports its income and pays any taxes due on this corporate income. Individual stockholders must also pay personal income taxes on dividends paid to them by a corporation.

8-4. Discuss the unique features and restrictions of six specialized organizational forms.

- In a limited partnership, general partners have unlimited liability, while limited partners have only limited liability so long as they are not active in the firm's management.

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- S corporations, also called Subchapter S corporations, enjoy a special tax status that permits them to avoid the corporate tax but requires individual stockholders to pay personal taxes on their proportionate shares of the business profits.
- In limited liability companies, individual owners have the advantage of limited liability and pay only personal income taxes on the firm's earnings.
- Professional corporations are set up for those who offer professional services (usually those in occupations that require a license) to protect them from the liability of other owners in the practice.
- Some enterprises (especially those with a social focus) benefit from greater credibility and authenticity when they organize as nonprofit corporations, such as 501(c)(3) organizations.
- Despite potential legal complications involved, sometimes the best organizational form for a small business is a hybrid option, which links nonprofit and for-profit entities.
- The benefit corporation may be the best form of organization for entrepreneurs who are intending to use the power of business to solve a social or environmental problem.

8-5. Understand the nature of strategic alliances and their uses in small businesses.

- Strategic alliances allow business firms to combine their resources without compromising their independent legal status.
- Strategic alliances may be formed by two or more independent businesses to achieve some common purpose. (A large corporation and a small business or two or more small businesses may collaborate on a joint project.)
- Entrepreneurs can improve their chances of creating and maintaining a successful alliance by establishing productive connections, identifying the best person to contact, being prepared to outline the partner's potential financial benefits, learning to speak the partner's "language," ensuring a win-win arrangement, and monitoring the progress of the alliance and making any necessary changes.

8-6. Describe the effective use of boards of directors and advisory boards.

- To be most effective, a board of directors should include properly qualified, independent outsiders, who provide a good fit with the nature and needs of the business.
- Boards of directors can assist small businesses by offering objective counsel and assistance to their chief executives.
- Directors can fill gaps in the expertise of a management team and monitor its activities.
- The compensation paid to board members varies greatly, with some small businesses paying no fees at all, but it is also true that companies usually get what they pay for.
- One alternative to an active board of directors is an advisory board, whose members are not personally liable for the company's actions.

Key Terms

advisory board p. 209
benefit corporation p. 203
board of directors p. 207
C corporation p. 196
corporate charter p. 196
corporation p. 196
general partner p. 201
joint and several liability p. 194
legal entity p. 196
limited liability company p. 201
limited partners p. 201
limited partnership p. 201
management team p. 186
nonprofit corporation p. 202
organizational test p. 202
partnership p. 193
partnership agreement p. 194
piercing the corporate veil p. 198
preemptive right p. 196
professional corporation p. 202
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S corporation p. 201
social capital p. 190
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sole proprietorship p. 191
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Discussion Questions

1. Why would investors tend to favor a new business led by a management team over one headed by a lone entrepreneur? Is this preference justified?
2. What are the merits of each of the three most basic legal forms of organization?
3. Does the concept of limited liability apply to a sole proprietorship? Why or why not?
4. Suppose a partnership is set up and operated without a formal partnership agreement. What problems might arise from this? Explain.
5. How do the three most basic forms of organization differ in terms of management control by the owner and the sharing of the firm's profits?
6. What is an S corporation, and what are its principal advantages?
7. Why are strategic alliances helpful to many small businesses? What steps can an entrepreneur take to create effective strategic alliances and to prevent their failure?
8. How might a board of directors be of value to management in a small corporation? What personal qualities and business qualifications are most important for a director?
9. What may account for the failure of most small companies to use boards of directors as more than "rubber stamps"? What impact is this likely to have on the business?
10. How do advisory boards differ from boards of directors? Which of the two would you recommend to a small business owner? Why?

You Make the Call

Situation 1

Just recently, Donny Eckols came up with the idea of starting an online service that would help investors who are looking for rental properties on the cheap to get connected with homeowners who really need to sell their houses fast. This opportunity holds special appeal for Eckols, whose parents have been involved in the real estate industry for decades. Eckols doesn't want to start this new business by himself, however, so he keeps prodding his friend John Starner to partner with him. The two have remained close friends since they roomed together in college.

While Starner thinks this potential start-up could very well turn out to be a smash hit, he just can't quite see himself in the real estate business. To him, it sounds a lot like sales, and that's more Eckols's thing, with his upbeat style and his natural ability to read people and anticipate their reactions. Starner's personality is very different, focusing on technology more than people and on ideas more than interactions. So far, he and Eckols have had a great friendship, but Starner is beginning to wonder if the good times will continue to roll once money is on the line and the pressure begins to mount. He knows that Eckols leans heavily on Starner's computer skills, even as Starner looks to Eckols to make life interesting and keep him connected.

Starner also fears that Eckols might begin to take over the business once it gets going. After all, he would bring a lot of industry insight to the new venture, given his family background, and it was his idea in the first place. How could he not take on a sense of ownership? Starner knows that his programming skills and ease with technology will fill in important gaps in what Eckols brings to the table, but will that be enough to keep him in the game? He has to decide soon. Eckols wants to launch the new company before the end of the month.

Question 1 How relevant are the individual personalities to the success of this start-up team? Do you think Starner and Eckols have a chance to survive a potential partnership? Why or why not?

Question 2 Do you consider it an advantage or a disadvantage that the members of this team are about the same age?

Question 3 On balance, is it good or bad that the company will be started by two men who are also very close friends? What are the potential benefits and drawbacks of mixing business and friendship in this case?

Situation 2

This is a true story related by David Allen, adjunct professor of entrepreneurship at Baylor University. The names have been changed to hide the identities of the individuals involved.

> One morning, while working in the office of my outdoor advertising company, I received a telephone call from an old high school acquaintance. He had started a humidor shop in partnership with his older brother, the older brother supplying the finances and the younger managing the shared venture. Gary asked me to call on him to discuss billboard advertising in order to make the local

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market aware of the new enterprise. After I explained the benefits of outdoor advertising to achieve his goals, Gary contracted with my company to display a number of small billboards throughout the market.

After designing the posters, ordering the printing work, and scheduling the specific locations that would best reach Gary's target market, the materials arrived and were posted on the agreed-upon date. About mid-morning on the posting date, the older brother, Jerry, called me and mentioned that he had seen some of the posters on billboards in the area. He wanted to know what was going on, because he had no idea that the displays had been ordered. I explained what had taken place and that Gary had contracted for the advertising space. Jerry expressed his displeasure over the telephone in no uncertain terms, so I asked him if he was dissatisfied with the design or the locations that had been assigned. He said that he actually was quite pleased with the showing, but he was simply upset with his brother for contracting for it without consulting with him first or even informing him as to what he had done. Jerry was, after all, the partner who had to pay the bills.

This incident has stayed in my memory over the years as a caution against starting a business using the partnership as the legal form of organization. Jerry understood that while he had not agreed to the transaction and, indeed, did not even know what his brother had done, he was nonetheless liable for paying the entire bill, because his partner had signed on behalf of the business. Over the years, I have seen too many partnerships destroyed because the partners failed to understand this crucial feature of general partnerships. Partnerships can work, but only when there is a strong partnership agreement in place to specify the precise duties and responsibilities of each partner within the firm. In addition, the partners need to be in complete agreement on the goals and direction of the partnership and the methods that will be employed to achieve them, otherwise the venture can go off the rails in very short order.

The good news of the incident that I just related is that the advertising did its job; the business found its footing quickly and was making profits in a very short time. Jerry was pleased with the outcome, but he had a long talk with Gary regarding the need for the two of them to confer before signing any contracts. Going a step further, they found a local attorney who understood the potential pitfalls of partnerships and worked out a partnership agreement that defined the roles and responsibilities of the two partners. The business thrived for several years until it eventually was sold to a third party.

While this particular story had a happy ending, too many good businesses falter and, in time, fail because partners are completely unaware of the joint and several liability aspect of their chosen form of organization.

Question 1 What are the advantages and disadvantages of running a business as a partnership?

Question 2 What other legal forms of organization could have been used for this business? Which form would you recommend? Why?

Situation 3

Julie Patton is co-founder and president of PM Meals, a food-services business that prepares and sells boxed meals and convenience snacks to hotels, convention operators, corporate clients, and community event planners. Patton makes most of the business decisions related to the company and is in charge of generating new accounts. The firm's other co-founder, Angela Marks, has culinary training and oversees the meal-preparation side of the operation. The food they offer represents relatively simple fare, but it is flavorful and attractively presented, exceeding by far what most clients would expect from a boxed-meal provider.

The company has entered a growth phase, which has attracted the attention of a high-potential investor. PM Meals could certainly use the money to support its growing business, but the investment would come with major strings attached. For example, even though the company has been performing nicely without a board of directors, the investor insists that it form one and that he be given a seat on the new board: "If I am going to put up money for the business, I want to be able to influence how my money is being used."

Patton and Marks are concerned that forming a board and including at least one outside investor (the one who insists on having a seat) will undermine their control and paralyze the business. As they weigh alternatives, they are leaning toward forming a three-person board and accepting the new investment—but they are far from certain as to what they should do.

Question 1 Would you accept the investment and the conditions that go along with it, or refuse it and go a different direction?

Question 2 Can one outside member on a board of three make any real difference in the way the board operates?

Question 3 If you were the owners, whom would you include on the board?

Question 4 If Patton and Marks decide to form a board of directors, what will determine its usefulness or effectiveness? Do you predict that it will be helpful? Why or why not?

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Experiential Exercises

1. Prepare a one-page résumé of your personal qualifications to launch a software instruction business at your college or university. Then write a critique that might be prepared by an investor, evaluating your strengths and weaknesses, as shown on the résumé. Identify in the critique any gaps or weaknesses you have that could be addressed by forming a management team to start the business.
2. Interview an attorney whose clients include small businesses. Inquire about the legal considerations involved in choosing the form of organization for a new business. Report your findings to the class.
3. Interview a small business owner who is involved in a strategic alliance with another firm. Ask which factors or issues they thought about most when deciding whether to enter into the alliance. In what ways did they structure the deal to protect against any of the concerns that were considered? Report your findings to the class.
4. Discuss the contributions of directors to small firms with a corporate director, attorney, banker, or business owner. Prepare a brief report on your findings. If you discover a particularly well-informed individual, suggest that person to your instructor as a possible guest speaker.

Business Plan

LAYING THE FOUNDATION

As part of laying the foundation to prepare your own business plan, respond to the following questions regarding your management team, legal form of organization, strategic alliances, and board of directors or advisory board.

Management Team Questions

1. Who are the members of your management team? What education, experience, and skills do they bring to the team?
2. What other key managers do you plan to recruit?
3. Do you plan to use consultants? If so, describe their qualifications.
4. What are your plans for future employee recruitment?
5. What will be the compensation and benefit plans for managers and other employees?
6. What style of management will be used? What will be the decision-making process in the company? What mechanisms are in place for effective communication between managers and employees? If possible, present a simple organizational chart.
7. How will personnel be motivated? How will creativity be encouraged? How will commitment and loyalty be developed?
8. What employee retention and training programs will be adopted? Who will be responsible for job descriptions and employee evaluations?

Organizational Form Questions

1. Who will have an ownership interest in the business?
2. Will the business function as a sole proprietorship, partnership, or corporation? If a partnership, will it be a general partnership or a limited partnership? If a corporation, will it be a C corporation, an S corporation, a limited liability company, a professional corporation, a nonprofit corporation, or a benefit corporation?
3. What are the liability implications of this form of organization?
4. What are the tax advantages and disadvantages of this form of organization?
5. If a corporation, where will the corporation be chartered and when will it be incorporated?
6. What attorney or legal firm has been selected to represent the firm? What type of relationship exists with the company's attorney or law firm?
7. What legal issues are presently or potentially significant?
8. What licenses and/or permits may be required?

Strategic Alliances Questions

1. What strategic alliances are already in place, and what others do you plan to establish in the future? Describe the nature of these alliances.
2. What are the responsibilities of and benefits to the parties involved in these strategic alliances?
3. What is the exit strategy if an alliance should fail?

Board of Directors/Advisory Board Questions

1. Do you plan to have a board of directors or an advisory board?
2. If a board of directors, who are the directors of the company?
3. What are the qualifications of the board members?
4. How will the directors be compensated?

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Chapter 8 Case

Please see Appendix A for the Chapter 8 Case Study.

Endnotes

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Chapter 9

The Location Plan

Learning Objectives

The Location Plan chapter will discuss the important factors that lead to success for small businesses that locate in physical facilities, in the home, or online. By studying this chapter, you should be able to . . .

9-1 Describe the five key factors in locating a start-up in a physical facility.

9-2 Discuss the challenges of designing and equipping a physical facility.

9-3 Recognize both the attraction and the challenges of creating a home-based start-up.

9-4 Understand the potential benefits of locating a start-up online.

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Spotlight on Small Business

On Location Tours

https://onlocationtours.com

For many small businesses, deciding on a location can have a significant impact on its success. That's why it's so important to consider many possibilities and select the best spot based on logical decision factors. In some cases, the decision seems to be already made for the small business owner. Settling in a certain city or a specific area may be the only way to get that business to work. This was the case for a sightseeing start-up called On Location Tours, which has a presence in New York and Boston.

Founded in 1999 by Georgette Blau, On Location Tours has knowledgeable and entertaining guides who show visitors around popular television and movie locations. Given that so many movies and television shows are shot in New York, On Location Tours had to establish a presence there. Specifically targeted are places like Ellen's Stardust Diner, which appeared in *New Year's Eve* and *American Idol*; Tiffany's & Co., which was featured in *Breakfast at Tiffany's*; and 30 Rockefeller Plaza, home to NBC Studios and the site of *Sleepless in Seattle*, *Ghostbusters*, and *Spiderman*. Many other popular locations are included on the tour.

To prepare its fare-paying visitors to get the most from seeing these famous places, On Location Tours shows the related movies or TV shows on the bus. When they arrive at the site, customers then have a more complete sense of the context, based on what they were just watching. This provides an enhanced tour experience.

Blau's venture has grown to become one of the largest tour companies in its industry. It serves more than 100,000 tourists and locals annually in New York and Boston. In brief, the mission of the business is to help people straddle fiction and reality. The guides help guests feel as though they are part of the TV show or movie, effectively bringing them closer to the characters themselves. To add spice to the experience, the company hires mostly local actors and actresses who have appeared in various TV shows and movies to lead the tours. Demand has been so strong in recent years that the company has been able to maintain its staff of seven full-time employees and as many as 32 guides (during peak season).

The company offers 12 different tours, all but one of them in New York City. They include the NYC TV & Movie Tour, the When Harry Met Seinfeld Tour, the Sopranos Sites Tour, and the Central Park Filming Location Walking Tour, all of which center on specific areas of the city. These tours can last from one to four hours, with prices ranging from $10 to $150.

For some options, most of a sightseer's time is spent on the bus. But the guide will make three to four stops where visitors have the opportunity to get off the bus and take pictures or enjoy some fresh air. The company also offers specialized packages, depending on the preferences of those planning the tour. And Blau organizes unique outings for schools, camps, and other groups—even a super tour birthday option. But these customized services are even more location-dependent than the company's standard offerings.

On Location Tours has been successful because New York City has many sites that the city's mob of annual visitors find interesting. The business owner clearly has been able to use these locations to grow the business. The company did, however, experience major but temporary setbacks during the 9/11 attacks in 2001 and the COVID-19 pandemic in 2020, when visitors stopped coming to New York City—a clear downside of being dependent on specific locations. This type of business obviously would not do well in locations that are largely unknown or unattractive to tourists. But this situation is not unusual for an entrepreneur searching for a location for their new venture. Where a small business chooses to locate can make all the difference between success and failure, so it is important to take the location decision seriously.

Sources: George Bodarky, "On Location Tours: Celebrating 20 Years," May 8, 2020, https://wfuv.org/content/location-tours-goes-virtual, accessed February 16, 2021; "On Location Tours," https://grouptools.com/catalog/on-location-tours, accessed February 16, 2021; and "TV and Movie-Themed Tours in New York City and Boston," https://onlocationtours.com, accessed February 16, 2021.

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A new venture idea begins to take shape as an entrepreneur works through all of the basic parts of the business plan. And that idea becomes even more real as resources are committed to the implementation of the plan, including the selection of a business location and any facilities and equipment. But, as the Spotlight feature at the start of this chapter shows, the location decision can have a great impact on the success of a small business.

Small businesses have a number of location options to consider. At the leaner end of the spectrum, alternatives may involve nothing more than a cell phone, some desk space at home, and a website. And locating online has changed everything for many start-ups. The Internet offers global market reach at minimal cost, which provides a tremendous boost to budding ventures that desperately need customers but are short on funding. The rise of the online venture has been a game-changing phenomenon.

Entrepreneurs at the other end of the location continuum, however, might need a new building, a fully stocked warehouse facility, and perhaps even forklifts and other equipment to get their planned operations off the ground. It all depends on the nature of the business. But, regardless of the specific resources involved, every location decision should be based on certain fundamental principles that can guide the process and minimize mistakes.

Those who purchase an existing business or a franchise usually receive considerable location guidance from team members of the acquired firm or the franchisor. But entrepreneurs who choose to start a venture from scratch will quickly find that the location decision can be very time consuming. To help make the task more manageable, this chapter addresses some of the major factors that should be considered when choosing a location and setting up physical facilities. And because starting and launching home- and Internet-based businesses have become such popular options, these alternatives are also covered in some detail. (Although the Internet can be an integral part of operations for both a traditional and a home-based business, we treat e-commerce ventures in a separate category because of the Internet's significance as the sole sales outlet for many small businesses.)

Regardless of how the site selection is made, a discussion of key location factors and how they support the location decision should be included in the business plan. This chapter will guide you through that process. But keep in mind that the depth of this discussion will vary from plan to plan, depending on the nature and specific needs of the new venture.

9-1 Locating the Start-up in a Traditional Physical Facility

9-1 Describe the five key factors in locating a start-up in a physical facility.

The choice of a location for a physical facility is often a one-time decision, but a small business owner may later relocate a venture to reduce operating costs, be closer to customers, or tap other advantages. While some entrepreneurs may be content in their current location, many would consider a move if they thought it would help their companies. That ability to be flexible led Ty Haney to relocate her active apparel start-up, Outdoor Voices, from New York to Austin, Texas. The company simply packed up its 40 employees and made the move to the Lone Star State. "It struck me that the city is super supportive of entrepreneurship," she explained. Haney is not alone in her upbeat view of Austin, as its "reasonable cost of living, loads of sunshine, well-educated people, and a fun streak" all contributed to its rise to the number 1 spot on *Inc.* magazine's list of the best metro areas in the United States for starting a business.[1] Location decisions can be complicated, but if carefully planned and wisely made, the payoff can be fantastic.

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9-1a The Importance of the Location Decision

The importance of the initial decision as to where to locate a traditional physical building is underscored by both the high cost of such a place and the hassle of pulling up stakes and moving an established business. Also, if the site is particularly poor, the business may never become successful, even with adequate financing and superior managerial ability. The importance of location is so clearly recognized by national chains that they spend hundreds of thousands of dollars investigating sites before establishing new facilities.

The choice of a good location is much more vital to some businesses than to others. The site chosen for an apparel store, for instance, can make or break the business because it must be convenient for customers. The physical location of a painting contractor's office, on the other hand, is of less importance, since customers do not need frequent access to the facility. But even painting contractors may suffer if their business site is poorly chosen. For example, some communities are more willing or able than others to invest resources to keep their properties in good condition, thereby providing greater opportunities for painting jobs.

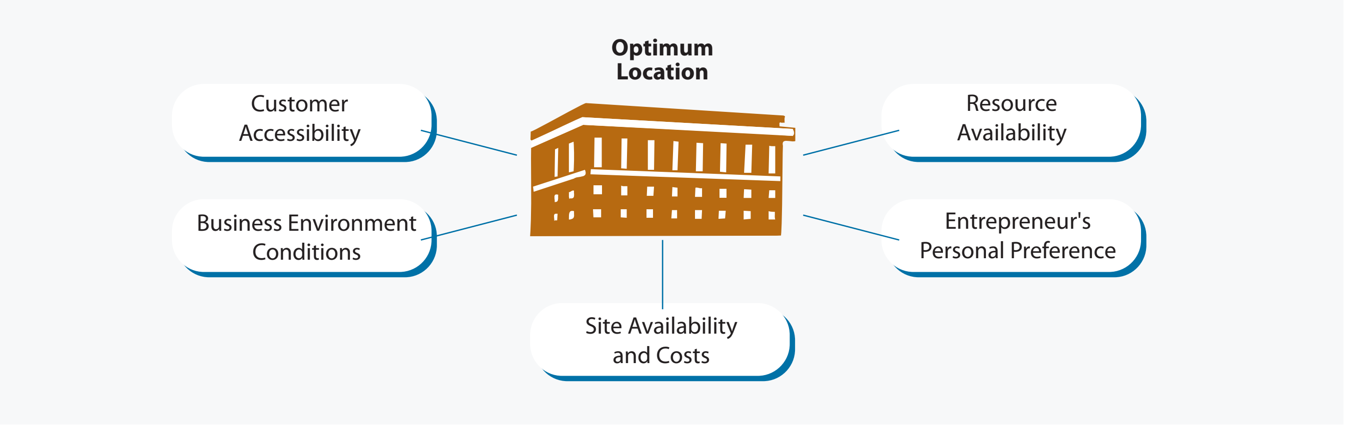
9-1b Key Factors in Selecting a Good Location

Five key factors, shown in Exhibit 9.1, guide the location selection process: customer accessibility, business environment conditions, the availability of resources, the entrepreneur's personal preference, and site availability and costs. Relevant questions to ask when making the location decision include the following:[2]

- *Neighbors:* What types of businesses are near the chosen location?
- *Security and safety:* What is the crime rate in the neighborhood?
- *Services:* Does the city provide reliable trash pickup, for example?
- *Past tenants' fate:* What happened to previous businesses in that location?
- *Location's life-cycle stage:* Is the area developing, vibrant, or in decline?

For a particular business and its unique situation, one factor may carry more weight than others. However, each of the five key factors should always have some influence on the final location decision.

Exhibit 9.1 Five Key Factors in Determining a Good Business Location



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Customer Accessibility

For many businesses, customer accessibility is an extremely important consideration in selecting a location. It is vital in industries in which the cost of shipping the finished product is high relative to the product's value. Products such as packaged ice and soft drinks, for example, must be produced near consuming markets because of the excessive transportation costs involved. Retail outlets and service firms (such as tire repair companies and hair stylists) must be located where they can provide handy access for targeted purchasers to avoid losing business to more conveniently placed competitors.

Choosing the best location for a retail store used to be a hit-or-miss proposition. The recent emergence and growing popularity of site-selection software has removed much of the guesswork. The number of software products available for this is growing rapidly. Some that may be worth a look include packages like REGIS Online software by SitesUSA, Tetrad's Sitewise Pro and Sitewise Mobile options, and a more recent location-analytics service called PiinPoint. But no matter which of these you may want to consider, try to arrange a test run before you invest your hard-earned dollars to be sure that the software is right for your business.

Site-selection programs can give users access to demographic information such as population age and income for specific neighborhoods, as well as details about other businesses located nearby, climate conditions, traffic flow, and much more. Just keep in mind that these software packages also have their limitations. For example, some emphasize traffic counts and geographic distance, which can easily overlook factors like traffic slowdowns during rush hour, the potential of railroads or interstates to divide buying clusters, and similar issues.

If you want to go it alone but still capture the power of detailed data to make your decision, it may be helpful to visit the United States Census Bureau at census.gov. Don't let all of the options presented on this site discourage you. If you are patient and work your way through some of the links, you will be amazed by the depth of helpful information you can uncover. We also suggest that you visit the website of *Site Selection* magazine (siteselection.com), which offers a wealth of information for researching locations and demographics.

Business Environment Conditions

A small business can be affected in a number of ways by the environment in which it operates. This includes weather conditions, which are sometimes the determining factor in a location decision. Although this could be entirely a matter of personal preference on the part of the decision maker, often it is about much more than that.

Climate was certainly an important consideration for Trey Cobb, owner of a high-performance car-parts maker called COBB Tuning, when he took the bold step of moving his small company from Texas to a custom-built facility in Utah. This particular move was all about climate—in this case, improving product-testing conditions. Cobb recognized the advantages of locating the company in an area that provided access to the varied geographic and weather conditions that would be necessary to fully test the car parts that his company manufactures.[3]

Competition, legal requirements, and tax structure are a few of the other critical environmental factors. Since entrepreneurs need profits to sustain their businesses, all factors affecting the financial picture are of great concern. State and local governments can help or hinder a new business by the business conditions they create. For example, state corporate income tax rates vary considerably across the United States, with only

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a few states having no such tax. Ranking states in terms of the impact that their public policies have on small businesses (based on a composite score computed from a total of 62 measures), the Small Business & Entrepreneurship Council publishes a "Small Business Policy Index" each year. In a recent report, the council found that the five states with the most favorable tax systems for small businesses were, in order, (1) Texas, (2) Nevada, (3) Florida, (4) South Dakota, and (5) Wyoming.[4]

Tax relief for the business is important, but don't forget to factor in the impact of a state's personal income tax rates, which will affect the pay your employees ultimately receive for their labor. These taxes will determine how far wage dollars will go and, in turn, the benefit and satisfaction your workers receive from the business. And there are other important elements in the equation, such as the overall cost of living. A lower *cost* of living can mean a higher *standard* of living for employees. To do cost-of-living research yourself, search online for "cost-of-living calculator," or contact local economic development agencies and request data on this and other factors, which they will provide free of charge.

Governments don't always do everything they can to help new companies get started and flourish. And the barriers may go far beyond issues of taxation. Consider these "wrinkles in the law" that made life difficult for small business owners:[5]

- Farmers in Lake Elmo, Minnesota, had to be careful where they raised the produce they offered for sale. The law stipulated that they could be fined $1,000 and spend 90 days in jail if they peddled pumpkins or Christmas trees that were grown outside city limits.
- Fisherman Robert J. Eldridge faced the possibility of a year in jail plus a $100,000 fine and a year of probation for untangling a whale from his fishing gear. His crime? He freed the ensnared mammal himself rather than waiting for state authorities to arrive and take care of it.
- Want to open a daycare center in Massachusetts? Better line up a contract with a toothbrush supplier first. All licensed centers in the state are required to assist children in brushing their teeth if they eat a meal during care that lasts four hours or longer.

Stories like these are not all that uncommon. And such setbacks can easily doom a small business, especially if it is new, lacks momentum, and is short on resources.

Still, most state and city governments go to great lengths to support start-ups. After all, their economic futures depend on new venture creation. Nonetheless, nearly all cities have regulations that restrict new business operations under certain circumstances. For example, some cities have **zoning ordinances** that may limit the operations of home-based businesses. These ordinances often apply to factors related to traffic and parking, signage, nonfamily employees working in a home, the use of a home more as a business than as a residence, the sale of retail goods to the public, and the storage of hazardous materials and work-related equipment.[6]

Availability of Resources

Access to raw materials, suitable labor, crucial suppliers, and transportation are some of the factors that have a bearing on location selection. Proximity to important sources of raw materials and an appropriate labor supply are particularly critical considerations in the location of most manufacturing businesses, whereas access to key suppliers is more likely to influence site selections for retail outlets and restaurant operations.

zoning ordinances
Local laws regulating land use.

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If the raw materials required by a company's operations are not readily available in all areas, then regions in which these materials abound will offer significant location advantages. This is especially true for businesses that are dependent on bulky or heavy raw materials that lose much of their size or weight in the manufacturing process. A sawmill is an example of a business that must stay close to its raw materials in order to operate economically.

YIUCHEUNG/SHUTTERSTOCK.COM

The suitability of the labor supply for a manufacturer depends on the nature of its production process. Here are a few important considerations:

- Labor-intensive operations need to be located near workers with appropriate skills and reasonable wage requirements.
- A history of acceptable levels of labor productivity and peaceful relations with employers in a particular area is beneficial to almost any production operation.
- Companies that depend on semiskilled or unskilled workers usually locate in an area with surplus labor, while other firms may need to be close to a pool of highly skilled labor.

If the required talent is unavailable, relocation may be necessary, even it if means moving to another state. According to Sharon K. Ward, an economic development consultant, finding a suitable workforce has been the most pressing need driving firms to relocate, especially for those depending on technical expertise.[7] Survey data show that nearly 80 percent of small businesses made significant changes in 2020 to adjust to the pandemic, with one-third adding new policies to allow their employees to work from home.[8] If this trend continues, employee talent may become more available, regardless of the location of the small business.

Access to good transportation is important to many companies. For example, good highways and mass transit systems provide customers with convenient access to retail stores, which encourages sales. For small manufacturers, quality transportation is especially vital. They must carefully evaluate all trucking routes, considering the costs of both transporting supplies to the manufacturing location and shipping the finished product to customers. It is critical to know whether these costs will allow their products to be competitively priced.

Personal Preference of the Entrepreneur

As a practical matter, many entrepreneurs tend to focus primarily on their personal preference and convenience when locating a business. Statistics hint at this, showing that nearly half of all entrepreneurs (47 percent) live no more than a five-minute drive from their venture's location.[9] And, despite a world of alternatives, small business owners often choose to stay in their home community. Just because an individual has

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always lived in a particular town, however, does not automatically make the town a satisfactory business location.

On the other hand, locating a business in one's home community may offer certain unique advantages that cannot be found elsewhere:

- From a personal point of view, the entrepreneur may generally appreciate and feel comfortable with the atmosphere of his or her home community.
- It may be easier to establish credit with hometown bankers who know an entrepreneur's personal background and reputation.
- Having personal connections in the local business community can lead to invaluable business advice.
- If local residents are potential customers, the small business owner probably will have a better idea of their tastes and preferences than would an outsider.
- It doesn't hurt that friends and relatives in the community may be quick to buy the product or service and gladly spread positive reports about it to others.

Though such decisions are usually based on emotion, there are clearly some potential benefits of locating a start-up close to home.

The personal preferences that drive the location decision are as varied as the entrepreneurs who make it. Sometimes, entrepreneurs choose a location offering unique lifestyle advantages, such as being close to a favorite golf course or a trustworthy babysitter. But while personal preference is important and should not be ignored, it would be unwise to allow this to take priority over obvious location weaknesses that are almost certain to limit or even doom the success of the enterprise. The location decision must take all relevant factors into consideration.

Site Availability and Costs

Once an entrepreneur has settled on a certain area for the business, a specific site must still be chosen. Many small business owners recognize the value of seeking professional assistance—often from local realtors—in determining site availability and appropriateness.

If an entrepreneur's top location choices are unavailable, other options must be considered. One alternative is to share facilities with other enterprises. This would include business incubators, which have been springing up for years in all areas of the country. A **business incubator** is a facility that rents space to new businesses or to people wishing to start businesses.[10] Incubators are often located in repurposed buildings, such as abandoned warehouses or schools. They serve fledgling businesses by making space available, offering management advice, and providing other forms of assistance (including clerical support), all of which help reduce operating costs. An incubator tenant can be fully operational the day after moving in, without buying phones, renting a copier, or hiring office employees.

Most incubators can accommodate different kinds of early-stage ventures, but some focus on a specific business niche, such as fashion, food, or design. Many provide access to industry-specific resources. FABRIC, for example, is a nonprofit incubator in Tempe, Arizona, that has helped more than 600 fashion entrepreneurs launch new companies created to disrupt, redefine, and reform the industry in sustainable ways. The service provides access to manufacturing, as well as guiding start-up hopefuls through all stages of business formation, including branding, product development, and marketing. As stated on the incubator's website, "It's like having a virtual

business incubator
A facility that provides shared space, services, and management assistance to new businesses.

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Production Manager, Technical Designer, Quality Controller, Business Coach, and Branding Expert guide you."[11]

The purpose of business incubators is to help new businesses hatch, grow, and then move on, so the situation is temporary *by design*. But it appears that many businesses are looking for permanent shared-office arrangements. Regus, a leading provider of shared office space, finds that its business is booming. The firm currently operates more than 3,000 business centers in 900 cities spread over nearly 120 countries.[12]

Perhaps you are more of a free spirit. One variation on the shared-office-space theme is the "co-working" movement, which involves shared working spaces (sometimes an office) that allow mostly freelancers, consultants, artists, and other independent workers to work and connect in the same location. Many such facilities are now available around the world, providing clean and safe places to function, plentiful networking opportunities, and a sense of camaraderie. This arrangement is not for everyone, but it provides a good working alternative for many entrepreneurs. And these days it is easy to find and book such a work or meeting space by using a shared-space marketplace like Optix, which can point you to venues in all corners of the globe.[13]

When it comes to site selection—whether permanent or temporary—the process should factor in all relevant costs. Unfortunately, an entrepreneur is frequently unable to afford the *best* site. The costs involved in building on a new site may be prohibitive, or the purchase price of an existing structure may exceed the entrepreneur's budget.

Assuming that suitable building space is available, the entrepreneur must decide whether to lease or buy. More small business owners choose to purchase rather than lease their buildings, but the benefits of leasing can sometimes outweigh the gains of owning:

- A large cash outlay is avoided, which can be especially important for a new small firm that lacks adequate financial resources.
- Risk is reduced by minimizing investment and by postponing commitments for space until the success of the business is assured and facility requirements are better known.
- It is usually more affordable to lease in a high-image area than to buy in a prime location.
- Leasing allows the entrepreneur to focus on running the business rather than managing a property.

However, there clearly are disadvantages to leasing as well. Those who buy will benefit financially when a well-selected property appreciates in value, and their facility costs will be stable and predictable over time. Just as important, they won't need to ask permission to make future changes or additions to the property.

If entering a lease agreement seems preferable, the entrepreneur first should check the landlord's insurance policies to be sure there is proper coverage for various types of risks. If not, the lessee should seek coverage under their own policy.

It is also wise to have the terms of the lease agreement reviewed by an attorney, who may be able to add special provisions to a lease, such as an escape clause that allows the lessee to exit the agreement under certain conditions. An attorney can also ensure that the entrepreneur will not be unduly exposed to liability for damages caused by the gross negligence of others. Consider the experience of one firm that wished to rent 300 square feet of storage space in a large complex of offices and shops. On the sixth page of the landlord's standard lease, the firm's lawyer found language that could have made the business responsible for the entire 30,000-square-foot complex if it burned

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down, regardless of blame! Competent legal counsel may not be cheap, but the services that it provides can certainly save an entrepreneur a lot of money and heartache.

9-2 Discuss the challenges of designing and equipping a physical facility.

9-2 Designing and Equipping the Physical Facility

A well-written location plan should describe the physical space in which the business will be housed and include an explanation of any equipment needs. The plan may call for a new building or an existing structure, but ordinarily a new business that needs physical space will occupy an existing building, perhaps after some minor or major remodeling.

9-2a Challenges in Designing the Physical Facility

When specifying building requirements, an entrepreneur must avoid committing to a space that is too large or too luxurious for the company's needs. At the same time, the space should not be so small or limiting that operations are hindered or become inefficient. Buildings do not produce profits directly—they merely house the operations and personnel that do so. Therefore, the ideal building will be practical, not extravagant.

The general suitability of a building for a given type of business operation depends on the functional requirements of the enterprise. For example, a restaurant should ideally be on one level to make service manageable, while a manufacturer's interlinked production processes should be in the same building and located near one another in order to be efficient. Other important factors to consider include the age and condition of the building, potential fire hazards, the quality of heating and air conditioning systems, the adequacy of lighting and restroom facilities, and appropriate entrances and exits. Obviously, these factors are weighted differently for a factory than for a wholesale or retail operation. But in every case, the comfort, convenience, and safety of the business's employees and customers should be taken into consideration.

When it comes to office space allocation and design, the optimal solution can be a moving target.[14] *The Wall Street Journal* reports that average office sizes peaked in the mid-1990s at around 240 square feet of area per office-using employee. But that figure has plunged since then to roughly 130 square feet per office-using employee, on average.[15] This obviously helps to reduce facility costs.

Office configurations have also gone through a substantial transformation. Companies have shifted toward open designs over the years with the expectation that staff then would be more accountable (since work is performed in plain view). They also expected interactions to increase, leading to greater collaboration and enhanced innovation. *Bloomberg CityLab* has reported that by 2017 some 70 percent of companies had shifted to the open-design concept.[16] But that trend has been reversing more recently. Of course, the COVID-19 pandemic highlighted health concerns from employees who worked closely together. But many managers had already suspected that such office configurations were cutting into employee collaboration and productivity.[17] It seems they were onto something. Researchers writing for the *Harvard Business Review* analyzed a company before and after its transition to an open-office redesign and were surprised to find that face-to-face interactions did not go *up* after the change—instead, they actually *fell* by some 70 percent! They added that electronic interactions between employees increased after the change to make up for at least some of the decline.[18]

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Because interaction-tracking technologies have become more powerful, this field of study has become much more sophisticated. Scientists have more insights than ever to help improve the design of work environments for firms of any size. For example, some discoveries from neuroscience are worth considering as you think about designing workspace for your business:[19]

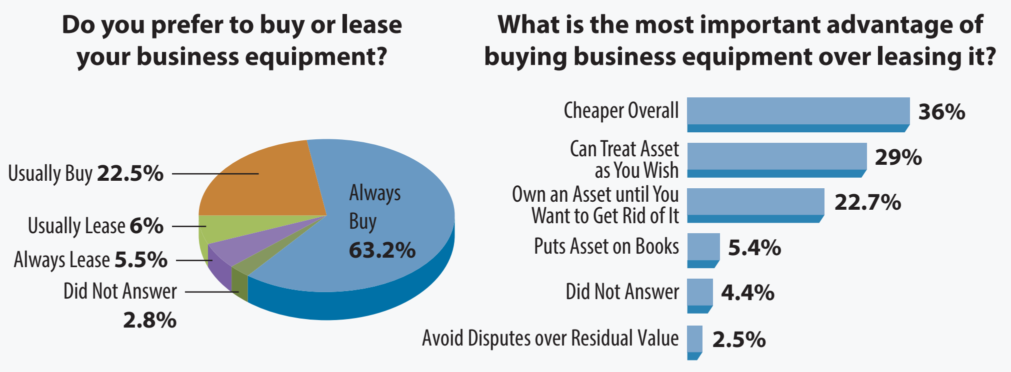
- Hearing voices above 55 decibels (like a loud phone call) causes stress for others.
- "Halfversations" (overhearing only one person's part of a conversation) are very distracting since our brains instinctively fill in the other caller's part of the chat.
- Nature sounds (rainfall, rushing water) can provide calming white noise.
- Working in confined spaces tends to increase focused thought for employees.
- Room colors can make a difference—blue stimulates productivity, green encourages concentration, and orange lifts the mood and improves decision making.

The bottom line for small business owners? It pays to think carefully about your office space needs and designs, from both a financial and a human point of view.

9-2b Challenges in Equipping the Physical Facility

The final step in arranging for physical facilities is the purchase or lease of equipment and tools. The National Federation of Independent Business has reported that, overwhelmingly, owners of small businesses would rather own their equipment than lease it (refer to Exhibit 9.2). The majority believe that, in the long run, it is cheaper to buy than to lease. Having the flexibility to use the equipment as they wish and to keep it until it is no longer needed are also important reasons small business owners prefer to own rather than lease. Still, the leasing option has advocates as well. So what should a small business owner do? To make an informed decision, use an equipment

Exhibit 9.2 Small Business Owners Choose Buying over Leasing



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lease-versus-buy calculator, a number of which can be found online with a simple search. It's also a good idea to check with an accountant to be sure that any tax consequences of your decision to lease or buy are considered.

Manufacturing Equipment

Machines used in factories can include either general-purpose or special-purpose equipment. **General-purpose equipment** requires minimal investment and is easily adapted to various operations. Small machine shops and cabinet shops use this type of equipment, which can be set up to handle two or more shop operations using the same piece of machinery. This offers flexibility, which is most important to industries in which products are so new that the technology is not yet well developed or there are frequent design changes. **Special-purpose equipment**, such as bottling machines and manufacturing robots used in factories, offers a narrower range of possible applications and is more expensive to buy or lease. However, a small firm can use special-purpose equipment economically only if it makes a standardized product on a fairly large scale. Upgrades via special tooling can lead to greater output per machine-hour of operation and reduce the labor cost per unit of product even further. On the downside, though, it is important to remember that this equipment often has little or no resale value, due to its limited range of possible applications.

Retail Equipment

general-purpose equipment
Machines that serve many functions in the production process.

special-purpose equipment
Machines designed to serve specialized functions in the production process.

Small retailers need merchandise-display racks and counters, storage racks, shelving, mirrors, seating for customers, shopping carts, cash registers, and other items to facilitate selling. Such equipment may be costly, but they are usually less expensive than that necessary for a factory operation. And enterprising entrepreneurs often find ways to reduce start-up or expansion costs by purchasing used equipment, making their own, or finding other ways to improvise.

If a store is intended to serve a high-income market, its fixtures should signal this by displaying the elegance and style expected by such customers. Intricately carved antique wood showcases, indirect lighting, thick rugs, and oversized chairs help to communicate luxury to clients. In contrast, a store that caters to lower-income customers should concentrate on simplicity. Luxurious fixtures and plush seating would suggest an atmosphere that is inconsistent with low prices and only add to the cost of the operation, making it more difficult to keep prices down.


TEREKHOV IGOR/SHUTTERSTOCK.COM

Office Equipment

Every business office—even a home office—needs furniture, filing and storage cabinets, and other such items. Major manufacturers of office furniture can certainly provide the necessary desks, chairs, and cabinetry, but so can scores of smaller vendors. Check out local sources of used office furniture, where you may find items that are

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still very presentable but a lot less expensive. And always make your decisions with the future in mind. If you select furnishings that are simple, free-standing, and detachable, you can easily move them all to a larger facility when your business takes off.

Selecting office equipment that can help a business operate efficiently can be challenging. Be sure to choose computers, multifunction printers, and communications systems that reflect the latest technological advances applicable to a particular business.

A company's major equipment needs should be identified in the location plan. This can ensure that the financial section of the plan will include funds for their purchase.

9-2c Business Image

All new ventures should be concerned with projecting the most appropriate image to customers and the public at large. The "look and feel" of the workplace should create an impression that says something about the quality of a firm's product or service and about the way the business is operated in general. For a small firm, and especially a start-up, it is important to use the physical facility to convey the image of a stable, professional company.

Factors as basic as color and interior design should be considered. Even before the first customer shows up, companies sometimes find that their financial backers are unwilling to hand over investment dollars until an office or retail store is perceived as attractive and inviting. If the image aspect of the facility equation is beyond your expertise and insight, you may need to consult a design professional with a trained eye who can help you to make decisions that work.

Image is the engine of sales, so carefully consider how to mold your space to create a distinct and appropriate impression, yet still provide plenty of space, allow easy traffic flow, pass building inspections, and more—all in keeping with your budget and business goals. The way your facility, customers, and employees come together will be critical to the success of your new business. Need some help figuring out how to make the most of available space or deciding how office arrangements might impact collaboration and workflow? You could purchase an office design software package like SmartDraw to help you visualize the possibilities.

9-3 Locating the Start-up in the Entrepreneur's Home

9-3 Recognize both the attraction and the challenges of creating a home-based start-up.

Rather than lease or buy a commercial site, many entrepreneurs choose instead to use their basement, garage, or spare room for their operations, creating a **home-based business**. In fact, the Small Business Administration reports that 60.1 percent of firms that do not hire paid employees are home-based, as are 23.3 percent of small employer firms.[20]

In the past, a home location for a business was almost always considered second-rate. But times have changed. Despite the limitations and potential for image problems, home-based entrepreneurs no longer feel embarrassed about their location. After all, Jeff Bezos started Amazon out of his garage in 1994, and within 30 days he was raking in $20,000 a week in sales![21] Launching a business from home may be viewed as a passing phase on the path to growth for companies like Amazon, but it has become a viable permanent option for an increasing number of start-ups.

home-based business
A business that maintains its primary facility in the residence of its owner.

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Living the Dream

There's Something Fishy about This Home-Based Business

If Jeff Bezos was able to launch a thriving business like Amazon out of his garage, then why couldn't Kenny Lin start his fish and coral venture from his basement?

That's precisely what Lin did—at least for a time. Fascinated with underwater worlds from his childhood in China, his interest in aquatic life continued after his family moved to New York City while he was still very young. But interest transformed into obsession some years later when he was working for a digital-advertising firm. Lin's (then) girlfriend gave him a three-gallon aquarium and some neon tetra fish for his desk. She wanted to bring something from nature into his long hours of work creating ad banners. Little did she know what her simple gesture would set in motion. "That was the fuse," says Lin, as he reflects back on the unanticipated change of his professional path.

Soon, he purchased a bigger tank for his house, which he filled with cichlids and a Bala shark. "After looking at a computer for 12 hours a day," he recalls, "it was very soothing to go home and look at a fish tank." So, when he learned that a friend was giving away a 90-gallon tank, Lin couldn't turn down the offer. It was at that point that he started experimenting with saltwater fish and coral, and with some dazzling surprises.

> *While in natural sunlight, coral usually appears brown—or white, when dead—he discovered that when illuminated with special lights, living coral would light up in brilliant color, turning his aquariums into fluorescent wonderlands.*

These breakthrough experiences turned Lin into something of a self-confessed "reefaholic." After adding a six-foot aquarium to his dining room, he started growing his own corals and swapping his salty creatures (to be precise, corals are animals, not plants) with other hobbyists.

After spending $35,000 in a single year on his underwater fascinations, Lin had a revelation: "I'm thinking, I'm spending all of this money. Who's making this money?" It began to sink in that maybe turning his hobby into a business would be more interesting than waking up as a 50-something still staring at a computer screen and writing code for a living. With the price of some types of corals running from $50 to $300 or more for exotic varieties, Lin concluded that it was time to start planning the launch of his own company.

Lin's venture had a very humble beginning. At first, it was just an online side hustle. But in 2016, he decided it was time to quit his coding job and jump in with both feet. By that time, he was married to his former girlfriend, and the couple had two children. To keep their expenses down while launching the business, Lin and his young family moved in with his parents, where he filled their 400-square-foot basement with his coral-growing operation.

While some ventures can thrive forever as home-based businesses, it became apparent to Lin that operating from home would be far too limiting for the vision he had in mind. So, after scraping together $80,000 in start-up capital from friends and family, Lin and a business partner opened a physical store in Staten Island, New York, which they called Pieces of the Ocean. The first few years were difficult, but the new venture team soon started to get a handle on managing their budding enterprise. In 2020, healthy sales from pandemic-lockdown customers allowed the company to turn a corner financially. The store grossed $650,000 in sales that year, and that trend has continued.

Lin couldn't be happier. Looking across the rows of glowing tanks in the store takes him back to the sense of delight that he found in nature when he was a child. "I love it," he offers. "It doesn't feel like a job." Perhaps he would feel differently if he were still operating from his parents' basement.

Sources: Te-Ping Chen, "Career Reboot: From App Developer to Aquarium Ace," *The Wall Street Journal*, May 2, 2021, https://www.wsj.com/articles/career-reboot-from-app-developer-to-aquarium-ace-11619971200, accessed May 7, 2021; Janet Jacobs, "How Much Does a Saltwater Aquarium Cost? (Full Breakdown)," February 26, 2021, https://www.fishtankreport.com/how-much-does-a-saltwater-tank-cost, accessed May 7, 2021; National Oceanic and Atmospheric Administration, "Are Corals Animals or Plants?" February 26, 2021, https://oceanservice.noaa.gov/facts/coral.html, accessed May 7, 2021; and https://www.piecesoftheocean.com/pages/about-us, accessed May 7, 2021.

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9-3a The Attraction of Home-Based Businesses

Why do many entrepreneurs find operating a business at home so appealing? Motivations vary, but the main attractions of a home-based business relate to financial and family lifestyle considerations, such as the following:

- To get a business up and running quickly, cheaply, and with little risk.
- To do something you love to do, and get paid for doing it.
- To be your own boss, and reap the rewards from your efforts.
- To have the flexibility to spend more time with family and friends.
- To avoid office politics, which often take up a lot of time and can create stress.
- To save time and money wasted on daily commutes.

Financial Considerations

Like most ventures, a home-based business has an important goal—earning money—and locating at home helps increase profits by reducing costs. For example, a freelance writer of magazine articles may need only a computer, a few office supplies, and an Internet connection to launch a business from home. Since most writers own a computer, the true start-up costs for such a business may be only a few hundred dollars.

This option can certainly limit the cost and therefore the risk of testing market demand for a new product or service. With the ups and downs of some industries, locating your business in your home may be the only reasonable approach to take. Starting at home allows you to build your business slowly, without the pressing burden of having to find the cash to cover rent for office space every month and pay other expenses. It even allows you to deduct costs related to space used in the home for business from any taxes that may be owed from the venture's income, as long as you conform to the rules established by the IRS.[22] Once you have clearly established that there is demand for your product or service and you have saved enough money, you can launch something more substantial.

Family Lifestyle Considerations

Many young entrepreneurs set up a family business because of close ties to relatives. Some who locate business operations in their home are motivated by the desire to spend more time with family members—or perhaps just to include them in the work.

Jake Kassan started a T-shirt business at home when he was just 16 and still in high school. But it wasn't long before shipping and accounting demands became overwhelming, and that's when the venture became a true family affair. Desperately in need of help, Kassan turned to his mother, Marla. She had all of the qualities he was looking for in an employee: "She was a quick study, a hard worker, and unusually loyal," he acknowledges. And it didn't hurt that she was willing to work for free!

Marla pitched in to help with Kassan's second start-up, and eventually a third, an online watch retailing business called MVMT. At that point, Kassan decided it was time to start paying his mom a proper salary. As she has taken on more responsibility, Marla's motherly instincts have expanded to match. "She's very protective of the business," reports Kassan. "She never wants to make a mistake."[23]

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It seems that the business created a timely opportunity for more than one member of the family.

9-3b The Challenges of Home-Based Businesses

Just as most businesses with commercial sites have their problems, home-based businesses face special challenges because of their location. We briefly examine two of these issues—business image and legal considerations. A third challenge—family and business conflicts—was discussed in Chapter 5.

Professional Image

Maintaining a professional image when working at home is a major challenge for many home-based entrepreneurs. In most cases, allowing young children to answer the telephone undermines a company's image. Likewise, a baby crying or a dog barking in the background during a phone call can be distracting to a client and discourage sales.

If clients or salespeople visit the home-based business, it is critical that a professional office area be maintained. Space limitations sometimes make this difficult. For example, when you own a home-based business, house guests can create a real problem. Unless you want Aunt Zerelda wandering into a client meeting in her bathrobe or your nephew Jimmie playing his electric guitar during a work call, ground rules need to be set for house guests. Otherwise, major disruptions to the business are bound to occur. But establishing appropriate boundaries between home and business is easier said than done. Consider one home-based business owner's take on this:[24]

> You sleep at home. You work at home. Sometimes it's hard to separate your private life and business life. You … can literally work from early morning until late at night. Your whole life revolves around your work.

So, it's not just a matter of preventing family members from spoiling business opportunities. Your personal life should also be shielded, in reasonable ways, from the creeping reach of the company's operations. The groan of extra car traffic, the presence of strangers (customers and employees) in the house, the inconvenient stacks of inventory and packing materials cluttering common areas—these and many other hassles are everyday fare for the family of a home-based entrepreneur. And they call for patience and an extra dose of understanding from everyone involved.


MONKEY BUSINESS IMAGES/SHUTTERSTOCK.COM

Legal Considerations

Local laws can sometimes pose serious problems for home-based businesses. Zoning ordinances, discussed earlier, regulate the types of enterprises permitted to operate within certain areas, and some cities outlaw any type of home-based business within city limits.

Municipalities have been easing zoning restrictions since the 1990s, but

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the pace of deregulation has recently accelerated. Nonetheless, these zoning laws, some dating as far back as the 1930s, can still create burdensome restrictions for a small business. The intent of such laws is to protect a neighborhood's residential quality by forbidding commercial signs, limiting noise, and preventing parking problems. The neighborhood you live in may have a homeowners' association that can also limit your ability to run a home-based business. Some entrepreneurs first become aware of these zoning laws when neighbors complain or initiate zoning enforcement actions.

As mentioned earlier, there are tax issues related to a home-based business. For example, a separate space must be clearly devoted to the activities of the business if an entrepreneur is to claim a tax deduction for a home office. A knowledgeable accountant can help explain these tax regulations.

And don't forget the insurance considerations that may affect a home-based business. A homeowner's policy is not likely to cover an entrepreneur's business activities, liabilities, and equipment. Therefore, they should always consult a trustworthy insurance agent about policy limitations and consider adding supplemental coverage to fill in any gaps. This may help to avoid unpleasant surprises down the road.

The bad news for home-based businesses is that they often face significant concerns and restrictions, such as those just outlined. The good news is that these ventures now have access to powerful business-application technologies that can help them compete, even against rivals with a commercial site. With this in mind, we examine Internet opportunities for new businesses in the next section.

9-4 E-Commerce: Locating a Start-up Online

9-4 Understand the potential benefits of locating a start-up online.

We are all very familiar with the term *e-commerce*, but what does it really describe? E-commerce refers to electronic commerce, or the buying and selling of products or services on the Internet. Online businesses are now growing in new ways and faster than ever—and with good reason. Having a presence online can fundamentally reshape the way small firms conduct business. Far more than a simple alternative to the physical facility, locating a start-up online can significantly boost the company's financial performance.

9-4a Benefits of E-Commerce for Start-ups

Electronic commerce can benefit a start-up in many ways. It certainly allows a new venture to compete with bigger businesses on a more level playing field. Because of their limited resources, small firms often cannot reach beyond local markets. So those small firms confined to a "brick-and-mortar world" typically can serve only a restricted region. But the Internet blurs geographic boundaries and expands a small company's reach. In fact, e-commerce allows any business to have access to customers almost anywhere in the world.

The experience of Beauty Encounter, a company that sells perfumes and beauty products, shows how the Internet is a great equalizer, giving small firms a presence comparable to that of marketplace giants. The business is an extension of three physical stores that were started by a Vietnamese couple who immigrated to the United States in 1980. Their daughter, Jacquelyn Tran, recognized the limitations of such operations and decided to carve out her own space in the global marketplace by establishing an online presence in 1999. Since then, the company has done nothing but grow. It now

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offers 20,000-plus products representing more than 1,000 brands, with new items being added daily, proving that small companies now can play in the big leagues.[25] An online presence can unlock the door of opportunity for such ventures, regardless of the industry.

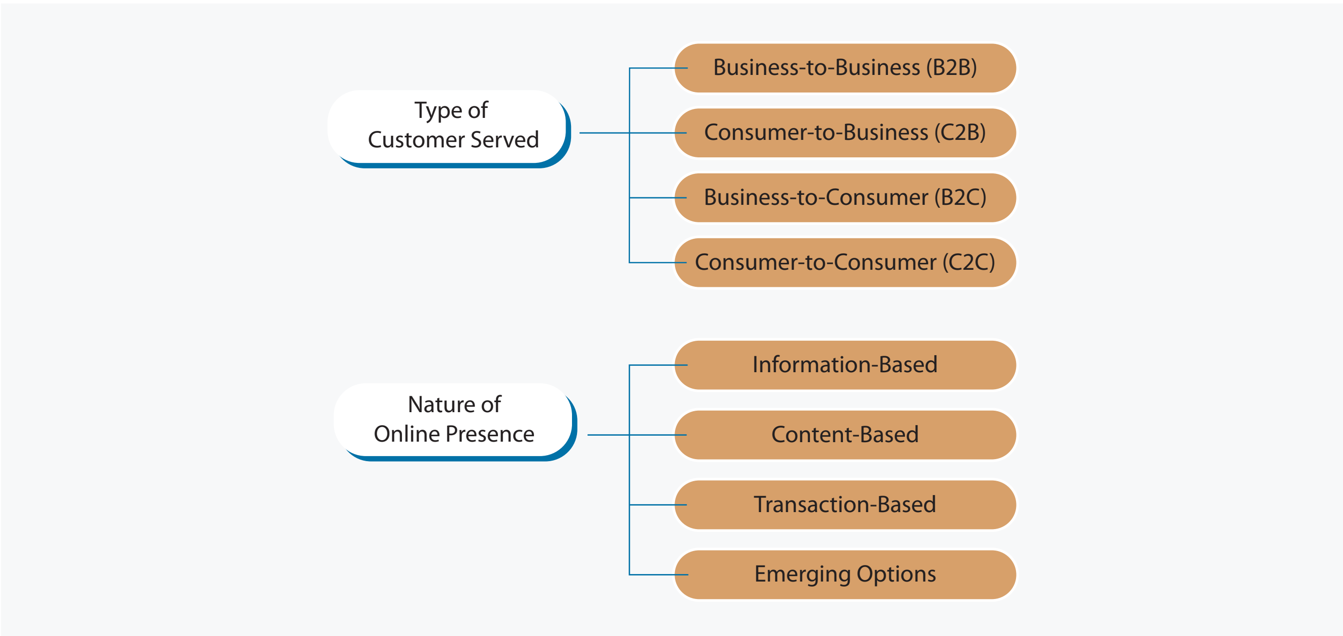
It should also be pointed out that an e-commerce operation can help the start-up with early cash flow problems by compressing the sales cycle—that is, reducing the time between receiving an order and converting the sale to cash. E-commerce systems can be designed to generate an order, authorize a credit card purchase, and contact a supplier and shipper in a matter of a few minutes, all without human assistance. The shorter cycle translates into quicker payments from customers and improved cash flows to the business.

9-4b E-Commerce Business Models

One of the fundamental features of an online operation is the business model upon which it is built. As discussed in Chapter 6, a business model is an analysis of how a firm plans to create, deliver, and capture value, focusing on the financial outcomes of strategic decisions and activities that will determine profits and cash flows. Online companies differ in their decisions concerning which customers to serve, how best to become profitable, and what to include on their websites. Exhibit 9.3 shows some possible alternatives for e-commerce business models. None of these models can currently be considered dominant, and some of the more complex Internet operations cannot be described by any single form. In reality, the world of e-commerce contains endless combinations of business models.

To help you grasp the possibilities, we first outline e-commerce business models according to the type of customer served and then describe models based on the nature of a company's online presence. As you consider a direction for your small business and its online aspirations, keep in mind that a poorly devised business model is often the primary cause of an online company's failure.

Exhibit 9.3 Basic E-Commerce Business Models



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Type of Customers Served

Marketing frameworks classify companies operating from traditional physical facilities as manufacturers, wholesalers, or retailers, depending on the customers they serve. E-commerce businesses also are commonly distinguished according to customer focus. There are four major categories of e-commerce business models: business-to-business (B2B), consumer-to-business (C2B), business-to-consumer (B2C), and consumer-to-consumer (C2C). In this section, we examine some strategies used by e-commerce firms within these four categories.

Business-to-Business Models The dollar amounts generated by firms using a **business-to-business (B2B) model** (selling to business customers) are significantly greater than those for firms with a business-to-consumer (B2C) model (selling to final consumers). Because B2B success stories generally receive less publicity than B2C ventures do, the potential of these business-focused opportunities is often overlooked. But aspiring entrepreneurs should be sure to consider B2B options.

B2B operations come in all shapes and sizes, but the most popular form of this strategy emphasizes sales transactions. By using online capabilities, a B2B firm can achieve greater efficiency in its buying and selling activities. For example, because it deals directly with its business clients online, Dell is able to build its computer systems and related products to meet the specific needs of its customers. The company relies heavily on the Internet to deliver its business solutions, but it also has an extensive sales force and IT consulting services to deliver value to its many customers worldwide.

Consumer-to-Business Models Some online ventures adopt what e-commerce experts call a **consumer-to-business (C2B) model**, even if almost by accident. This would include the countless individual bloggers, publishers, YouTube posters, and other content creators who choose to sign on with affiliate marketing services (explained in greater detail later in this chapter). Merchants participating in these programs pay such online influencers to drive their audiences to the sellers' websites, basing the amount of compensation on the volume of traffic delivered. This creates potential sales for merchants, which is why they are willing to reward the individual affiliates.

Consumer-to-business models can also apply to work outsourcing for freelancers and other specialists who have a "side hustle" and want to get connected with companies that will pay for their services. The model may not apply as readily to independent service providers who look to their work as a primary source of income, an orientation that might arguably be more consistent with a B2B classification. In any case, these options reflect opportunities arising from the rapidly expanding gig economy that was described in Chapter 4. Online work-outsourcing marketplaces are increasing in number and availability, with some of the better-known services in this category including Freelancer.com, Gigster.com, Guru.com, PeoplePerHour.com, and Upwork.com, along with many others.

To be clear, the flow of online traffic goes both ways as these sites also allow businesses to find, hire, manage, and pay remote contractors. The market for global talent is as close as your computer! Just as work-outsourcing marketplaces help freelancers reach the clients with which they would like to work, they can also help entrepreneurs locate the support services necessary to improve their own operations. These advantages can easily translate to sales growth and an improved bottom line.

Business-to-Consumer Models The **business-to-consumer (B2C) model** focuses on sales of products or services to final consumers and has been perfected by online superstars like Amazon, Apple, and Best Buy. B2C ventures sell a wide variety of products, with offerings ranging from clothing to pet items, computer software to groceries, and

business-to-business (B2B) model
A business model based on businesses selling to business customers electronically.

consumer-to-business (C2B) model
A business model based on individual freelancers or affiliate marketers selling their services to business customers.

business-to-consumer (B2C) model
A business model based on selling to final consumers electronically.

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much more. The B2C model offers three main advantages over traditional retailing: convenient use, immediate transactions, and round-the-clock access to a broad array of products and services.

Opening up an online business has never been easier, thanks to the "online storefront" option and support services offered by giant operators like Amazon, eBay, and Walmart Marketplace. But some small business owners prefer to avoid big Internet marketplaces and establish their own presence online.

A number of e-commerce platform providers now make it relatively easy for even a one-person online store to appear to be a polished, sophisticated retail operation. Some of the most popular of these providers include BigCommerce, GoDaddy, Shopify, Square Online, Wix, and 3dcart, which specialize in helping people set up their own virtual storefronts. These companies typically charge from around $10 to $30 a month for their services (some packages cost a lot more and a few are free, but be sure to read the fine print), with some additional transaction fees that range from 0.5 to 3 percent of sales. But they make getting started a snap: Sign up and select a name, choose one of the preset designs and themes, upload images of products to be offered, and then let the selling begin. Most of these services even provide a dashboard that allows small business owners to gauge the number of orders and examine sales analytics. These powerful tools can deliver impressive results.[26]

No matter which platform they adopt, B2C e-commerce businesses certainly face unique challenges, including how to manage payment security risks and data breaches, customers who refuse to purchase a product without first seeing it or trying it on, and more. But they also enjoy tremendous flexibility. For example, they are able to change merchandise mixes and prices quickly, and they can easily modify the appearance of their online store. Traditional merchants located in physical stores would find such changes to be very costly and time-consuming, making it nearly impossible for them to keep up with fast-moving markets.

Many producers and wholesalers today are choosing to bypass retailers and take their product or service directly to the final consumer through online operations, a strategy sometimes referred to as **disintermediation**. This decision is driven mostly by the increasingly slim margins that they get when selling through big retailers. And the model can work like a charm—consider Casper Mattress, Hubble Contacts, and Warby Parker.

When Andres Niño and Nicholas Hurtado launched Beckett Simonon in 2012, it was with the specific intent to offer their line of handcrafted men's shoes directly to the end user. Their online-only sales model allows them to offer shoes for around $200 that would normally cost $600 if they were sold through a traditional retail sales channel—and also to provide a much higher level of customer service. The owners explain their unique perspective and business philosophy:[27]

> Retailers know a large percentage of the shoes … offered in stores will not sell. So, what they do sell needs to support the entire operation. This system affects not only the prices you pay, but also the producers and the planet. There's a lot of waste, plus the quest for high-profit margins usually comes at the expense of factory workers' dignity and safety. This makes no sense to us.

Because Beckett Simonon's shoes never go into production until a customer orders a pair, the company is able to reduce costs and free up cash flow. These savings are passed along to the customer, who enjoys what is essentially the wholesale price. The company's sales have been growing rapidly, showing that its concept may be right on the money. That's the power of the online option—it offers market reach and flexibility that would not otherwise be available.

disintermediation
The bypassing of retailers by a producer or wholesaler in order to sell its product or service directly to the final consumer.

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As B2C e-commerce models continue to develop and evolve, new alternatives will emerge, which is bound to catch established rivals off guard. Even some very large competitors find it difficult to keep up online. For example, Google's creative service offerings have forced Microsoft to reconsider how it prices its software, and full-service travel agencies are still trying to figure out how to adjust their approaches to deal with online competitors like KAYAK and CheapOair. An alert entrepreneur will monitor movement in the marketplace to be able to respond quickly to potential risks and identify emerging opportunities.

Consumer-to-Consumer Models A growing number of entrepreneurs who sell their wares online do so without creating either a website or a storefront. Instead, they use **auction sites**, which fall under what is sometimes called the **consumer-to-consumer (C2C) model**. This model is usually set up around online marketplaces that allow individuals to list products available for sale to potential bidders.

Online auctions have become one of the most celebrated success stories on the Internet. And eBay, founded in 1995 by computer programmer Pierre Omidyar, is the 900-pound gorilla of auction sites. According to eBay's Fast Facts for investors, the company has more than 159 million active buyers and 19 million sellers around the world who transact business through the site's 1.5 billion live listings at any given time. It may also surprise you to know that more than $22.1 billion worth of merchandise was sold on eBay during one recent three-month period.[28] That works out to a mind-blowing $2,811 in goods *every second*.

You can buy or sell nearly anything on eBay, and it's incredibly easy. Auction-site consultants can coach you on how to become a successful seller—for a fee, of course. But you can also find a wealth of free information on eBay's website that will teach you about the ins and outs of operating a business using their platform.

To show you how simple it is to get started, Exhibit 9.4 outlines a four-step procedure for selling items on eBay. As easy as it is to sell a few items on eBay, it is a very different matter to actually make money as an ongoing business on the site. As in the more conventional forms of retailing, a well-thought-out business plan is helpful in turning your business idea (or hobby) into a money-making proposition.

Auction sites like eBay generate most of their revenue through listing fees and transaction charges. To continue its growth, eBay has been leaning into product categories where it used to have unquestioned strength, including sneakers, luxury watches, and refurbished or used parts. Analysts point to tell-tale signs of the company's renewed focus:[29]

> [E]Bay launched an authentication program for luxury watches (priced $2,000 and above) and sneakers ($100 and above) to prevent counterfeits and other fraudulent practices on these items. The marketplace also launched new marketing campaigns around these segments, including a campaign on social network TikTok for sneakers that generated 4.7 billion views.

auction sites
Web-based businesses offering participants the ability to list products for consumer bidding.

consumer-to-consumer (C2C) model
A business model usually set up around online auction sites that allow individuals to list items available for sale to potential bidders.

Exhibit 9.4 Selling Your Item on eBay

Step 1: Set up an eBay seller's account, which is free of charge.
Step 2: Create a listing for the item to be offered for sale.
Step 3: Manage your listing: Determine whether anyone has bid on or purchased your item, revise your listing (if needed and when listing rules allow this), and answer questions about the listing from potential buyers.
Step 4: Wrap up the sale by communicating with the buyer, receiving payment, shipping the item, and leaving feedback for the purchaser.

Source: Adapted from "Getting Started Selling on eBay," http://pages.ebay.com/help/sell/sell-getstarted.html, accessed January 22, 2018.

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These were helpful moves as the company is no longer the only show in town. Today, eBay faces competition from the likes of Bonanza.com, eBid.net, Etsy.com, and a number of other aggressive challengers.

The company has also been taking steps to expand the eBay Stores side of its business, which gives sellers access to millions of shoppers worldwide. This option helps commercial sellers achieve success by providing powerful tools to help them build, manage, promote, and track their eBay presence. They also enjoy other advantages, like more free listings and lower final value fees than those who sell on the site without a store. To sweeten the deal, eBay offers different levels of stores—like Starter, Basic, and Premium—with a subscription-fee structure that best suits the specific needs of sellers.[30]

The Nature of Online Presence

A second broad way of categorizing e-commerce models relates to a firm's intended level of online presence (refer to Exhibit 9.3). The role of a website can range from merely offering information and basic content to enabling complex business transactions, as we discuss in the following sections.

Information-Based Model A website built on the **information-based model** offers only information about a business, its products, and other related matters. It is typically just a complement to an existing street-side operation. Many small businesses use this model for their online operations. Your dentist or plumber may have a website that simply describes the services offered but probably will require a phone call to set up an appointment. These sites often feature a "Contact Us" link that will take the user to a separate Web page displaying the company's address and phone number and, in many cases, offer "click-through" access that allows the user to get in touch with the business via email.

The Internet has become the first stop for consumers who need information on a local business. So, it makes sense for small companies to create websites that can then be picked up by consumer searches. Businesses should also be listed on local platforms offered by major search engines. This can be done on Bing Places for Business, Google My Business, Yahoo, YellowPages.com, and dozens of other alternatives, which can easily be found by searching for "business directories" online.

Content-Based Model The **content-based model** of e-commerce is a variation of the information-based alternative in that it also features a website that provides access to information but not the ability to make purchases. Rather than selling products or services, a content-based website provides information (content) for those who visit it, usually with the hope of attracting a healthy stream of visitors.

In most cases, this online traffic can be monetized (turned into a source of revenue), assuming that is what the website creator has in mind. For example, it is easy enough to have Google place ads or banners on your website; you would then earn money each time a visitor clicks on them (refer to google.com/adsense for details). Ad revenue is usually disappointingly low, but another option is to become an online affiliate. Affiliate marketing programs (sometimes called *associates programs*) arrange for online merchants to pay a commission to websites for any traffic that those sites send to them. For example, Amazon's Associates Program pays referral fees of up to 10 percent on qualified sales of its products that are initiated through links on an affiliate's website. As a bonus, the program is easy to use, and the company will show you countless options for building links and ads for Amazon products on your site.[31] But this is just one example of hundreds of affiliate programs that you could choose to join.

information-based model
A business model in which a website simply offers information about a business, its products, and other related matters.

content-based model
A business model in which a website provides information (content) that attracts visitors, usually with the hope of generating revenue through advertising or by directing those visitors to other websites.

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Transaction-Based Model In a **transaction-based model** of e-commerce, a website is set up to provide a mechanism for buying or selling products or services. The transaction-based model could be considered the center of the e-commerce universe, with online stores where visitors go to shop, click, and buy.

Countless Internet start-ups sell products or services that have a definite focus. For example, Bernie Rothrock had an alpaca ranch fall into his lap, and he had to figure out something to do with the alpacas' sheared wool. He decided to use it to make socks, which are exceptionally soft and warm. The socks can be purchased through a dedicated website (maximusandpenelope.com), which Rothrock named after two of the alpacas on the ranch.[32]

Other ventures are direct extensions of a physical store, creating what is sometimes called an omnichannel retail strategy. If you want to purchase a new printer, for instance, you might research options on Office Depot's website and then either buy your selection online or pick up the printer at your neighborhood Office Depot store. Although Office Depot is a large corporation with millions of customers, many small businesses are following the same general model, and with excellent results.

Many e-commerce companies generate a lot of sales by merging the content- and transaction-based models into one website. Launched in 1999, Bodybuilding.com asserts that it is the largest online fitness store in the world. The endless volume of educational content on the site, most of which promotes products that are sold through its transaction features, attracts more than 33 million unique visitors each month.[33]

However, this raises a thorny ethical question: How can an online company feature content that is so closely tied to its own products? To maintain integrity in this situation, the company should be transparent and make sure that all claims are legitimate. After all, the long-term performance of the company will depend on it.

According to David Grubbs, who has started and operated more than two dozen online businesses across a number of different industries, Internet entrepreneurs who want to achieve extraordinary results must be sure to emphasize three things:[34]

1. *Be authentic and truthful about your brand, your products/services, and the benefits and features they offer.* Honesty about what the business can and cannot deliver will be received as a breath of fresh air to consumers today, and that authenticity can help build a loyal base of customers who keep coming back for more.
2. *Develop personal and lasting relationships with customers*. Having an open dialog with customers enables businesses to adapt quickly online and ensure they are in-step with users' needs.
3. *Understand, at a very deep level, the digital metrics that matter and constantly test the website to improve them*. Online competition is fierce and ever-changing, so online brands only grow if they identify what is critical to measure and then develop the discipline of constant testing in relentless pursuit of optimal website performance.

The term *metrics* here simply refers to a website's key performance indicators that determine its efficiency in converting visitors to paying customers. Internet entrepreneurs watch these very closely. Crucial metrics to keep an eye on include factors like click-through rates (the ratio of total visitors to those who click on a link), conversion rates (the percentage of total visitors who actually respond to a website's offer), and earnings per click (average revenue generated each time a visitor clicks on a link), among several others.

transaction-based model
A business model in which a website provides a mechanism for buying or selling products or services.

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It follows that entrepreneurs who create the greatest benefit for their customers and treat them honestly and fairly are far more likely to succeed. Websites that make false or overstated claims are usually short-lived, as the news of their misdeeds spreads quickly on social media. As with traditional operations, enduring and impactful online businesses must have integrity and deliver genuine value to their customers.

Emerging Options The Internet world is known for how fast it moves, and entrepreneurial minds are constantly finding new ways to cash in on its potential. In most cases, these are variations on the content-based model discussed earlier.

Blogs are online journals created to trade comments with friends and other readers, but they can also be managed as a money-making venture. Small firms have found blogs easy to use and thus an attractive platform from which to promote the sale of an overstocked item or to give an employee special recognition. But Web traffic on a blog can also generate considerable income from advertising and paid links. The amount earned is dependent on such factors as how much traffic the site generates, the trustworthiness of the content offered, and how relevant the ads are to those who visit.

Podcasts, the audio or video files that are distributed online, have 68 million listeners every week in the United States alone.[35] Comedian, former radio personality, and multimedia ranter Adam Carolla launched his podcast venture in 2009 and now records humorous, sometimes offensive, episodes that he archives online. Millions of listeners tune in each month to hear what he has to say (he actually set the record as the "most downloaded podcast"), and that translates to substantial profits.[36]

Carolla and other podcasters make money in a number of different ways, such as by peddling ads and sponsorships, asking for donations, selling subscriptions, and charging for access to live events. Popular shows can generate $15 million a year in ad revenue alone, but smaller names can still carve out a decent business. For example, the monthly take for a podcast series about the history of New York City called *The Bowery Boys* runs around $3,800, while *The Podcast on the Left* grosses more than $57,000.[37]

The reach of *YouTube videos* can be exploited to create a following that can be turned into profit. YouTube offers a Partner Program that allows content creators to show advertisements on their videos and split with YouTube the $3 to $5 that advertisers pay for every 1,000 views (55 percent going to publishers).[38] One recent analysis revealed that the top 10 YouTube stars each received from $15 million to $29.5 million annually just from advertising.[39] But that's only the beginning of the profit potential the platform can lead to.

Online style guru Michelle Phan is but one example of the many entrepreneurs who have created something of a small business empire from their YouTube celebrity. Phan used the platform to push her book to best-seller status, introduce her own L'Oreal cosmetics line, promote a beauty sampling start-up called Ipsy (which she later sold), and launch a handful of other ventures.[40] Others have tapped into the platform's reach to promote crowdfunding campaigns, to push original content to go viral so that media outlets will pay to use it, or to make residual income as an affiliate marketer for brands that can push products through their channel.[41] Entrepreneurs clearly can generate income from YouTube in a number of ways.

Other social media platforms that are likely to offer the greatest income potential include Facebook, Instagram, Pinterest, TikTok, and Twitter. You can certainly use these and a growing number of other social media tools to promote your small business (more on this in Chapter 17). But the point here is that you can build a great business *within* these platforms, too. In other words, many of the opportunities that can be created from a well-crafted YouTube presence (affiliate marketing, selling digital products, publishing sponsored posts, etc.) apply to these other options, too. As these examples demonstrate,

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Living the Dream

Getting Fired Up about Podcasting

"Your big idea is not either/or," explains former army veteran and somewhat unconventional entrepreneur John Lee Dumas. "It's not something you are passionate about *or* something you have expertise in. It's both. Your big idea needs to be a combination of your passion and your expertise."

Dumas should know because this is the formula that led him to introduce a podcast in 2012 called *Entrepreneurs on Fire* that today pulls in an audience of more than a million people each month. He started out with the modest vision of providing free content that would be of interest to listeners. Little did he know that just over a year later the venture would be throwing off six figures in monthly revenue! And it bears mentioning that Dumas's podcasting has served as a launchpad for other highly profitable outcomes, including sales of his insightful book, *The Common Path to Uncommon Success*.

Though Dumas has landed on his entrepreneurial feet, the professional path that led to this point was not so straightforward. He describes his journey as a time of great frustration.

> After I graduated from high school, I applied for a ROTC military scholarship so my parents wouldn't have to pay for my college. I spent four years at Providence College and in my senior year, 9/11 happened. One year later I was commanding a tank platoon with four tanks and 16 men in Iraq. We were getting shot at and seeing death, and only 12 of us made it back. It was incredibly traumatic.
>
> When I finished my active duty, I began what I called my "six years of struggle." I still had these skewed beliefs of what I thought success was, which was a lot of money, so I made bad decisions searching for that. I was also struggling with PTSD.
>
> I applied to law school because I thought it would make my family proud and because I saw that it had brought my dad financial independence. But I was miserable there. The PTSD made it difficult to focus and do the work, so I dropped out after one semester. Then I tried corporate finance, residential real estate, and commercial real estate. Nothing worked.

Nothing, that is, until he found his way into podcasting. That step took him through a doorway to a wide-open world of opportunity!

In his podcasts, Dumas has interviewed more than 3,000 entrepreneurs, including many of the big names in success circles—people like Barbara Corcoran, Tim Ferriss, Seth Godin, Tony Robbins, and Gary Vaynerchuk. His goal all along has been to "teach people how to find their next big idea so they can wake up every day and live in their zone of fire," which, to Dumas, means "doing something that lights them up and excites them."

Based on the financial success that Dumas has enjoyed, it is reasonable to conclude that his podcast is filling a sizeable need. The venture and others that have spun off from it have been bringing in more than $2 million a year since 2013. But Dumas concedes that his business could have grown even more. "That's the life I've created," he states unapologetically. "I'm not willing to work ten times harder to make two times more. That's not the equation I want to live."

A fundamental principle of living a fulfilling, successful life is knowing when to say enough is enough. Dumas obviously has figured this out. But the question would never have come up in the first place were it not for his podcast.

Sources: Celinne Da Costa, "How This Entrepreneur Built an Award-Winning Podcast and a Seven-Figure Empire by Becoming a Person of Value," *Forbes Women*, March 18, 2021, https://www.forbes.com/sites/celinnedacosta/2021/03/18/how-this-entrepreneur-built-an-award-winning-podcast-and-a-seven-figure-empire-by-becoming-a-person-of-value, accessed April 30, 2021; Fire Nation, "About Entrepreneurs on Fire," https://www.eofire.com/about, accessed April 30, 2021; and John Lee Dumas, *The Common Path to Uncommon Success: A Roadmap to Financial Freedom and Fulfillment* (Nashville, TN: Harper Collins Leadership, 2021).

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new online business concepts are being created all the time, and alert entrepreneurs are finding ways to make the most of them.

9-4c Online Businesses and the Part-Time Start-up Advantage

When an entrepreneur launches a new company, many times they must decide whether to give up an existing job and work full-time with the start-up or hold on to the job while getting a part-time business going on the side. There are advantages and drawbacks to each approach, of course, but the upside to keeping your day job is considerable. One writer put it this way:[42]

> If you've quit your job and have no savings to fall back on, things could get real ugly real fast. You may face eviction. Creditors may seize your assets. Debt from unpaid taxes to the Internal Revenue Service may quickly pile up, leading to wage garnishment of any employment you hold. Your parents' couch is suddenly in your near future…. [It's better to] test things out and make adjustments based on the results. Then, when you have a source of income you can rely on, make plans to leave your job at a time that makes sense.

Research has reported that, indeed, many entrepreneurs prefer to launch a part-time enterprise to keep the income flowing until they can afford to make a complete transition to the new business. This is especially true for those who tend to be more risk averse and less self-confident.[43] Although many kinds of businesses can be started on a part-time basis, a growing number of small business owners are finding that the flexibility and low cost of launching an online business make this a very attractive option. Others are choosing to stay in the part-time lane by participating in the gig economy that was mentioned in Chapter 4.

Keeping a foot in both worlds may be advantageous and satisfying, but holding on to a full-time career while launching a new venture on the side can be extremely grueling. It is not at all unusual for these hardy souls to work 90 to 100 hours a week while the company is in its start-up phase, with only about half of those hours being spent in regular employment. In other words, a "part-time" business has a way of tying up weekends and evenings, and it may take years to grow the start-up to the point where the founder(s) can afford to set aside regular employment and work for the new company full time.

On the upside, the part-time approach can reduce the risk of making the transition to life as an entrepreneur, with research showing that such ventures tend to survive longer than those launched by owners who chose to jump in with both feet from the start.[44] But perhaps more important to our discussion here, the Internet is often the enabling platform that makes it possible to convert these part-time start-up dreams into a full-time entrepreneurial reality.

Clearly, the location decision is complicated, but it is extremely important to get it right. Many questions need to be answered, but there are also many sources of information to help you decide on the location that will work best for your planned venture. Don't get impatient—take your time, do your research, and make a wise choice. A world of endless business opportunities awaits you.

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9-1. Describe the five key factors in locating a start-up in a physical facility.

- Customer accessibility is a key location factor in industries with high transportation costs, as well as those that must provide handy access for targeted customers to avoid losing those customers to more conveniently located competitors.
- Business environment factors affecting the location decision are climate, competition, legal requirements, and tax structure.
- Availability of resources such as raw materials, suitable labor, crucial suppliers, and transportation can be important to location decisions.
- Though it can interfere with sound decision making, the entrepreneur's personal preference is a practical consideration in selecting a location.
- An appropriate site must be available and priced within the entrepreneur's budget.

9-2. Discuss the challenges of designing and equipping a physical facility.

- The general suitability of a building depends on the functional requirements of the business; it should be neither too large and extravagant nor too small and restrictive.
- The comfort, convenience, and safety of the business's employees and customers must not be overlooked.
- Deciding whether to purchase or lease equipment is an important choice many entrepreneurs face.
- Most small manufacturing firms must use general-purpose equipment, but some can use special-purpose equipment for specialized operations.
- Small retailers must have merchandise display racks and counters, storage racks, shelving, mirrors, shopping carts, cash registers, and other equipment that facilitates selling.
- Fixtures and other retailing equipment should create an atmosphere appropriate for customers in the retailer's target market.
- Entrepreneurs should choose office equipment (like computers and communications systems) that reflect the latest advances in technology applicable to a particular business.
- All new ventures, regardless of their function, should project an image that is appropriate to and supportive of the business and its intentions.

9-3. Recognize both the attraction and the challenges of creating a home-based start-up.

- Home-based businesses are started both for financial reasons and to accommodate family lifestyle considerations.
- Operating a business at home can pose challenges beyond family and business conflict, particularly in the areas of professional image and legal considerations.
- Technology has made it possible to operate many types of businesses from almost any location.

9-4. Understand the potential benefits of locating a start-up online.

- E-commerce offers small firms the opportunity to compete with bigger companies on a more level playing field.
- Internet operations can help small firms with early cash flow problems by compressing the sales cycle.
- Business-to-business (B2B) companies generate far more sales than ventures following alternative models.
- Similar in some ways to B2B trade, consumer-to-business (C2B) models help freelancers and other specialists link up with companies that need their services, creating mutually beneficial connections.
- The three main advantages of online business-to-consumer (B2C) firms are convenient use, immediate transactions, and continuous access to a variety of products and services.
- Internet auction sites, like eBay, are based on the consumer-to-consumer (C2C) model and can help even the smallest of businesses access a worldwide market with great convenience.
- The role of a website can range from merely offering information and content to permitting the buying and selling of products and services online.

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- Emerging platforms for online ventures include blogging, podcasting, and creating a following on YouTube or other social media platforms to generate revenue from ads and sponsorships, donations, subscription charges, or fees for access to live events.
- Internet-based businesses can be started on a part-time basis, which reduces the personal risk of the entrepreneur if the venture should fail.

Key Terms

auction sites p. 237
business incubator p. 224
business-to-business (B2B) model p. 235
business-to-consumer (B2C) model p. 235
consumer-to-business (C2B) model p. 235
consumer-to-consumer (C2C) model p. 237
content-based model p. 238
disintermediation p. 236
general-purpose equipment p. 228
home-based business p. 229
information-based model p. 238
special-purpose equipment p. 228
transaction-based model p. 239
zoning ordinances p. 222

Discussion Questions

1. What are the key attributes of a good business location? Which of these would probably be most important for a retail location? Why?
2. Which resource factors might be most vital to a new manufacturing venture that produces residential home furniture? Why?
3. Is the hometown of the business owner likely to be a good location? Is it logical for an owner to allow personal preferences to influence a decision about business location? Explain your answers.
4. Under what conditions would it be most appropriate for a small business to buy rather than lease a building for its operations?
5. What are the greatest challenges that a small business is likely to face when designing its physical facilities? What are the advantages and disadvantages of open-office configurations?
6. What factors should an entrepreneur evaluate when considering a home-based business? Be specific.
7. How might zoning and tax laws impact the decision to start a home-based business?
8. Describe B2B, C2B, B2C, and C2C business models, pointing out conditions under which they might be most useful.
9. What are the primary features of the information-based, content-based, and transaction-based models of e-commerce? Which of these offers the greatest business potential? Explain your answers.
10. What are some of the emerging options for making money in an online business? Which of these has the greatest potential for profits and long-term growth?

You Make the Call

Situation 1

Entrepreneurs Joe Stengard and his wife, Jackie Piel, had a decision to make. Located just outside of St. Louis, Missouri, their five-year-old company, S&P Crafts, was growing rapidly, and they were in desperate need of more space to make their custom-ordered craft kits.

A move always involves a certain measure of risk, so the couple was hesitant to transfer the company's operations. However, an economic development organization in Warren County, Missouri, offered attractive incentives in the form of tax breaks and financial assistance if they would move to a new facility in the rural town of Hopewell. Initial research indicated that a local workforce was readily available and had skills appropriate to the operation, so Stengard and Piel decided to move.

Since the change of address, company sales have tripled. And the new facility has grown from 10,000 square feet to 40,000 square feet in just two short years.

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Question 1 How important was the location decision for these two entrepreneurs? Why?

Question 2 What types of permits and zoning ordinances did Stengard and Piel likely need to consider before deciding to relocate?

Question 3 How could Stengard and Piel use the Internet to expand their business?

Situation 2

You may be noticing a lot more "pop-up stores" opening up these days. They may look like regular stores, but they are open for only a few months—and that is by design. But these small shops can have a significant impact on local economies, especially during the holiday rush.

Small business owners use pop-up stores for a number of reasons, such as to spread the word about a brand, to test a new line of products, or to try out a new sales channel. Ashley Johnson took this step to increase exposure for her company and its products. Johnson is owner of Fairway Fine Fashions, a company that sells to "female golfing enthusiasts who crave the best-designed, best-made, and most fashionable golf apparel on the planet." To rev up sales, she joined a few other fashion designers and launched a pop-up store on Chicago's Michigan Avenue, a trendy shopping area. The 16-day pop-up was all about exposure—that is, getting new customers to notice her designs so that they might become long-term buyers in the years ahead. Johnson is counting on this move to drive new sales at her website.

Question 1 What are the major advantages that Johnson is likely to enjoy as the result of operating out of a pop-up store?

Question 2 What are the major disadvantages and special challenges that the company is likely run into as a result of following this strategy?

Question 3 Do you think it was a good idea for Johnson to try this approach? Can you think of any other options that might have worked better for her?

Situation 3

Eliza Roundtree, a single parent, wants to start an interior design business to help support her two young children. She works in the banking industry but has always had a desire to start a business. She enjoys decorating her own home and is often asked, "Have you ever considered doing this professionally? You have such a good sense of colors and how they blend together with fabrics, furnishings, and design."

Roundtree is unsure whether she should locate in a commercial site or in her home, which is in a city of 16,500 in rural central Texas. She is leaning toward locating at home because she wants more time with her children. However, she is concerned that the home-based location is too far from the closest sizeable city (about 45 miles away), which is where most of her potential customers live.

Initially, her services would include planning for mid-market residential interior design projects, which would involve estimating project options and costs and consulting with clients on colors, fabrics, and furnishings. Eventually, she would like to specialize in creating luxury interiors for owners of upscale homes. But she has a lot to learn before she will be ready for that.

Question 1 What are some potential problems that Roundtree will face if she locates her new business at home?

Question 2 What do you consider the major benefits of a home-based business for Roundtree?

Question 3 How could Roundtree use technology to help operate a home-based business?

Experiential Exercises

1. Search for articles online that provide rankings of states or cities as business locations. What definite trends do you notice? Report on your findings.
2. Identify and evaluate a local site that is now vacant because of a business closure. Point out the strengths and weaknesses of that location for the former business, and comment on the part that location may have played in the closure.
3. Interview a small business owner concerning the strengths and weaknesses of their business's location. Prepare a brief report summarizing your findings.
4. Think of a local small business that you believe might benefit from adding e-commerce as a supporting feature of its strategy. Prepare a report on the reasons this particular business is not involved in e-commerce, and recommend an e-commerce strategy that would help to boost its performance.
5. Do some research online to determine what e-commerce assistance is available to small firms. Report on your findings.

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Business Plan

LAYING THE FOUNDATION

As part of laying the foundation for preparing your own business plan, respond to the following questions regarding location.

Physical Start-up Location Questions

1. How important are your personal reasons for choosing a location?
2. What business environment factors will influence your location decision?
3. What resources are most critical to this decision?
4. How important is customer accessibility to your location decision?
5. How will the formal site evaluation be conducted?
6. What laws and tax policies of state and local governments need to be considered?
7. What is the cost of the proposed site?

Physical Facility Questions

1. What are the major considerations in choosing between a new and an existing building?
2. What is the possibility of leasing a building or equipment?
3. How feasible is it to locate in a business incubator?
4. What is the major objective of your building design?
5. What types of equipment do you need for your business?

Home-Based Start-up Location Questions

1. Will a home-based business be a possibility for you?
2. For the venture you are planning, what would be the advantages and disadvantages of locating the business in your home?
3. Have you given consideration to family lifestyle issues?
4. Will your home project the appropriate image for the business?
5. What zoning ordinances, if any, regulate the type of home-based business you want to start?

Online Start-up Questions

1. What type of customers will be served by the online start-up?
2. What technical limitations (such as the cost of designing and developing a website or constantly changing software needs) might hinder the company you plan to launch?
3. How will you deal with nontechnical issues (privacy concerns, website security, global languages and cultures, etc.) that may limit the success of your online business?
4. Do you plan to open a storefront hosted by Amazon, eBay, or one of the other online giants, or would an independent website be better suited to the needs of your business?
5. What will be the nature of the online presence you hope to establish? Will you use an information-based, content-based, or transaction-based model or one of the newer options?
6. Will you start the Internet business on a part-time basis, or do you plan to be involved full-time?

Chapter 9 Case

Please see Appendix A for the Chapter 9 Case Study.

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Chapter 10

Understanding a Firm's Financial Statements

Looking Ahead

Leanring Objectives

The purpose of the Understanding a Firm's Financial Statements chapter is to help you learn about financial statements and what they are saying about your business. By studying this chapter, you should be able to . . .

10-1 Describe the purpose and content of an income statement.

10-2 Describe the purpose and content of a balance sheet.

10-3 Use the income statement and balance sheets to compute a company's cash flows.

10-4 Analyze the financial statements using ratios to see more clearly how decisions affect a firm's financial position.

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Spotlight on Small Business

G&P Properties

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Johnny Stites worked in his family's construction company for 43 years, serving as both the president and CEO. In that time, he led the business through five recessions, wage and price controls, high inflation and interest rates, S&L and bank failures, two major stock market crashes, and ever-increasing government regulations.

Stites quickly learned why it was critically important to understand the financial statements of the company and what they were saying about the performance of the business.

"When you start and run your own business, it no longer matters whether you were a marketing, management, finance, or any other specific major. As an entrepreneur, you must know how a business operates, which requires more than having knowledge in a specific academic field. So, whatever your major, you had best know the basics of accounting and finance. You do not need to be an accountant, but you had better be able to read and understand financial statements. Sure, you can hire an accountant, but if you do not understand what the numbers are telling you, you are in big trouble.

The construction industry is one of the riskiest industries you can enter, second only to the restaurant industry. For years, we would bid a job based on our best understanding of the costs. But then, we would have to wait to the completion of the job to see if we made or lost money—not exactly an ideal situation to be in.

We eventually developed the ability to know how we were doing in terms of profits and costs daily. Today, not having accurate and timely accounting information would be deadly."

Source: Interview with Johnny Stites, December 2, 2020.

Entrepreneurs do not start companies so that they can learn accounting—that's for certain. In fact, for many students and aspiring entrepreneurs, accounting is not their favorite subject. Regardless, you will need to learn the basics of accounting, sooner rather than later.

Before we begin studying the three basic **financial statements**, or what are also called *accounting statements* (the income statement, balance sheet, and the statement of cash flows), we will lay a foundation by telling a story about two young sisters who started their own small business, a lemonade stand.

The Lemonade Kids

financial statements
A firm's income statement, balance sheet, and cash flow statement; also called *accounting statements*.

Ellen and Mackenzie Dalton, ages 13 and 15, wanted to buy a $360 iPad to share. Their parents agreed to fund $260 of the cost but required Ellen and Mackenzie to raise the remaining $100. To earn money, the sisters decided to operate a lemonade stand for two Saturdays in a nearby park.

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To start the business, they each invested $5 from their savings. Their mom, Kate, said that she would lend them the additional money they would need, assuming that:

1. Ellen and Mackenzie would repay her in two weeks, and
2. Kate would keep the books for their business and expect them to learn what the numbers meant.

Setting Up the Business

A balance sheet, Kate explained to Ellen and Mackenzie, is a table that shows the following as of a specific date:

1. The dollar amount of the firm's assets.
2. The sources of the money used to pay for the assets.

Kate continued to explain that there are two sources of money to pay for the assets. The sisters could (1) borrow money, or (2) as the owners of the business, put their own money into the business.

The first means of paying for assets is called *debt* and the second is *owners' equity*. A company's total assets will always equal the total debt plus the owners' equity invested in the business:

Total assets = Money borrowed from others + Money invested by the owners

or, more simply,

Total assets = Debt + Owners' equity

For instance, Ellen and Mackenzie's beginning $10 in cash represented their only asset as well as their equity in the business. Kate then wrote out a simple balance sheet:

Assets		Loans (debt) and owners' equity	
		Loans	$ 0
Cash	$10	The sisters' equity	$10
Total assets	$10	Total loans and equity	$10

After evaluating what supplies they would need, the kids requested a $40 loan from their mother. The new balance sheet then appeared as follows:

Assets		Loans (debt) and owners' equity	
		Loan from Mom	$40
Cash	$50	The sisters' equity	$10
Total assets	$50	Total loans and equity	$50

$50 = $10 beginning cash + $40 in cash from loan

$40 loan from mom

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In preparing for their opening day, the pair bought $40 of "premium pink lemonade mix" and paper cups. Kate explained that the lemonade mix and cups constituted their *inventory* of supplies. After they paid for the inventory, the resulting balance sheet was as follows:

$10 = $50 beginning cash – $40 to buy inventory

Assets		**Loans (debt) and owners' equity**	
Cash	$10	Loan from Mom	$40
Inventory	$40	The sisters' equity	$10
Total assets	$50	Total loans and equity	$50

Purchased $40 of inventory

The First Saturday

To begin, Ellen and Mackenzie chose a prime location for their lemonade stand. They also realized that not all passers-by carried cash. So, they created a sign-up sheet where customers could record their contact information for later payment.

By the end of the day, they had sold 60 cups at $1 each—30 cups that were bought on "credit" and 30 with cash. Since the lemonade cost them only 25 cents a cup, they made 75 cents per cup in profits, for a total of $45 in profit [$45 = ($1 sale price per cup –25 cents cost per cup) × 60 cups].

Kate explained that an income statement reports the results of a firm's operations over a period—in this case, for a day. So, the income statement for their first Saturday of selling looked like this:

Sales (60 cups × $1 per cup sales price)	$60
Cost of lemonade sold (60 cups × $0.25 cost per cup)	(15)
Profits	$45

Their balance sheet at the end of the day was as follows:

$40 = $10 beginning cash + $30 cash sales

$30 owed from creditor customers

Assets		**Loans (debt) and owners' equity**		
Cash	$40	Loan from Mom		$40
Accounts receivable	$30	Equity:		
Inventory	$25	The sisters' original investment	$10	
		Retained profits	$45	
		Total equity		$55
Total assets	$95	Total loans and equity		$95

$25 = $40 beginning inventory – $15 decrease in inventory sold

$45 profits retained in the business

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When Ellen looked at the income statement and balance sheet, she questioned why cash and profits were not the same. Kate taught her an important lesson: *Computing a company's cash flows requires that you look at both the income statement and the changes in the balance sheet*. She then explained:

- They had not collected \$30 in cash of their sales, which resulted in \$30 of accounts receivable.
- The \$15 cost of goods sold was not a cash outflow since the inventory that was sold had been purchased previously. They "sold" \$15 of inventory and received the cash.

Thus, reconciling their profits with the change in cash requires the following calculation:

Profits		\$45	
Increase in accounts receivable	(\$30)		\$30 in credit sales to be collected later
Decrease in inventory	15		Cash received from selling inventory
Net increase in assets		(15)	
Change in cash		\$30	

Collecting Accounts Receivable

Not wanting to let their accounts receivable go uncollected for too long, the pair hired a friend, Erin, for \$5 to make calls to their credit customers. To their delight, by Friday night, Abbey (accompanied by a friend) had collected all the money they were owed. With the money collected, cash increased by \$30 and accounts receivable decreased by \$30. The balance sheet appeared as follows:

\$70 = \$40 beginning cash + \$30 of accounts receivable collected

Assets		**Loans (debt) and owners' equity**		
Cash	\$70	Loan from Mom		\$40
Accounts receivable	0	Equity:		
Inventory	\$25	The sisters' original investment	\$10	
		Retained profits	\$45	
		Total equity		\$55
Total assets	\$95	Total loans and equity		\$95

Collected all \$30 of accounts receivable

Planning for the Next Saturday

Anticipating the next weekend, Ellen and Mackenzie decided to relocate their operation to a park with a high volume of potential customers. They also hired two friends, each for \$10 a day, to expand to three stands. The park was far away, so they chose to do business on a cash-only basis.

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The Second Saturday of Business

The team arrived Saturday morning, and by mid-afternoon, they had sold 100 cups of lemonade, depleting their entire inventory! The partners were delighted to see that they had made $50 in profits. Their income statement for the second day looked like this:

Sales ($1 sales price per cup × 100 cups)	$100
Cost of lemonade ($0.25 cost per cup × 100 cups)	($25)
Salaries (2 friends × $10 + $5 paid to Erin)	($25)
Profits	$ 50

The balance sheet at the end of the day appeared as follows:

$145 = $70 beginning cash + $100 cash sales – $25 paid to friends and Erin

Total profits for both days: $45 profits (day 1) plus $50 profits (day 2)

Assets		**Loans (debt) and owners' equity**		
Cash	$145	Loan from Mom		$ 40
Accounts receivable	0	Equity		
Inventory	0	The sisters'		
		original investment	$10	
		Retained profits	$95	
		Total equity		$105
Total assets	$145	Total loans and equity		$145

Sold all $25 of inventory

Looking at their balance sheet, Ellen and Mackenzie realized they had accomplished their goal! They had enough to pay for their portion of the iPad ($100), repay the $40 loan to their mom, and still had $5 to split.

This story simplifies how to think about accounting statements. If you understand the Lemonade Kids' financial results, you are ready to move on to the next step. Our starting point is the income statement.

10-1 Describe the purpose and content of an income statement.

10-1 The Income Statement

An **income statement**, or *profit and loss statement*, indicates the amount of profits or losses generated by a firm *over a given period of time*, usually monthly, quarterly, or yearly. In its most basic form, the income statement may be represented by the following equation:

$$\text{Sales (revenue)} - \text{Expenses} = \text{Profits (income)}$$

(Note: For our purposes, we generally use the term *profits*, instead of *earnings* or *income*, but all three terms can be used interchangeably.)

10-1a An Overview of the Income Statement

income statement
A financial report showing the amount of profits or losses from a firm's operations over a given period; also called a *profit and loss statement*.

An income statement answers the question "How profitable is the business?" In providing the answer, the income statement reports financial information related to five areas of business activity:

1. Sales (revenue)
2. Cost of producing or acquiring the goods or services sold by the company

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3. Operating expenses (marketing expenses, rent, managers' salaries, depreciation expense, etc.)
4. Interest expense
5. Tax payments

A small business owner should pay close attention to the income statement to determine trends and make comparisons with competitors. Profit margins (profits ÷ sales) should be watched carefully. Large expenses should also be monitored to ensure that they are being controlled.

In addition to measuring profits, you must also consider how your decisions affect your company's profits. Philip Campbell, a CPA, offers this perspective on entrepreneurs who don't know what drives their firm's profits:[1]

> *If you ask a business owner whether he runs his company to make money, the answer will always be "Yes." The reality is, he doesn't. . . . More often than not, you hear words like "brand," "market share," or "shelf space." When you hear those words, you can be sure that you've just found an opportunity to make some money.*
>
> *Why? Because those words always are used to justify unprofitable decisions. They are big red flags that you are not making decisions based on a common-sense approach to profitability. When you hear those words, ask yourself this simple question: "Are we making this decision based on profitability or for some other (possibly hidden) reason?"*

A complete overview of an income statement is presented in Exhibit 10-1 shown on the next page, where:

- We begin with the firm's revenues or sales. Then, we subtract the **cost of goods sold** to compute the firm's **gross profits**.
- From gross profits, we deduct **operating expenses**, (including marketing and selling expenses, general and administrative expenses, and depreciation expense) to determine **operating profits**.
- From the firm's operating profits, we deduct any **interest expense** incurred from borrowing money (debt) to find **profits before taxes**, also called *taxable income*.
- Finally, we deduct income taxes from profits before taxes to get **net profits.** The net profits are the "bottom line" of an income statement—the profits that can be reinvested in the firm or distributed to the owners—*assuming that there is cash available to do so.*

10-1b ACE, Inc.: The Income Statement Illustrated

For an example, see Exhibit 10.2 which shows the 2021 income statement for ACE, Inc., a medical supply company founded and owned by three sisters, Ashley, Cameron, and Erin Bates. From the firm's income statement, we see that:

- The company had sales of $850,000 for the 12-month period ending December 31, 2021. We then subtract the cost of goods sold of $550,000, resulting in a gross profit of $300,000.
- The company had $200,000 in operating expenses, which included marketing expenses, general and administrative expenses, and **depreciation expense**. After total operating expenses were subtracted, the company's operating profits were $100,000.

cost of goods sold
The cost of producing or acquiring goods or services to be sold by a firm.

gross profits
Sales less the cost of goods sold.

operating expenses
Costs related to marketing and selling a firm's product or service, general and administrative expenses, and depreciation.

operating profits
Gross profits less operating expenses.

interest expense
The cost of borrowed money.

profits before taxes
Operating profits less interest expense; also called *taxable income*.

net profits
Earnings that may be distributed to the owners or reinvested in the company.

depreciation expense
The cost of a firm's building and equipment, allocated over the asset's useful life.

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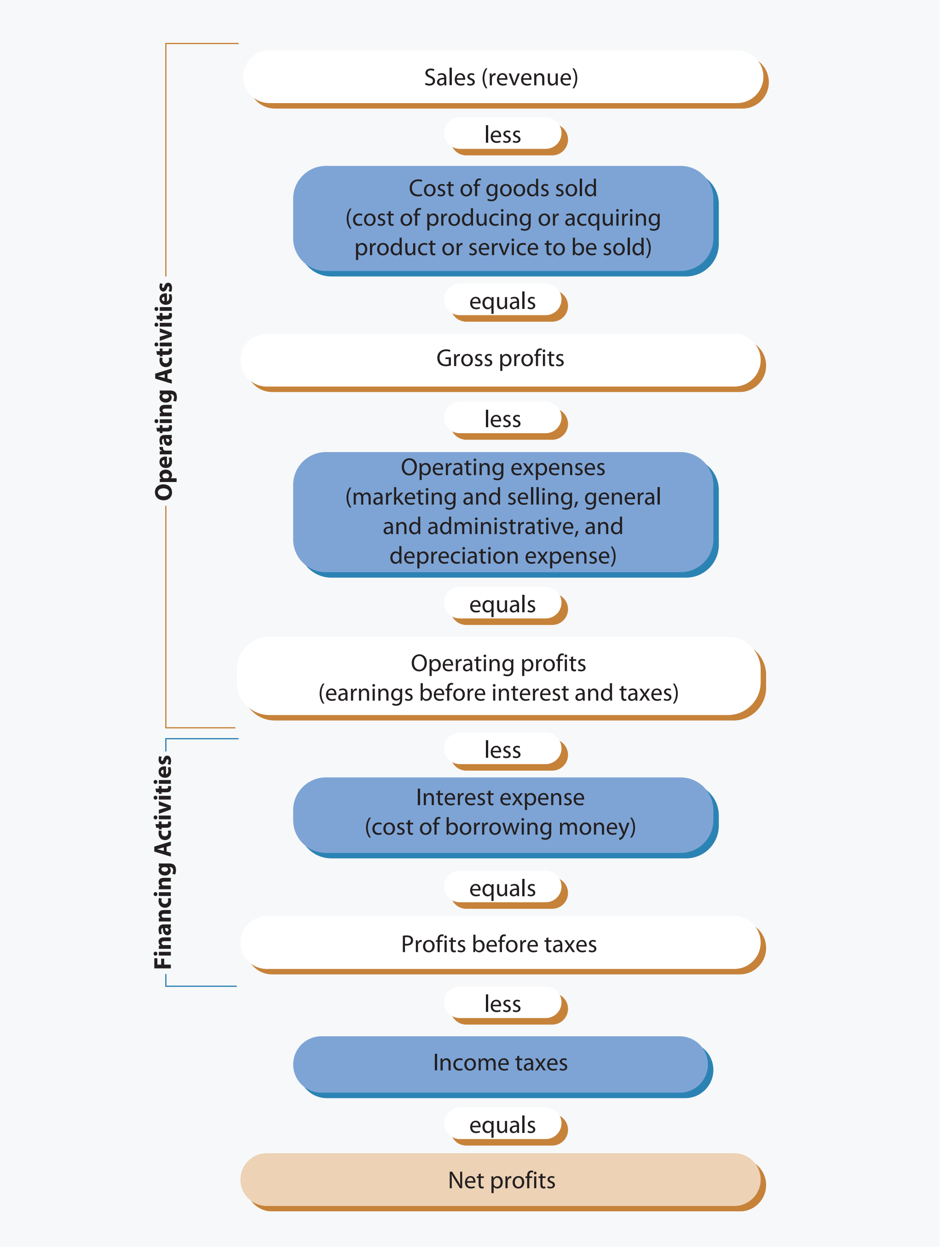
Exhibit 10.1 The Income Statement: An Overview



- ACE's interest expense of $20,000 is deducted from operating profits to arrive at the company's profits before taxes, or taxable income, of $80,000.
- Assuming a 25 percent tax rate, the company paid $20,000 in income taxes ($80,000 profits before tax × 0.25 tax rate = $20,000), leaving net profits of $60,000. *The net profits are the profits that ACE earned after paying all expenses—cost of goods sold, operating expenses, interest expense, and income taxes.*

profit margins
Profits as a percentage of sales.

In the last column in Exhibit 10.2, we have expressed each amount in the income statement as a percentage of sales. In the right margin, we show what are called **profit margins**,

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Exhibit 10.2 Income Statement for ACE, Inc., for the Year Ending December 31, 2021

			Percentage of Sales	
Sales		$850,000	100%	
Cost of goods sold		(550,000)	−65%	
Gross profits		$300,000	35% ←	Gross profit margin
Operating expenses:				
Marketing expenses	($90,000)			
General and administrative expenses	(80,000)			
Depreciation	(30,000)			
Total operating expenses		($200,000)	−24%	
Operating profits		$100,000	12% ←	Operating profit margin
Interest expense		(20,000)	−2%	
Profits before taxes		$ 80,000	9%	
Income taxes (25%)		(20,000)	−2%	
Net profits		$ 60,000	7% ←	Net profit margin
Net profits		$ 60,000		
Dividends paid		(15,000)		
Addition to retained earnings		$ 45,000		

which simply express a firm's profits as a percentage of sales. Specifically, ACE, Inc., has the following profit margins:

- A gross profit margin of 35 percent.
- An operating profit margin of 12 percent.
- A net profit margin of 7 percent.

So, for every $100 of sales, the company earns $35 in gross profits, $12 in operating profits, and $7 in net profits.

So, what did ACE's owners do with their profits? As shown at the bottom of Exhibit 10.2, $15,000 in **dividends** was distributed to them; the remaining $45,000 ($60,000 net profits less $15,000 in dividends) was retained by the firm—an amount you will see later in the balance sheet. *Note that dividends paid to a firm's owners, are not considered an expense in the income statement. Instead, they are viewed as a return of principal to the owners.*

10-2 The Balance Sheet

10-2 Describe the purpose and content of a balance sheet.

While an income statement reports the results of business operations over a given time period, a **balance sheet** provides a snapshot of a business's financial position at a *specific point in time*. It reports the dollar amounts of the following:

- The assets a firm owns.
- The liabilities (or debt) owed.
- The amount of the owners' investment (owners' equity) on that date.

In its simplest form, a balance sheet follows this formula:

$$\text{Total assets} = \text{Debt} + \text{Owners' equity}$$

dividend
A distribution of a firm's profits to the owners.

balance sheet
A financial report showing a firm's assets, liabilities, and owners' equity at a specific point in time.

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Living the Dream

Avoiding the Path to Failure

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Jeff Sandefer, a successful entrepreneur and educator, talks about avoiding the path to failure. He puts it this way:

> *Have you ever thought, "I don't need to know anything about finance and accounting? Once my business is up and running, I'll just hire someone to handle all the numbers"? If so . . . here's a time-tested recipe for failure in business:*
>
> 1. Begin with a good idea.
> 2. Have a great deal of drive and determination.
> 3. Raise money from investors.
> 4. Grow your revenues as quickly as possible.
> 5. Fail to acquire basic financial skills.
> 6. Hire someone else to "run the numbers" for you.
>
> It's a proven formula for destroying a promising business. And the faster sales rise, the fierier the crash when you run out of cash.
>
> Do you want to build a business that can survive minor financial setbacks? Do you want to avoid the embarrassment (and the possibility of criminal charges) that comes from losing large sums of other people's money?
>
> If so, you must learn to ask the fundamental questions of finance and master the tools you need to answer them. If you do this and minimize investments, grow at a controlled rate with plenty of cash on hand for emergencies, and keep your business processes simple and focused on satisfying customers, you'll be much more likely to build a healthy business or, at a minimum, avoid an embarrassing collapse.

Source: Jeff Sandefer, "Searching for the Mythical Numbers Guru," Acton Foundation for Entrepreneurship Excellence, March 2012, p. 1.

So, for every dollar of assets, there *must* be a dollar of financing in the form of debt or owner's equity.

10-2a An Overview of the Balance Sheet

Many small business owners make the mistake of paying close attention to the firm's income statement, but very little to the balance sheet. The balance sheet, as well as the yearly changes between two balance sheets, provides critical information on how effectively the firm's assets are being managed and on the financing of the assets.

The entrepreneur is not the only one who needs to be well versed about the balance sheet. Lenders, such as bankers, investors, and suppliers, who are considering how much credit to grant, rely heavily on a firm's balance sheet in their decision making.

Exhibit 10.3 illustrates the elements in the balance sheet of a typical firm. Each of the three main components of the balance sheet—assets, debt, and owners' equity—is discussed in the following sections.

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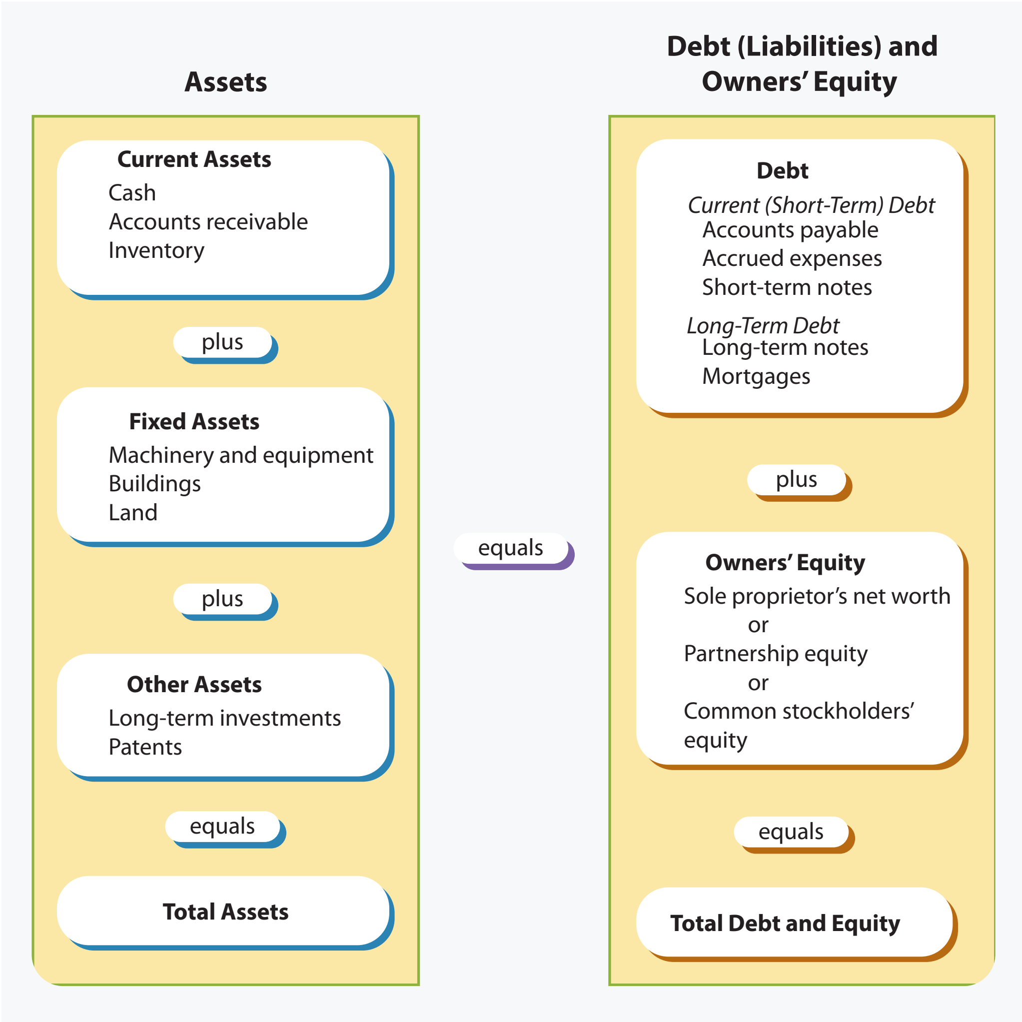
Exhibit 10.3 The Balance Sheet: An Overview



Assets

Assets, shown on the left side of Exhibit 10.3, are what the company owns that have monetary value. They are always grouped into three categories: (1) current assets, (2) fixed assets, and (3) other assets.

1. **Current assets** (also known as *working capital*) primarily include cash, accounts receivable, and inventory. They are always listed first on the balance sheet and are a firm's most liquid assets (they can be converted into cash quickly).
   - **Cash** is money in the bank and may include some marketable securities, such as short-term government securities, that can be sold very quickly.
   - **Accounts receivable** are created when selling products or services to customers on credit, such as allowing the customer 30 days to pay for the goods being purchased. Sales are recorded when they occur, but instead of receiving cash, we increase accounts receivable for the amounts owed. When we collect what is owed, cash increases and accounts receivable is reduced by the amounts paid.

current assets
Assets that can be converted into cash relatively quickly.

cash
Money in the bank as well as securities that can be sold very quickly, such as a government security.

accounts receivable
Balances owed by customers on current accounts.

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- **Inventory** includes the products being held by a firm for sale in the business's operations. Service companies typically have little or no inventory, but nearly all other companies do.

2. **Fixed assets**, also called *property, plant, and equipment (PPE)***,** are physical assets that a company owns that will be used in the business for more than one year. They include such assets as machinery, trucks, computers, buildings, and land.

   A firm's fixed assets remain on the balance sheet at their original cost as gross fixed assets until they are disposed of. Some businesses are more capital-intensive than others and will have a greater amount invested in fixed assets.

   Most fixed assets are also **depreciable assets**—they wear out or become obsolete over time. Each year, fixed assets are depreciated over their expected useful life. Consider the following example:

   - Assume that a business purchased a truck for $20,000 with an expected useful life of four years.
   - The cost of $20,000 is shown on the balance sheet as a **gross fixed asset** upon purchase.
   - The cost of the truck is depreciated (expensed) over its useful life.
   - A $5,000 depreciation expense is shown annually on the income statement ($20,000 ÷ 4 years = $5,000).
   - Each year, the cumulative depreciation expense (**accumulated depreciation**) is reported in the balance sheet, and is subtracted from the original cost of the fixed asset to yield the **net fixed asset**.

inventory
A firm's products held in anticipation of eventual sale as part of operations.

fixed assets
Physical assets that will be used in the business for more than one year, such as equipment, buildings, and land; also called *property, plant, and equipment* (*PPE*).

depreciable assets
Assets whose value declines, or depreciates, over time.

gross fixed assets
Depreciable assets at their original cost, before any depreciation expense has been taken.

accumulated depreciation
Total (cumulative) depreciation expense taken over a fixed asset's life.

net fixed assets
Gross fixed assets less accumulated depreciation.

other assets
Intangible assets, such as patents, copyrights, and goodwill.

debt
Financing provided by creditors.

The income statements and the balance sheets at the end of each year appear as follows:

In the income statement:

	Year 1	Year 2	Year 3	Year 4
Depreciation expense	$5,000	$5,000	$5,000	$5,000

In the balance sheets:

	Year 1	Year 2	Year 3	Year 4
Gross fixed asset	$20,000	$20,000	$20,000	$20,000
Accumulated depreciation	(5,000)	(10,000)	(15,000)	(20,000)
Net fixed asset	$15,000	$10,000	$ 5,000	$ 0

Notice that the gross fixed assets do not change, but the net fixed assets are reduced.

3. **Other assets** include patents, copyrights, and goodwill. For a start-up company, organizational costs—costs incurred in organizing and promoting the business—may also be included in this category.

Debt (Liabilities)

Let's now return to Exhibit 10.3 and look at the right side of the balance sheet, which indicates how a firm is financing its assets. As previously mentioned, financing has two main sources: debt (liabilities) and owners' equity.

Debt is financing provided by creditors. As shown in Exhibit 10.3, it is divided into current (short-term) debt and long-term debt.

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1. **Current debt**, or *short-term liabilities*, is borrowed money to be repaid within 12 months. Examples include accounts payable, accrued expenses, and short-term notes.
   - **Accounts payable,** or *trade credit,* represent credit extended by suppliers to a firm when it purchases inventory. Consider the following example:
     1. A firm buys $10,000 in inventory on credit.
     2. The supplier (the seller) allows the firm (the buyer) 30 days to pay for the inventory.
     3. As a result, there is a $10,000 increase in inventory in the balance sheet, and accounts payable also increases by $10,000.
     4. Then when the company pays the supplier, both cash and accounts payable would decrease by $10,000.
        - **Accrued expenses** are operating expenses that have been incurred and are owed but not yet paid. The amount of the expense is included in the income statement when owed and shown as a liability (accrued expense) in the balance sheet until paid.
        - **Short-term notes** are agreements to repay cash amounts borrowed from a bank or other lending institution for 12 months or less. They are a primary source of financing for most small businesses. Consider this example:
     1. You borrow $50,000 from a bank for 90 days (one quarter of a year) to purchase inventory.
     2. The interest rate on the loan is 8 percent, so you will incur $1,000 in interest ($1,000 = $50,000 principal owed × 8% interest rate × ¼ year).
     3. The interest paid on the loan is shown as an interest expense in the income statement, and the principal amount borrowed appears as a liability in the balance sheet.
2. **Long-term debt** is a loan granted for longer than 12 months from banks or other financial institutions.
   - When a firm borrows money for over one year to buy equipment, it signs an agreement—a **long-term note**—promising to repay the loan plus interest over the number of years the loan is outstanding. As with short-term notes, the interest is an expense shown in the income statement and the amount of the principal is a liability reported on the balance sheet.
   - When a firm borrows money, say, for 30 years to purchase a warehouse or office building, the real estate usually serves as collateral for the long-term note which is called a **mortgage**. If the borrower is unable to repay the loan, the lender can take the real estate in settlement.

current debt
Borrowed money that must be repaid within 12 months; also called *short-term liabilities.*

accounts payable
Outstanding credit that is owed to suppliers; also called *trade credit.*

accrued expenses
Operating expenses that have been incurred but not paid; shown as an expense in the income statement and as a liability in the balance sheet until paid.

short-term note
An agreement to repay a cash amount borrowed from a bank or other lending source within 12 months or less.

long-term debt
A loan from a bank or other financial institution with repayment terms of more than 12 months.

long-term note
An agreement to repay a cash amount borrowed from a bank or other lending source, plus interest, for a period longer than 12 months.

mortgage
A long-term note to purchase a building or land.

Owners' Equity

Owners' equity is money that the owners invest in a business. Owners can invest directly by writing a check to the company or by leaving all or part of their profits in the company, which are called **retained earnings**, to be invested and used to grow the business. (Note that shares of **common stock** are issued to investors in corporations, representing their ownership in the corporation.)

$$\text{Retained earnings} = \begin{array}{c}\text{Cumulative total}\\ \text{of all net profits}\\ \text{over the life of the business}\end{array} - \begin{array}{c}\text{Cumulative total}\\ \text{of all dividends paid}\\ \text{over the life of the business}\end{array}$$

owners' equity
Owners' cash investments in a company plus the net profits that have been retained in the firm.

retained earnings
Cumulative net profits retained in a company over the life of the business.

common stock
Stock shares that represent ownership in a corporation.

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So, we then can calculate the owners' total equity as follows:

$$\text{Owners' equity} = \text{Owners' investment} + \overbrace{\text{Cumulative profits} - \text{Cumulative dividends paid to owners}}^{\textbf{Earnings retained within the business}}$$

10-2b ACE, Inc.: The Balance Sheet Illustrated

Exhibit 10.4 presents balance sheets for ACE, Inc., for December 31, 2020, and December 31, 2021, along with changes between the two dates. The 2020 and 2021 year-end balance sheets for ACE show the following:

- That the firm began 2021 (ended 2020) with $800,000 in total assets and ended 2021 with total assets of $920,000.
- How much has been invested in current assets (cash, accounts receivable, and inventory) and in fixed assets.
- How much debt and equity were used to finance the assets.
- That about half of the equity came from investments made by the owners (common stock), and the other half came from reinvesting profits in the business (retained earnings).

Exhibit 10.4 Balance Sheets for ACE, Inc., for December 31, 2020, and December 31, 2021

	2020	2021	Changes
Assets			
Current assets:			
Cash	$ 45,000	$ 50,000	$ 5,000
Accounts receivable	75,000	80,000	5,000
Inventory	180,000	220,000	40,000
Total current assets	$300,000	$350,000	$ 50,000
Fixed assets:			
Gross fixed assets	$860,000	$960,000	$100,000
Accumulated depreciation	(360,000)	(390,000)	(30,000)
Net fixed assets	$500,000	$570,000	$ 70,000
TOTAL ASSETS	$800,000	$920,000	$120,000
Debt (Liabilities) and Equity			
Current liabilities:			
Accounts payable	$ 15,000	$ 20,000	$ 5,000
Short-term notes	60,000	80,000	20,000
Total current liabilities (debt)	$ 75,000	$100,000	$ 25,000
Long-term debt	150,000	200,000	50,000
Total debt	$225,000	$300,000	$ 75,000
Owners' equity			
Common stock	$300,000	$300,000	$ 0
Retained earnings	$275,000	320,000	45,000
Total owners' equity	$575,000	$620,000	$ 45,000
TOTAL DEBT AND EQUITY	$800,000	$920,000	$120,000

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- Referring back to the income statement in Exhibit 10.2, we see that the $45,000 increase in retained earnings, shown in the Changes column in Exhibit 10.4, represents the firm's net profits for the year ($60,000) less the dividends paid to the owners ($15,000).

It's apparent from these balance sheets that they help a small business owner know the financial strength and capabilities of the business, which cannot otherwise be known.

Thus far, we have discussed the income statement and the balance sheets as separate reports. Exhibit 10.5 shows how the income statement and the balance sheets complement each other. To understand how a firm performed during 2021, you must know the following information:

- The firm's financial position at the beginning of 2021 (balance sheet on December 31, 2020).
- The firm's profits during the year (income statement for all of 2021).
- The financial position at the end of 2021 (balance sheet on December 31, 2021).

Exhibit 10.5 Viewing the Income Statement and Balance Sheet Together

10-3 The Statement of Cash Flows

10-3 Compute a company's cash flows by using the income statement and balance sheets.

Effectively managing cash flows is critical for small business owners. Even though cash is the lifeblood of a business, many business owners really don't have a handle on the firm's cash flows. For this reason, an owner must understand the sources and uses of the firm's cash, illustrated by a **statement of cash flows**. In other words, this financial report answers the questions "Where did the cash come from and where did it go?"

statement of cash flows A financial report showing a firm's sources of cash as well as its uses of cash.

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Living the Dream

Understand Your Numbers, and Take Important Relationships with You

© RYAN GIBSON

Ryan Gibson, an entrepreneur in his thirties, is founder and CEO of Rydell Holdings, a firm that invests in early-stage companies. With college majors in real estate and entrepreneurship, he began a career in real estate and now invests in private businesses, while continuing to make significant real estate investments.

Gibson believes that understanding the numbers behind a business is essential for success. He offers this advice:

> On a Sunday afternoon in the early days of our engagement, my fiancée, Megan, and I were on a long drive when she asked me a loaded question: "What are you passionate about?" What came flying out of my mouth that day, what I was most passionate about at the time, and what to this day continues to capture my imagination is still the same: "Numbers!"
>
> When it comes to investing in and managing real estate and starting and operating businesses, I work hard to discover the stories that numbers tell me. Real estate investing, for example, is a business with a minimal number of variables. Back in the 2008–2009 recession, there was a lot of uncertainty, which makes markets less efficient. Conventional wisdom says that is when you need to buy.
>
> At that time, I was investing in student housing. When the market shook, I had one metric that determined what I should pay for a property: What should I pay for a piece of property if I made a down payment of 20 percent, paid all my expenses, and rented out each bedroom for $200 per month? That determined my offering price. My reasoning was that I would be able to get anyone to lease a room for $200 each month, and every dollar I could lease it for over that was profit.
>
> In life, I am an emotional guy—I cry in movies. I am also very impatient. But in real estate investing, I am unemotional and the model of patience. I decide what my offer price should be, given the numbers, and that's the offer I make. Only rarely is the initial offer accepted outright. More often than not, I either receive a counter from the seller or no response at all. When this happens, I wait.
>
> Most of the properties I have purchased throughout the years have been the result of waiting until the seller is willing to accept my offer. For example, I once found an apartment complex that had been foreclosed on. I was finally able to contact the decision maker at the bank and make an offer. I ran my numbers that said I should offer $880,000. I received no response from that offer. I made the same offer to the bank every month for a full year. After a year, the bank sold it to me for the $880,000. Because I was able to optimize the operations and the market got better, I sold it four years later for $2,080,000.
>
> I have taken this mindset into each business that I have invested in. As I am starting a new business, I always start by developing key performance indicators (KPIs). These metrics tell the story of how the business is performing. I then identify what levers I can pull to affect the KPIs. I decide in advance what I will do, depending on what the numbers tell me. I think of these levers as "if/then" statements.
>
> Finally, while I track the numbers closely and know what they say, I believe numbers should be combined with relationships to tell the whole story. If you rely only on numbers and ignore relationships, inside and outside the company, you may have a profitable business, but you will not have a culture to be proud of. But, if you rely only on relationships and ignore the numbers, you will probably have a strong culture but an unprofitable business.

Source: Written by Ryan Gibson, May 31, 2021.

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10-3a Profits versus Cash Flows

It's important to remember that *the profits shown on a company's income statement are not the same as its cash flows!* Without adequate cash flows, even companies that show a profit can still go bankrupt!

An income statement is not a measure of cash flows because it is calculated on an *accrual* basis rather than a *cash* basis:

- In **accrual-basis accounting**, revenues are recorded when earned—whether or not they have been received in cash—and expenses are recorded when they are incurred—even if money has not actually been paid out.
- In **cash-basis accounting**, profits are reported when cash is received, and expenses are recorded when they are paid.

There are numerous reasons that profits based on an accrual-basis accounting system will differ from a firm's cash flows. Here are three examples:

1. Sales reported in an income statement include both *cash* sales and *credit* sales.
2. Cash spent for inventory doesn't represent all inventory purchases since some inventory is financed by credit.
3. The depreciation expense on the income statement does not involve cash.

So, the question—and its answer—that every small business owner should ask and understand is "How do I compute my firm's cash flows?"

10-3b An Overview of Measuring a Firm's Cash Flows

We can explain the cash inflows and outflows of a business by looking at three **cash flow activities**—operating, investing, and financing activities.

Activity 1: Cash Flows from Operations

To begin, it is essential for a small business owner to know how much cash is being generated in the ordinary day-to-day operations. Measuring a firm's cash flows from operations requires the following steps:

1. Begin with net profits and add back depreciation expense for the year, since depreciation is not a cash expense.
2. Subtract (add) any increase (decrease) in accounts receivable.
3. Subtract (add) any increase (decrease) in inventory.
4. Add (subtract) any increase (decrease) in accounts payable.

Activity 2: Cash Flows from Investment

When a company buys (or sells) fixed assets, cash outflows (inflows) occur, which show up in the balance sheet as a change in *gross* fixed assets (not *net* fixed assets). The same is true for changes in "other assets."

Activity 3: Cash Flows from Financing

The cash flows associated with financing a business are as follows:

1. A cash inflow when a company borrows more money (increase in short-term and/or long-term debt) or issues more common stock (increase in common equity).
2. A cash outflow when a firm repays debt (decreases in short-term and/or long-term debt) or the firm pays dividends to the owners.

accrual-basis accounting
An accounting method of recording profits when earned and expenses when incurred, whether or not the profits have been received in cash or the expenses paid.

cash-basis accounting
An accounting method of recording profits when cash is received and recording expenses when they are paid.

cash flow activities
Operating, investing, and financing activities that result in cash inflows or outflows.

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When we talk about borrowing or repaying debt when financing the business, note that accounts payable are not included, as they are already considered in cash flows from operations. Only debt from sources such as banks and other financial institutions in the form of short-term notes and long-term debt are included in financing activities.

We have now explained each of the three activities that account for a firm's cash flows. It is a tedious process and requires that you practice so that it becomes intuitive. We will illustrate the process by calculating ACE's cash flows.

10-3c ACE, Inc.: Statement of Cash Flows Illustrated

To compute ACE's cash flows, we need to return to the firm's income statement (Exhibit 10.2) and balance sheets (Exhibit 10.4).

Activity 1: ACE's Cash Flows from Operations

Referring to ACE's income statement and balance sheets, we can determine the firm's cash flows from operating activities as follows:

Net profits	$60,000	
Add back depreciation	30,000	
Profits before depreciation		$90,000
Less increase in accounts receivable (uncollected sales)		(5,000)
Less payments for inventory consisting of:		
Increase in inventory	($40,000)	
Less increase in accounts payable (inventory purchased on credit)	$ 5,000	
Net cash payments for inventory		($35,000)
Cash flows from operations		$50,000

So, ACE generated $50,000 in positive cash flows in the ordinary course of its business operations.

Activity 2: ACE's Cash Flows from Investment

ACE spent $100,000 on new plant and equipment in 2021, based on the change in gross fixed assets from $860,000 to $960,000, as shown in its balance sheets.

Activity 3: ACE's Cash Flows from Financing

To compute financing cash flows, we consider the following:

- The income statement, where it indicates that ACE paid $15,000 in dividends to the owners.
- The balance sheets, where we see that short-term debt increased by $20,000 and long-term debt increased by $50,000, both sources of cash flow.

Thus, in net, ACE raised $55,000 in financing cash flows:

Increase in short-term debt	$20,000
Increase in long-term debt	$50,000
Less dividends paid to owners	(15,000)
Financing cash flows	$55,000

In summary, ACE generated $50,000 in cash flows from operations, invested $100,000 in additional fixed assets, and generated $55,000 from financing activities. The three

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activities resulted in a net increase in cash flows of $5,000. The complete statement of cash flows for ACE, Inc., is presented in Exhibit 10.6.

Let's review the process we used for computing ACE's cash flows:

1. We used only net profits and depreciation expense from the income statement.
2. We relied on the following guidelines:
    - An increase (decrease) in an asset is a use (source) of cash.
    - An increase (decrease) in liabilities/equity is a source (use) of cash.
3. We used every change in ACE's balance sheets, with two exceptions:
    - We ignored accumulated depreciation and net fixed assets—they involve the noncash item of depreciation—and used only the change in *gross* fixed assets.
    - We disregarded the change in retained earnings since it equals net profits and dividends paid, two items that are captured elsewhere.

We should now understand the process for determining a company's cash flows. It's not easy to understand, but knowledge of this process is necessary in order to have success as an entrepreneur.

Exhibit 10.6 Statement of cash flows for ACE, Inc. for the Year Ending December 31, 2021

Operating cash flows:		
Net profits	$60,000	
Add back depreciation	30,000	
Profits before depreciation		$ 90,000
Less increase in accounts receivable (uncollected sales)		(5,000)
Less payments for inventory consisting of:		
Increase in inventory Less increase in accounts payable (inventory purchased on credit)	($40,000) $ 5,000	
Cash payments for inventory		(35,000)
Cash flows from operations		$ 50,000
Investing cash flows:		
Less increase in gross fixed assets		($100,000)
Financing cash flows:		
Increase in short-term notes	$20,000	
Increase in long-term debt	50,000	
Less dividends paid to owners	(15,000)	
Financing cash flows		$ 55,000
Increase in cash		$ 5,000
Beginning cash (December 31, 2020)		45,000
Ending cash (December 31, 2021)		$ 50,000

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10-4 Use ratios to analyze the financial statements to see how decisions affect a firm's financial position.

10-4 Evaluating a Firm's Financial Position

Having now completed our explanation of accounting statements, we will next look at using financial ratios to learn more from the statements about a firm's financial position.

10-4a Analyzing Financial Statements: An Overview

An entrepreneur's decisions play out primarily in four ways when it comes to finances:

1. The ability to pay debt as it comes due.
2. The profits generated from the firm's assets (return on assets).
3. How the firm is financed—choosing between debt or equity.
4. The rate of return on the owners' equity investment (return on equity).

We will examine each in turn.

The Ability to Repay Debt Coming Due

An owner needs to know if the company has the capacity to meet its short-term (one year or less) debt commitments. The **liquidity** of a business depends on the availability of cash to meet maturing debt obligations.

The **current ratio** is traditionally used to measure a company's liquidity. This ratio compares a firm's *current assets* (cash and assets that will soon convert into cash) to the debt that will soon need to be paid (*current liabilities)*. The current ratio is calculated as follows:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The higher (lower) the current ratio, the more (less) the company's liquidity.

Profitability on Assets (Return on Assets)

An important question that a firm's owners must answer is whether the company's profits are satisfactory relative to the total amount of assets invested in the company. After all, a firm's assets are invested to produce profits—operating profits, in this case. A comparison of operating profits to total assets reveals the rate of return that is being earned on the firm's total assets invested in the business.

We compute the **return on assets** as follows:

$$\text{Return on assets} = \frac{\text{Operating profits}}{\text{Total assets}}$$

If we separate the parts of this ratio, we can learn more about why a company's return on assets is high or low:

$$\textit{Return on assets} = \textit{Operating profit margin} \times \textit{Total asset turnover}$$

$$\textit{Return on assets} = \frac{\textit{Operating profits}}{\textit{Sales}} \times \frac{\textit{Sales}}{\textit{Total assets}}$$

where

- The **operating profit margin** tells us how well the firm is managing its income statement by keeping expenses low relative to sales.
- The **total asset turnover** indicates how well the owners are managing the company's balance sheet by generating sales for every dollar invested in assets.

liquidity
The degree to which a firm has working capital available to meet maturing debt obligations.

current ratio
A measure of a company's relative liquidity, determined by dividing current assets by current liabilities.

return on assets
A measure of a firm's profitability relative to the amount of its assets, determined by dividing operating profits by total assets.

operating profit margin
A measure of a firm's ability to manage its income statement by keeping expenses low relative to sales.

total asset turnover
A measure of a firm's ability to manage its assets efficiently by generating sales per dollar of assets.

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Naturally, a small business owner would prefer to earn an attractive rate of return compared to companies in their industry, which requires the operating profit margin and the total asset turnover to be high.

Financing the Business: Choosing Debt versus Equity

How much debt, relative to total assets, is used to finance a business is extremely important. The more debt a business uses, the more financial risk it assumes because the debt must be repaid no matter how much profit the firm earns. It is a fixed cost. However, if a company earns a higher return on its assets than the interest rate being paid on its debt, the owners benefit from using debt.

The **debt ratio** reveals what percentage of the firm's assets is financed by debt and is computed as follows:

$$\text{Debt ratio} = \frac{\text{Total debt}}{\text{Total assets}}$$

Profits for the Owners (Return on Equity)

All decisions ultimately affect the profits earned by the owners relative to their own investment in the business. The financial ratio used here is the **return on equity**, which is computed as follows:

$$\text{Return on equity} = \frac{\text{Net profits}}{\text{Total owners' equity}}$$

Of course, a higher rate of return on equity is better than a lower rate of return.

10-4b ACE, Inc.: Financial Position Analysis Illustrated

Exhibit 10.7 provides a list of the financial ratios described above, along with these ratios computed for ACE, Inc., and a comparison to industry averages.

Exhibit 10.7 Financial Ratio Analysis for ACE, Inc.

Financial ratios	ACE, Inc.	Industry Norm
1. Ability to pay debt as it comes due: Current ratio $= \frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{\$350{,}000}{\$100{,}000} = 3.50$	2.70
2. Company's profitability on its assets: Return on assets $= \frac{\text{Operating profits}}{\text{Total assets}}$	$\frac{\$100{,}000}{\$920{,}000} = 10.87\%$	13.2%
Operating profit margin $= \frac{\text{Operating Profits}}{\text{Sales}}$	$\frac{\$100{,}000}{\$850{,}000} = 11.76\%$	11.0%
Total asset turnover $= \frac{\text{Sales}}{\text{Total assets}}$	$\frac{\$850{,}000}{\$920{,}000} = 0.92$	1.20
3. The amount of debt the company uses: Debt ratio $= \frac{\text{Total debt}}{\text{Total assets}}$	$\frac{\$300{,}000}{\$920{,}000} = 32.61\%$	40.0%
4. Rate of return earned by the owners on their equity investment: Return on equity $= \frac{\text{Net profits}}{\text{Owners' equity}}$	$\frac{\$60{,}000}{\$620{,}000} = 9.68\%$	12.5%

debt ratio
A measure of what percentage of a firm's assets is financed by debt, determined by dividing total debt by total assets.

return on equity
A measure of the rate of return that owners receive on their equity investment, calculated by dividing net profits by total owners' equity.

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ACE's Ability to Repay Debt Coming Due

As you can see in Exhibit 10.7, for ACE:

- The current ratio is 3.50, compared to an industry norm of 2.70. Therefore, the firm has $3.50 in current assets for every $1 of short-term debt, compared to an industry average of $2.70 of current assets for every $1 in short-term debt.
- Based on the current ratio, ACE is more liquid than the average firm in the industry.

ACE's Profitability on Assets (Return on Assets)

As shown in Exhibit 10.7, for ACE:

- The return on assets of 10.87 percent is less than the industry norm of 13.2 percent, indicating that ACE is generating less operating profit on each dollar of assets than its competitors. That is not good!
- To understand more about the low return on assets, we can look at the *operating profit margin* and *total asset turnover* for ACE, along with industry averages:

		Operating profit margin	×	Total asset turnover	=	Return on assets
ACE	=	11.76%	×	0.92	=	10.87%
Industry	=	11.00%	×	1.20	=	13.20%

- The company is competitive in managing its income statement—keeping costs and expenses low relative to sales (operating profit margin).
- The total asset turnover shows that the firm is not using its assets efficiently. It generates $0.92 in sales per $1 of assets, while the competition produces $1.20 from every $1 of assets.

ACE's Financing Decisions—Debt versus Equity

Referring again to Exhibit 10.7, we see that for ACE:

- The firm finances 32.61 percent of its assets with debt, compared to competitors' 40.0 percent, and therefore it has less financial risk as well as less debt to repay. It will be able to survive a downturn in the economy more easily than its average competitor.

ACE's Return on Equity (Profits to the Owners)

As seen in Exhibit 10.7, ACE's return on equity is 9.68 percent, while the industry average for return on equity is 12.5 percent. Since the firm's owners are not receiving a return on their investment equivalent to owners of comparable businesses, consider the following:

- A firm with a high (low) return on *assets* will have a high (low) return on *equity*. It is impossible to have a good return on equity if you are not earning a good return on your assets.
- As the amount of a firm's debt increases, its return on equity will increase, *provided that the return on assets is higher than the interest rate paid on any debt*.
- ACE has a lower return on *equity* in part because it has a lower return on *assets*. It also uses less debt than the average firm in the industry, causing its return on equity to be lower than that of other firms. However, using less debt does reduce the firm's risk.

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Our analysis of financial statements is now complete. You are now better prepared to know what financial statements can tell you about a business—knowledge that can be found in no other way than by interpreting the numbers.

In this chapter, we focused on understanding financial statements related to a firm's historical financial performance. In the next chapter, we will look to the future with the financial statements. When writing a business plan, you need to demonstrate how your decisions will play out in terms of the firm's finances.

10-1. Describe the purpose and content of an income statement.

- An income statement (also known as a profit and loss statement) indicates the amount of profits or losses generated by a firm over a given time period.
- An income statement is, in its most basic form, represented by the equation:

  Sales (revenue) – Expenses = Profits (income)

- An income statement answers the question "How profitable is the business?" by looking at five broad areas of business activity: (1) sales, (2) cost of producing or acquiring goods or services, (3) operating expenses, (4) interest expense, and (5) tax payments.

10-2. Describe the purpose and content of a balance sheet.

- A balance sheet provides a snapshot of a firm's financial position at a specific point in time.
- It shows the assets a firm owns, its liabilities, and the amount of owners' equity on a specific date.
- In its most simple form, the balance sheet is represented by the formula:

  Total assets = Debt + Owners' equity

- Total assets include current, fixed, and other assets.
- Debt is financing provided by creditors. It can be current (short-term) debt and/or long-term debt.
- Owners' equity is the owners' investment in the business, both in terms of actual cash invested and earnings that have been retained in the business.
- Because the balance sheet offers a snapshot of a firm's financial condition at a specific point in time and the income statement reports a firm's performance over a given period of time, both are needed to fully evaluate a firm's financial position.
- Three financial reports are needed to evaluate a firm's performance over a given time: a balance sheet showing a firm's financial position at the beginning of a year, a balance sheet for the end of the year, and an income statement spanning the time between the two balance sheets.

10-3. Compute a company's cash flows by using the income statement and balance sheets.

- A statement of cash flows shows the sources and uses of a firm's cash.
- There are three cash flow activities: (1) cash flows from operations (operating activities), (2) cash flows related to the investment in fixed assets and other assets (investing activities), and (3) cash flows related to financing the firm (financing activities).
- Cash flows from operations are calculated by adding back the depreciation expense to the net profits and then subtracting (or adding) any increase (or decrease) in accounts receivable, in inventory, and in accounts payable.

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- Investments in fixed assets are recorded in the statement of cash flows as a change in gross fixed assets, as shown in a firm's balance sheets.
- Financing a business involves borrowing money, issuing more common equity (common stock), repaying debts, and paying dividends.
- In a cash flow statement, the only changes ignored in a firm's balance sheets are changes in accumulated depreciation, net fixed assets, and retained earnings.

10-4. Use ratios to analyze the financial statements to see how decisions affect a firm's financial position.

- Financial ratios help examine a firm's (1) ability to pay debt as it comes due, (2) profitability on assets, (3) use of debt or equity, and (4) rate of return on the owners' equity investment.
- A firm's ability to pay debt as it comes due (its liquidity) is most often evaluated by looking at a firm's current ratio (current assets divided by current liabilities).
- A company's profitability on assets is assessed by using the following company ratios:
  1. Return on assets (operating profits ÷ total assets).
  2. Operating profit margin (operating profits ÷ sales).
  3. Total asset turnover (sales ÷ total assets).
- The debt ratio is used to evaluate what percentage of a firm's assets is financed by debt (total debt ÷ total assets).
- The return on equity is a measure of the rate of return earned by owners on their equity investment (net profits divided by total owners' equity).

Key Terms

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accounts receivable p. 194
accrual-basis accounting p. 200
accrued expenses p. 196
accumulated depreciation p. 195
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total asset turnover p. 203

Discussion Questions

1. Explain the purposes of the income statement and balance sheets.
2. What determines a company's profitability?
3. Distinguish among (a) gross profits, (b) operating profits, and (c) net profits.
4. The balance sheet reports information on a firm's (a) assets, (b) debt, and (c) owners' equity. What is included in each of these reported categories?
5. How are owners' equity and debt different?
6. Distinguish between common stock and retained earnings.

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7. What is the relationship between an income statement and a balance sheet?
8. Why aren't a firm's cash flows equal to its profits?
9. Describe the three major components of a statement of cash flows.
10. What questions do financial ratios help answer about a firm's financial position?

You Make the Call

Situation 1

The Donahoo Western Furnishings Company was formed on December 31, 2020, with $1,000,000 in equity plus $500,000 in long-term debt. On January 1, 2021, all the firm's capital was held in cash. The following transactions occurred during January 2021:

- January 2: Donahoo purchased $1,000,000 worth of furniture for resale. It paid $500,000 in cash and financed the balance using trade credit (accounts payable) that required payment in 60 days.
- January 3: Donahoo sold $250,000 worth of furniture that it had paid $200,000 to acquire. The entire sale was on credit terms of net 90 days.
- January 15: Donahoo purchased more furniture for $200,000. This time, it used trade credit for the entire amount of the purchase, with credit terms of net 60 days.
- January 31: Donahoo sold $500,000 worth of furniture, for which it had paid $400,000. The furniture was sold for 10 percent cash down, with the remainder payable in 90 days. In addition, the firm paid a cash dividend of $100,000 to its stockholders and paid off $250,000 of its long-term debt.

Question 1 What did Donahoo's balance sheet look like at the outset of the firm's life?

Question 2 What did the firm's balance sheet look like after each transaction?

Question 3 Ignoring taxes, determine how much income Donahoo earned during January. Prepare an income statement for the month. Recognize an interest expense of 1 percent for the month (12 percent annually) on the $500,000 long-term debt, which has not been paid but is owed.

Question 4 What was Donahoo's cash flow for the month of January?

Situation 2

At the beginning of 2021, Mary Abrahams purchased a small business, the Maitz Company, whose income statement and balance sheets are shown below.

Income Statement for the Maitz Company for 2021

Sales		$175,000
Cost of goods sold		(105,000)
Gross profits		$ 70,000
Operating expenses:		
Depreciation	$ 5,000	
Administrative expenses	20,000	
Selling expenses	26,000	
Total operating expenses	$ (51,000)	
Operating profits		$ 19,000
Interest expense		(3,000)
Profits before taxes		$ 16,000
Taxes		(8,000)
Net profits		$ 8,000

Balance Sheets for the Maitz Company for 2020 and 2021

Assets	**2020**	**2021**
Current assets:		
Cash	$ 8,000	$ 10,000
Accounts receivable	15,000	20,000
Inventory	22,000	25,000
Total current assets	$45,000	$ 55,000
Fixed assets:		
Gross fixed assets	$50,000	$ 55,000
Accumulated depreciation	(15,000)	(20,000)
Net fixed assets	$35,000	$ 35,000
Other assets	12,000	10,000
TOTAL ASSETS	$92,000	$100,000
Debt (Liabilities) and Equity		
Current debt:		
Accounts payable	$10,000	$ 12,000
Accruals	7,000	8,000
Short-term notes	5,000	5,000
Total current debt	$22,000	$ 25,000
Long-term debt	15,000	15,000
Total debt	$37,000	$ 40,000
Equity	$55,000	$ 60,000
TOTAL DEBT AND EQUITY	$92,000	$100,000

The firm has been profitable, but Abrahams has been disappointed by the lack of cash flows. She had hoped to have about $10,000 a year available for personal living expenses. However, there never seems to be much cash available for purposes other than business needs. Abrahams has asked you to examine the financial statements and explain why, although they show profits, she does not have any discretionary cash for personal needs. She

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observed, "I thought that I could take the profits and add back depreciation to find out how much cash I was generating. However, that doesn't seem to be the case. What's happening?"

Question 1 Given the information provided by the financial statements, what would you tell Abrahams? (As part of your answer, calculate the firm's cash flows.)

Question 2 How would you describe the cash flow pattern for the Maitz Company?

Situation 3

Philip Spencer, the owner of Wholesome Foods, has hired you to evaluate his firm's financial performance. The firm's financial data are provided below, along with an average for the financial ratios that Spencer collected on several competing peer firms.

Question 1 Compute the financial ratios discussed in the chapter for Wholesome Foods for 2020 and 2021.

Question 2 Prepare a statement of cash flows for the firm for 2020 and 2021.

Question 3 Interpret your findings, both for the firm's financial ratios compared to those of the peer group and for the cash flow statement.

Assets	**2019**	**2020**	**2021**
Cash	$ 21,000	$ 20,200	25,000
Accounts receivable	42,000	33,000	46,000
Inventory	51,000	84,000	96,000
Prepaid rent	1,200	1,100	2,000
Total current assets	$ 115,200	$ 138,300	$ 169,000
Gross property, plant, and equipment	650,000	664,000	740,000
Accumulated depreciation	(364,000)	(394,000)	(434,000)
Net property, plant, and equipment	$ 286,000	$ 270,000	$ 306,000
TOTAL ASSETS	$ 401,200	$ 408,300	$ 475,000
Debt (Liabilities) and Equity	**2019**	**2020**	**2021**
Accounts payable	$ 48,000	$ 57,000	$ 52,400
Accrued expenses	9,500	9,000	12,000
Short-term notes	11,500	9,000	20,000
Total current liabilities	$ 69,000	$ 75,000	$ 84,400
Long-term debt	160,000	150,000	185,000
Common stock	$ 22,200	$ 22,200	$ 34,500
Retained earnings	150,000	161,100	171,100
Total owners' equity	$ 172,200	$ 183,300	$ 205,600
TOTAL DEBT AND EQUITY	$ 401,200	$ 408,300	$ 475,000

Income Statement	**2020**	**2021**
Sales	$ 600,000	$ 650,000
Cost of goods sold	(460,000)	(487,500)
Gross profits	$ 140,000	$ 162,500
Operating expenses:		
General and administrative expenses	$ 30,000	$ 37,500
Depreciation expense	30,000	40,000
Total operating expenses	$ 60,000	$ 77,500
Operating profits	$ 80,000	$ 85,000
Interest expense	(10,000)	(12,000)
Profits before taxes	$ 70,000	$ 73,000
Taxes	(27,100)	(30,000)
Net profits	$ 42,900	$ 43,000
Net profits	$ 42,900	$ 43,000
Dividends paid	(31,800)	(33,000)
Addition to retained earnings	$ 11,100	$ 10,000

Financial Ratios (Averages)	**Peer Companies**
Current ratio	1.80
Return on assets	16.8%
Operating profit margin	14.0%
Total asset turnover	1.20
Debt ratio	0.50
Return on equity	18.0%

Experiential Exercises

1. Interview an owner of a small firm about the financial statements they use. Ask the owner how important financial data are to their decision making.
2. Review a small firm's financial statements, and describe the firm's financial position. Find out if the owner agrees with your conclusions.
3. Dun & Bradstreet and Risk Management Association compile financial information about many companies. They provide, among other information, income statements and balance sheets for an average firm in an industry. Search online (or use your school's library) for financial information on two

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industries of your choice, and compute the following data for each industry:

a. The percentage of assets in current assets, and the percentage of assets in fixed assets (property, plant, and equipment).

b. The percentage of financing from debt, and the percentage of financing from owners' equity.

c. The gross profits as a percentage of sales, and the operating profits as a percentage of sales.

Chapter 10 Case

Please see Appendix A for the Chapter 10 Case Study.

ENDNOTE

1. Philip Campbell, "Are You Really Focused on Profits?" June 2008, http://www.inc.com/resources/finance/articles/20060601/campbell.html, accessed February 15, 2021.

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Chapter 11

Forecasting Financial Requirements

Looking Ahead

Learning Objectives

In this chapter on forecasting financial requirements, we develop financial projections to help small business owners understand what to expect from their new venture in the future. By studying this chapter, you should be able to . . .

11-1 Describe the purpose of financial forecasting

11-2 Develop a pro forma income statement to forecast a new venture's profitability.

11-3 Determine a company's asset and financing requirements using a pro forma balance sheet.

11-4 Forecast a firm's cash flows.

11-5 Provide suggestions for effective financial forecasting.

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Spotlight on Small Business

The Big Smoke

thebigsmoke.com

Source: The Belleford Group

Developing a solid financial plan can help contribute to a healthy business. For some small businesses, running out of cash is a primary reason for failing. Alexandra Tselios, founder and CEO of The Big Smoke, agrees. She quotes a friend, who had run a number of successful companies: "Entrepreneurs usually have a lot to learn, but they run out of money by the time they [have] truly figured out the lesson." Tselios thinks that the underlying problem is the absence of realistic financial forecasts.

Founded in 2013, The Big Smoke emerged as an opinion leader site in Australia. Within months of launching, the digital opinion platform saw immediate success, but some financial hardships as well. In the first year of operations, Tselios had no financial forecasts. Being Overwhelmed with the initial stages of business and becoming a leading opinion site resulted in her wasting a lot of money. She realized that she had to commit to understanding the mechanics of her business.

At times, businesses with great concepts wear out prematurely due to a lack of understanding of how different activities within the business affect profits and cash flows. According to Tselios, "A big risk to any company is running out of cash." Fortunately, she was eventually able to avoid this problem by becoming effective at forecasting her financial needs.

Since its launch, The Big Smoke has expanded to the United States and continues to permeate the media. Tselios credits forecasting and financial planning for allowing this expansion. "Having a realistic summary of what is likely to occur regarding both sales and cash flow will help business owners ensure they protect themselves, their staff, and their company."

Sources: Carmarlena Murdaca, "How to Reduce Financial Risk in Small Business," 2018, http://www.news.com.au/feature/special-features/how-to-reduce-financial-risk-in-small-business/news-story/247360ab2567742c20f95908d8619956, accessed June 11, 2021; http://thebig smoke.com/about-us/, accessed June 11, 2021; and https://www.alexandratselios.com/the-big-smoke, accessed June 11, 2021.

A *good idea may or may not be a good investment opportunity.* As we discussed in Chapter 3, a good investment opportunity requires a product or service that meets a definite customer need and creates a sustainable competitive advantage. To be attractive, an opportunity must generate strong profits relative to the required amount of investment. Therefore, projections of a venture's profits, its asset and financing requirements, and its cash flows are essential in determining whether a venture is economically viable.

11-1 The Purpose of Financial Forecasting

11-1 Describe the purpose of financial forecasting.

In Chapter 6, we discussed the need for a start-up to "discover" its business model by iterating until the entrepreneur is able to arrive at the best vision for the business. The reason for this is the limited, if any, past experience on which to base a start-up's numbers. The entrepreneur is simply testing their best guesses.

If you are successful in crafting a sustainable business model, you will eventually need to raise outside capital or at least develop a more in-depth financial plan for management to use. At that point, you will need to forecast, to the best of your ability, the financial outcomes that could result from your decisions.

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Granted, the numbers never seem to work out in quite the way that you planned. However, *the process allows you to understand what drives your numbers, and that's important for company managers, lenders, and investors to know*. Specifically, lenders will look at what the numbers say about the likelihood of repayment. Investors will attempt to value your company based on the numbers.

The purpose of **pro forma financial statements** is to answer three questions:

1. *How profitable can you expect the firm to be,* given the projected sales levels and the expected sales-expenses relationships?
2. *How much and what type of financing (debt or equity) will be needed* to finance a firm's assets?
3. *Will the firm have adequate cash flows?* If so, how will they be used? If not, where will the additional cash come from?

Preparing historical financial statements, such as income statements, balance sheets, and statements of cash flows, is not a difficult task. However, *projecting* what may happen to a business in the future in terms of profits and cash flows is another matter.

An established firm has the benefit of past data, in terms of both past revenue and past costs and expenses. It is necessary to anticipate how the market could change, what the firm will be doing differently in the future, and how the changes will affect the financial numbers. The main difficulty here is predicting sales, which can be greatly affected by influences outside of the business itself.

Once financial projections have been prepared, the process should not stop there. Because of the uncertainty of what can happen, the small business owner should always be asking, "What could go wrong, and if it does happen, what will I do?" For instance, the owner needs to plan how to respond if sales are significantly lower or higher than projected. A firm can get into trouble not only when sales are inadequate, but also when the firm is experiencing high growth.

When seeking financing, an entrepreneur must be able to give informed answers about the firm's needs, including the amount of money required, the purposes for which it will be used, and when and how the lender or investor will be paid back. Only careful financial planning can provide answers to these questions.

Let's now look at the processes for projecting a firm's profitability, asset and financing requirements, and cash flows.

11-2 Develop a pro forma income statement to forecast a new venture's profitability.

11-2 Forecasting Profitability

Profits reward an owner for investing in a company and constitute *a primary source of financing for future growth if reinvested in the business*. Therefore, it is essential for an entrepreneur to understand the factors that drive a company's profits. (Return to Exhibit 10.1, in Chapter 10, for an overview of the income statement.)

11-2a An Overview of Forecasting Profitability

pro forma financial statements
Statements that project a firm's financial position, including its projected profits, assets and financing requirements, and cash flows.

To forecast profitability, an entrepreneur needs to know what will determine the five drivers of a firm's profits:

1. *Amount of sales*. The dollar amount of sales equals the price of the product or service times the number of units sold, or the amount of service rendered.
2. *Cost of goods sold*. Cost of goods sold is the cost of producing or purchasing the firm's products or services. These costs can either be *fixed* (those that do

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not vary with a change in sales volume) or *variable* (those that change proportionally with sales).

3. *Operating expenses*. These expenses relate to marketing and distributing the product, general and administrative expenses, and depreciation expenses. Like cost of goods sold, operating expenses can be fixed or variable in nature.
4. *Interest expense*. An entrepreneur who borrows money agrees to pay interest on the loan principal. For example, a loan of \$25,000 for a full year at a 12 percent interest rate results in an interest expense of \$3,000 for the year ($\$3,000 = 0.12 \times \$25,000$).
5. *Taxes*. A firm's income taxes are figured as a percentage of profits before taxes (also known as taxable income).

Based on the foregoing explanation of forecasting profitability, we will now illustrate the process.

11-2b D&R Products, Inc.: Forecasting Profitability Illustrated

We will use an example to demonstrate how to forecast a new venture's profits.[1] David Allen is planning to start a new business called D&R Products, Inc., which will do wood trim work for luxury homes. In thinking about how to build an economically viable company in terms of profits and cash flows, Allen has evaluated potential *revenue models* and *cost structures*. His beginning assumptions are described in the following sections.

Revenue Model

Allen envisions a *revenue model* based on two complementary revenue streams: product design and product sales/installations. After extensively interviewing prospective customers, building contractors, and suppliers, along with doing industry research, Allen has made the following estimates for the first two years of operations:

1. *Product design*. For customers who want to be engaged in the creation of their own wood trim for new homes or renovations, the firm will do the following:
   - Provide user-friendly design software.
   - Have alliances with professional interior designers who will work with the customer to create a design that is not only aesthetically pleasing but also architecturally sound.
   - Offer an open platform that will allow customers to interface with other customers who are designing their own wood trim.

   From the interior designers, the firm will receive 10 percent of the revenue stream resulting from their work with D&R contacts. While Allen does not see this revenue stream as a major source of income, he does expect it to lead to increased product sales and installations.

2. *Product sales and installations*. The primary source of revenue for D&R will be the actual sale and installation of its product in new and renovated homes, eventually expanding to

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larger commercial projects. The anticipated revenues from this activity over the next two years are as follows:

- *Year 1:* Allen already has contracts for 10 jobs and expects to acquire another 10—20 jobs in total—by the end of the first year, at an average price of $12,500 per job. Thus, revenue from product sales and installations is projected to be $250,000 in the first year, computed as follows:

$$20 \text{ jobs} \times \$12{,}500 \text{ average price per job} = \$250{,}000$$

Allen further estimates that revenue from product design will only amount to $10,000 in this first year. So, total revenues for year 1 are projected to be $260,000:

Product sales and installations	$250,000
Product design	10,000
Total revenues	$260,000

- *Year 2:* Allen forecasts 30 jobs in the second year, again believing that the average revenue per job will be $12,500. He also expects $25,000 in product design sales, for a total revenue of $400,000:

Product sales and installations	$375,000
Product design	25,000
Total revenue	$400,000

Cost Structure

In terms of cost structure, Allen has carefully identified expected fixed and variable costs of goods sold and operating expenses.

The firm will have a cost advantage in the form of a newly developed machine that will allow it to adapt to varying design specifications in a very economical manner. Allen has made the following estimates on costs and expenses:

1. *Cost of goods sold.*
   - The fixed cost of goods sold (including production costs and employee salaries) is expected to amount to $100,000 per year.
   - The variable costs of production will be around 20 percent of product sales and installations.
   - There will be fixed costs of $10,000 per year related to product design.
2. *Operating expenses.*
   - The fixed operating expenses (marketing expenses, general and administrative expenses) are estimated to be $46,000 per year.
   - The depreciation expense will be $4,000 annually.
   - The variable operating expenses will be approximately 30 percent of product sales and installations.
   - There will be no operating costs for product design.
3. *Interest expense.* Based on the anticipated amount of money to be borrowed and the corresponding interest rate, Allen expects interest expense to be $8,000 in the first year, increasing to $12,000 in the second year.
4. *Taxes.* Income taxes will be 25 percent of profits before taxes (taxable income).

Given the above estimates, we can forecast D&R Products' profits, as shown in the pro forma income statement in Exhibit 11.1. We first enter our assumptions in

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Exhibit 11.1 Pro Forma Income Statements for D&R Products, Inc.

	A	B	C	D	E
3	INCOME STATEMENT ASSUMPTIONS:				
4		**Year 1**	**Year 2**		
5	Product sales and installations:				
6	Number of projected jobs	20	30		
7	Average selling price per job	$ 12,500	$ 12,500		
8	Fixed cost of goods sold	$100,000	$100,000		
9	Fixed operating expenses	$ 46,000	$ 46,000		
10	Depreciation expense	$ 4,000	$ 4,000		
11	Interest expense	$ 8,000	$ 12,000		
12	Variable cost of goods sold	20%	20%		
13	Variable operating expenses	30%	30%		
14	Product design:				
15	Projected design revenues	$ 10,000	$ 25,000	**Equations based on assumptions**	
16	Fixed design costs	$ 10,000	$ 10,000		
17					
18	Income tax rate	25%	25%		
19				*Equations for:*	
20				***Year 1***	***Year 2***
21	Sales:				
22	Product sales and installations	$250,000	$375,000	=B6*B7	=C6*C7
23	Product design	10,000	25,000	=B15	=C15
24	Total sales	$260,000	$400,000	=SUM(B22:B23)	=SUM(C22:C23)
25					
26	Cost of goods sold:				
27	Cost of goods sold: product sales and installations				
28	Fixed cost of goods sold	$100,000	$100,000	=B8	=C8
29	Variable cost of goods sold (20% of product sales)	50,000	75,000	=B22*B12	=C22*C12
30	Total cost of goods sold: product sales and installations	$150,000	$175,000	=SUM(B28:B29)	=SUM(C28:C29)
31	Total cost of goods sold: product design	10,000	10,000	=B16	=C16
32	Total cost of goods sold	$160,000	$185,000	=SUM(B30:B31)	=SUM(C30:C31)
33	Gross Profits	$100,000	$215,000	=B24-B32	=C24-C32
34					
35	Operating expenses: product sales and installations				
36	Fixed operating expenses	$ 46,000	$ 46,000	=B9	=C9
37	Variable operating expenses (30% of product sales)	75,000	112,500	=B13*B22	=C13*C22
38	Depreciation expense	4,000	4,000	=B10	=C10
39	Total operating expenses: product sales and installations	$125,000	$162,500	=SUM(B36:B38)	=SUM(C36:C38)
40	Operating profits	$ (25,000)	$ 52,500	=B33-B39	=C33-C39
41	Interest expense (interest rate 12%)	8,000	12,000	=B11	=C11
42	Profits before taxes	$ (33,000)	$ 40,500	=B40-B41	=C40-C41
43	Taxes (25% of profits before tax)	0	10,125	0	=C42*C18
44	Net profits	$ (33,000)	$ 30,375	=B42-B43	=C42-C43

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a spreadsheet (rows 3–18). Then, in rows 20–44, we see the two years of pro forma income statements (columns B and C) and the equations used to compute the numbers (columns D and E), where:

- Rows 22 and 23 show the projected revenues for product sales/installations (row 22) and for product design activities (row 23).
- Row 24 shows total sales.
- Rows 28–30 provide the cost of goods sold for product sales/installations.
- Row 31 gives us the expected costs of $10,000 for product design.
- Row 32 then sums the cost of goods sold for both product sales/installations and product design to arrive at the total cost of goods sold.
- Row 33 gives us gross profits, which equals total sales less total cost of goods sold.
- Rows 36–39 present the anticipated operating expenses associated with product sales and installations; there are no operating expenses related to product design.
- Row 40 provides operating profits, which equals gross profits less total operating expenses.
- Row 41 shows the interest expense for borrowing money.
- Row 42 is profits before taxes (operating profits less interest expense).
- Row 43 equals the tax expense. Since D&R Products is expected to have a loss in the first year, the taxes will be zero. The taxes in the second year are calculated as the tax rate (25 percent) multiplied by the profits before taxes. (In reality, the firm would not expect to pay taxes in the second year either, since tax laws allow a firm to carry losses in one year forward into future years. However, we are ignoring this reality in order to provide a simple example.)
- Row 44 shows the firm's projected net profits—profits before taxes minus income taxes.

These computations indicate that D&R Products is expected to have a $33,000 net loss in its first year, followed by a net profit of $30,375 in its second year.

A start-up typically experiences losses for a period of time, frequently as long as two or three years.[2] In a real-world situation, an entrepreneur should project the profits of a new company at least three years into the future (or, preferably, five years into the future, if it can be done with some degree of confidence).

We will now shift our attention from forecasting profits to estimating asset and financing requirements.

11-3 Determine a company's asset and financing requirements using a pro forma balance sheet.

11-3 Forecasting Asset and Financing Requirements

The amount and types of assets required for a new venture will vary, depending on the nature of the business. High-technology businesses—such as computer manufacturers, designers of semiconductor chips, and medical device companies—often require billions of dollars in investment. Most service businesses, on the other hand, require minimal initial capital. For example, an information technology firm serving the medical field would have little in the way of assets. Most likely, it would lease its office space and have no inventory. Its only asset of any significance would be accounts receivable.

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Living the Dream

Financial Planning Makes a Difference at REEcycle

REEcycle was founded by three students from the University of Houston, led by Casey McNeil as the firm's CEO. The company reclaims precious materials known as rare earth elements from recycling companies that have no use for them.

A primary example of these unwanted materials is earth magnets, which are used in computer hard drives. After purchasing unwanted magnets from e-waste companies, REEcycle uses a patented process to extract the critical rare earth elements locked inside. The firm then sells the recycled elements to companies that will use these materials to design cutting-edge technologies, including electric cars, wind turbines, and even missile guidance systems.

The owners discovered early on just how difficult it would be to raise funding, such as venture capital, for such a high-risk venture. In part, it was a chicken-and-egg problem—without funding, large prototypes could not be built; but without a prototype, funds could not be raised. So, the three founders decided to compete in various business plan competitions across the United States. They successfully raised over $300,000 in cash and in-kind prizes for the company. This money was quickly put to use.

One of the problems that REEcycle faced was finding investors interested in funding a company at such an early stage. Furthermore, the business was not working on a problem that could be solved in a garage; it required large facilities and extensive use of heavy equipment. Another issue was the price volatility of their product. It experienced some of the most volatile swings ever seen in commodities markets. Businesses were literally living and dying by the swings of the market. Thus, timing the market correctly was an important risk factor.

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To get the odds in their favor, the management team needed to purchase the most critically necessary elements for their product in a way that would balance supply and demand. For this to happen, they needed the ability to forecast the financial consequences of their decisions. For example, they decided to use three-year averages for the prices of the elements the company produced, allowing them to set a "floor" price point that the company would have to stay above to be successful. This allowed the company to set benchmarks for the efficiencies that had to be met in all aspects of the process and forced the founders to develop strategies for keeping all costs at a bare minimum. This way of thinking prevented REEcycle from becoming overzealous in its financial projections, which might have led to a lack of trust by investors and, ultimately, the company's demise.

The company now operates out of the University of Houston's Innovation Center. Because of the significant risk involved in scaling up the scientific processes used by the company, REEcycle plans on using funds from competitions and grants to completely scale the company before any investor funding is taken. This not only mitigates the risk taken by investors, but also significantly increases the amount of control that the founders will have over the company for years to come.

Source: Written by Casey McNeil, founder and CEO, REEcycle, Inc., April 25, 2018.

Most firms of any size need both working capital (cash, accounts receivable, and inventory) and fixed assets (property, plant, and equipment). For instance, a grocery store requires operating cash, inventory, and possibly limited accounts receivable. In addition, the owner will have to acquire cash registers, shopping carts, shelving, office equipment, and a building. In other words, the need to invest in assets results in a corresponding need for financing.

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Working capital is another term used in the business world for current assets—namely, cash, accounts receivable, and inventory that are required in the day-to-day operations of the business. The term is also sometimes used loosely to mean current assets less current liabilities, which is called **net working capital**. Net working capital is a measure of a company's liquidity. The greater a firm's net working capital, the greater its ability to pay on any debt commitment as it comes due.[3]

Too frequently, small business owners tend to underestimate the amount of capital a business requires. Consequently, the financing they get may be inadequate. Without the money to invest in assets, they try to do without anything that is not essential and to spend as little as possible even on basic items.

When Dan Cassidy started Baha's Fajita Bar, a restaurant aimed at serving college students, his goal was to raise $100,000 in capital. However, he opened the restaurant when he had raised only $70,000. In six months, he ran out of cash and had to close the business. The problem became critical when students went home for spring break and were slow to eat at restaurants in the weeks immediately following their return to school. Cassidy's unfortunate experience shows just how risky it can be for a small business owner to ignore the potential for unexpected challenges and to underestimate the firm's capital needs.

While being undercapitalized is rarely, if ever, a good decision, the goal of the entrepreneur should be to minimize and control, rather than to maximize and own resources.

To the greatest extent possible, the entrepreneur should use other people's resources—for instance, leasing equipment rather than buying, negotiating with suppliers to provide inventory "just in time" to minimize inventory in storage, and arranging to collect money owed the firm before having to pay its bills. As discussed in Chapter 1, this is called *bootstrapping*, and it's one of the most common ways entrepreneurs accomplish more with less.

When Cecilia Levine, the owner of MFI International, a manufacturing firm, had the opportunity to get a contract to make clothing for a Fortune 500 company, she became a master of bootstrapping.[4]

> *I never expected the fast growth and demand that my services would have. To finance the growth, debt financing would have been helpful, but it was not an option. The definition of credit in the dictionary reads, "The ability of a customer to obtain goods or services before payment, based on the trust that payment is going to be made in the future." What it does not say is that for a banker, trust means having collateral, and without collateral you don't get credit. But I still had children to feed and the desire to succeed, so I looked for another form of financing—bootstrapping.*
>
> *I had a major customer who believed in me, and who had the equipment I needed. He sold me the equipment and then would reduce his weekly payment of my invoices by an amount to cover the cost of the equipment. Also, the customer paid me each Friday for what we produced and shipped that week. Everyone who worked for me understood that if we didn't perform and finish the needed production for the*

net working capital
A measure of a company's liquidity (current assets less current liabilities).

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week, we didn't get paid by our customer. When I received the payment from the customer, I was then able to pay my employees. We were a team, and we understood the meaning of cash flow. Therefore, we performed.

Working with a limited amount of capital makes forecasting even more important because you have less room for error. Moreover, the uncertainties surrounding an entirely new venture make estimating asset and financing requirements difficult. Even for an established business, forecasts are never perfect. There are always surprises—you can count on it.

In gathering needed information for financial forecasting, an entrepreneur should search for relevant information from a variety of sources. The Risk Management Association, Dun & Bradstreet, banks, trade associations, and similar organizations compile financial information for a variety of industries.

Along with public data, common sense and educated guesswork are required. Continually ask yourself, "Does this make economic sense?" and "What could go wrong?" However, no source of information can compare with talking to prospective customers. As we have said on numerous occasions, sitting in a room with your computer, without ever getting out and talking to potential customers, is a sure way to miss the obvious.

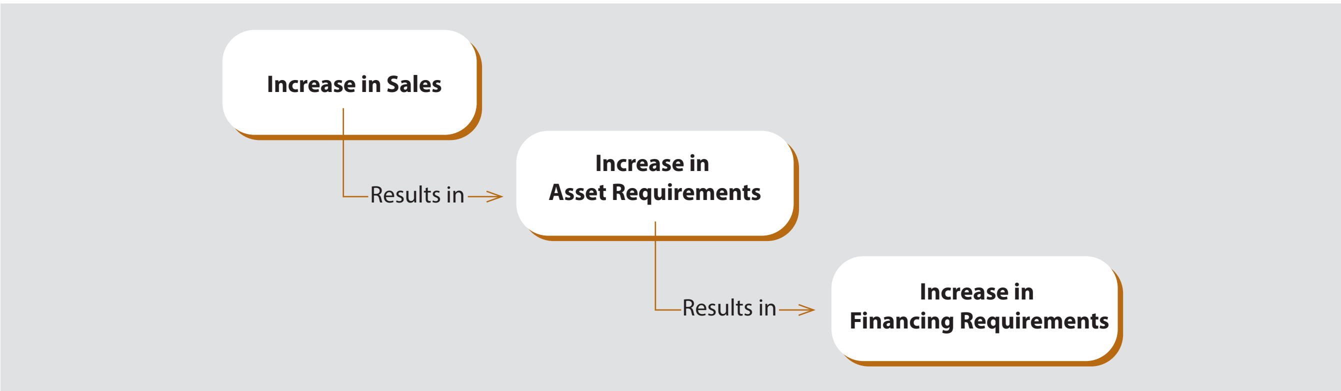
11-3a An Overview of Determining Asset Requirements

The key to effectively forecasting asset requirements is first to understand the relationship between a firm's projected sales and its assets. A firm's sales are the primary force driving future asset needs. Exhibit 11.2 depicts this relationship, which can be expressed simply:

The greater a firm's sales, the greater the asset requirements will be and, in turn, the greater the need for financing.

Since asset needs increase as sales increase, a firm's asset requirements are often estimated as a percentage of sales. Therefore, if future sales have been projected, a ratio of assets to sales can be used to estimate asset requirements.

Exhibit 11.2 Assets-to-Sales Relationships



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This method of estimating asset requirements is called the **percentage-of-sales technique**. It can also be used to project numbers for individual assets, such as accounts receivable and inventory. For example, assets as a percentage of sales generally average 20 percent for grocery stores, compared with 65 percent for oil and gas companies.

11-3b D&R Products, Inc.: Determining Asset Requirements Illustrated

To illustrate the percentage-of-sales technique, let's return to D&R Products, Inc., where we will estimate the firm's asset requirements for the first two years, given the company's sales projections.

- In Exhibit 11.1, the firm's pro forma income statements for product sales and installations (not including design revenues) were forecasted to be $250,000 and $375,000 in years 1 and 2, respectively.
- Allen also estimated the firm's current asset requirements (cash, accounts receivable, and inventory) as a percentage of product sales and installations:

Current Assets	Current Assets as a Percentage of Sales and Installations
Cash	4%
Accounts receivable	10%
Inventory	25%

- Allen has determined that he will need equipment that will cost $10,000. Also, he has found a building suitable for a manufacturing facility for $40,000. These will be shown in the balance sheet as $50,000 in gross fixed assets.
- Since the depreciation expense reported in the income statement (Exhibit 11.1) is $4,000 per year, the accumulated depreciation will be $4,000 in year 1, increasing (accumulating) to $8,000 the next year.
- Given the anticipated sales and the assets-to-sales relationships, Allen is able to forecast the asset requirements for his venture. If product sales and installations are $250,000 in year 1 and $375,000 in year 2, Allen estimates the following:

Assets	Assumptions	Year 1	Year 2
Forecasted product and installation sales		$250,000	$375,000
Forecasted current asset requirements:			
Cash	4% of sales	$ 10,000	$ 15,000
Accounts receivable	10% of sales	25,000	37,500
Inventory	25% of sales	62,500	93,750
Total current assets		$ 97,500	$146,250
Forecasted fixed asset requirements:			
Gross fixed assets	Equipment and building costs	$ 50,000	$ 50,000
Accumulated depreciation	$4,000 annually	(4,000)	(8,000)
Net fixed assets		$ 46,000	$ 42,000
TOTAL ASSETS		$143,500	$188,250

- Thus, Allen expects to need $143,500 in assets by the end of the first year, and $188,250 by the conclusion of the second year.

percentage-of-sales technique
A method of forecasting asset requirements, using a ratio of assets to sales.

At this point, Allen should test how sensitive the results of the model are to changes in the assumptions being made. He needs to determine which assumptions

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have the greatest impact on the outcomes. Then he can focus his research on what matters most.

With a sense of the asset investments required to achieve the forecasted profits, Allen now needs to consider how these assets will be financed.

11-3c An Overview of Determining Financing Requirements

There must be a corresponding dollar of financing for every dollar of assets. Stated another way, debt plus equity must equal total assets.

To forecast a company's financing needs effectively, a small business owner must understand certain basic principles that govern the financing of firms, which can be stated as follows:

1. The more assets a business needs, the greater its financing requirements. Thus, a firm that is experiencing rapid sales growth requires more assets and, consequently, faces greater pressure to find financing—and that pressure can be unbearable if not managed carefully.
2. A company should finance its growth in such a way as to maintain adequate liquidity. (*Liquidity* represents the degree to which a firm has current assets available to meet maturing short-term debt.)
   - As already mentioned, a common weakness in small business financing is the tendency to maintain a disproportionately small investment in liquid assets.
   - In Chapter 10, we used the *current ratio* (current assets divided by current liabilities) as a measure of liquidity. (To minimize their chance of not being repaid on short-term debts as they come due, some bankers require small business owners to maintain a current ratio of at least 2.0, meaning that current assets should be twice the amount of current liabilities.)
3. The amount of money that a firm can borrow is dependent in part on the amount of money the owners put into the business in the form of owners' equity. Because banks and other lenders would never provide *all* the necessary debt financing for a firm, they might specify that at least half of the firm's financing must come from owners' equity, while the rest can come from debt. In other words, the owners would have to limit the firm's *debt ratio* (total debt divided by total assets) to 50 percent.[5]
4. Some types of short-term debt—specifically, *accounts payable* and *accrued expenses*—maintain a relatively constant relationship with sales.
   - As sales increase, more inventory will generally be required. If the inventory is purchased on credit, accounts payable will increase as well. As a result, accounts payable will track increases in sales.
   - The same holds true for accrued expenses. More business means more expenses, some of which will be accrued as liabilities, rather than being paid immediately.

   Given the "spontaneous" relationship of these types of liabilities with sales, they are sometimes referred to as **spontaneous debt financing**. While not the more formal type of debt, such as bank loans, these accrued liabilities can be a significantly large source of financing for many small companies. The remainder of debt financing must come from loans by banks and other lending sources.
5. For the typical small firm, cash flows generated from operations are the primary source of equity capital for financing future growth. Recall that *retained earnings* are profits that are retained within the company rather than being distributed to the owners. But, be careful not to think of retained earnings as a cash account that can be spent. As already noted, a firm may have significant profits but no cash to reinvest.

spontaneous debt financing
Short-term debts, such as accounts payable, that automatically increase in proportion to a firm's sales.

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The essence of these principles can be captured in the following equation:

$$\text{Total asset requirement} = \text{Total sources of financing} = \text{Spontaneous debt financing} + \text{Loans from banks and other lenders} + \text{Owners' investment} + \text{Retained earnings}$$

Small business owners who thoroughly understand these five principles and their relationships with each other will be effective in forecasting their firm's financial requirements—and they will be more effective in acquiring the necessary financing.

11-3d D&R Products, Inc.: Determining Financing Requirements Illustrated

Recall that Allen projected asset requirements of $143,500 and $188,250 for years 1 and 2, respectively. He also has estimated the financing requirements, based on the following facts and assumptions:

1. Allen negotiated with a supplier to receive 30 days' credit on inventory purchases, which results in accounts payable running about 8 percent of sales.[6]
2. Allen estimates that accrued expenses, which are short-term liabilities on the balance sheet, will amount to about 4 percent of sales. This approximation comes from his evaluation of accrued expenses in similar businesses.
3. Allen plans to invest $110,000 of his personal savings to provide the needed start-up equity for the business. He will receive common stock in return for his investment.
4. A bank has agreed to provide a short-term line of credit of $25,000 to D&R Products. A **line of credit** is simply a short-term loan, usually from a bank, to help with temporary needs, such as seasonal increases in inventory. It works like a credit card—the company has the option to borrow up to the limit (in this case, $25,000) as needed and then pay it down when it is no longer needed.
5. The bank has also agreed to help finance the purchase of a building for manufacturing and warehousing the firm's products. Of the $40,000 needed to purchase the building, the bank will lend the firm $30,000, with the building serving as collateral for the loan. The loan will be repaid over 10 years in equal principal payments of $3,000 plus interest on the remaining balance each year.
6. As part of the loan agreement, the bank has imposed two restrictions:
   - The firm's current ratio must remain at 2.0 or above.
   - No more than 50 percent of the firm's financing may come from debt, both short-term and long-term (that is, total debt should be no more than 50 percent of total assets).

   Failure to comply with either of these conditions will cause the bank loan to come due immediately.

With this information, Allen can now estimate the sources of financing for the firm. If sales resulting from product sales and installations are $250,000 in year 1 and $375,000 in year 2, Allen estimates the following available sources of financing:

Sources of Financing	Assumptions	Year 1	Year 2
Accounts payable	8% of sales	$ 20,000	$ 30,000
Accrued expenses	4% of sales	$ 10,000	$ 15,000
Mortgage	year 1: $30,000 – $3,000 payment year 2: $27,000 – $3,000 payment	$ 27,000	$ 24,000
Common stock	Owner's investment	$110,000	$110,000

line of credit
A short-term loan, usually from a bank.

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Any remaining financing, up to $25,000, can come from the bank line of credit. If the line of credit is inadequate to meet the firm's needs, Allen will have to put more equity into the business.

Based on this information, Allen can now develop pro forma balance sheets for D&R Products. Exhibit 11.3 shows the assumptions made, the equations underlying

Exhibit 11.3 Pro Forma Balance Sheets for D&R Products, Inc.

	A	B	C	D	E
3	*BALANCE SHEET ASSUMPTIONS*	**Year 1**	**Year 2**		
4	Projected revenues: product sales and installations	$250,000	$375,000		
5	Cash/sales	4%	4%		
6	Account receivable/sales	10%	10%		
7	Inventory/sales	25%	25%		
8	Gross fixed assets	$ 50,000	$ 50,000		
9	Accounts payable/sales	8%	8%		
10	Accrued expenses/sales	4%	4%	**Equations based on assumptions**	
11	Cost of equipment	$ 10,000	$ 10,000		
12	Building cost	$ 40,000	$ 40,000		
13				*Equations for:*	
14	**Assets**			***Year 1***	***Year 2***
15	Cash	$ 10,000	$ 15,000	=B4*B5	=C4*C5
16	Accounts receivable	25,000	37,500	=B4*B6	=C4*C6
17	Inventory	62,500	93,750	=B4*B7	=C4*C7
18	Total current assets	$ 97,500	$146,250	=SUM(B15:B17)	=SUM(C15:C17)
19	Gross fixed assets	$ 50,000	$ 50,000	=B8	=C8
20	Accumulated depreciation	(4,000)	(8,000)	Depreciation expense for year 1	Accumulated depreciation expense for years 1 and 2
21	Net fixed assets	$ 46,000	$ 42,000	=B19+B20	=C19+C20
22	TOTAL ASSETS	$143,500	$188,250	=B18+B21	=C18+C21
23					
24	**Debt Liabilities and Equity**				
25	Accounts payable	$ 20,000	$ 30,000	=B4*B9	=C4*C9
26	Accrued expenses	10,000	15,000	=B4*B10	=C4*C10
27	Short-term line of credit	9,500	11,875	Required financing	Required financing
28	Total current liabilities	$ 39,500	$ 56,875	=SUM(B25:B27)	=SUM(C25:C27)
29	Mortgage	27,000	24,000	Original loan of $30,000-annual payment of $3,000	Year 1 balance of $27,000-annual payment of $3,000
30	Total debt	$ 66,500	$ 80,875	=SUM(B28:B29)	=SUM(C28:C29)
31	Ownership equity				
32	Common stock	$110,000	$110,000	Given	Given
33	Retained earnings	(33,000)	(2,625)	Year 1 loss	Year 1 loss + year 2 profit
34	Total ownership equity	$ 77,000	$107,375	=SUM(B32:B33)	=SUM(C32:C33)
35	TOTAL DEBT AND EQUITY	$143,500	$188,250	=SUM(B30:B33)	=SUM(C30:C33)
36					
37	Current ratio	$ 2.47	$ 2.57	=B18/B28	=C18/C28
38	Debt ratio	46%	43%	=B30/B35	=C30/C35

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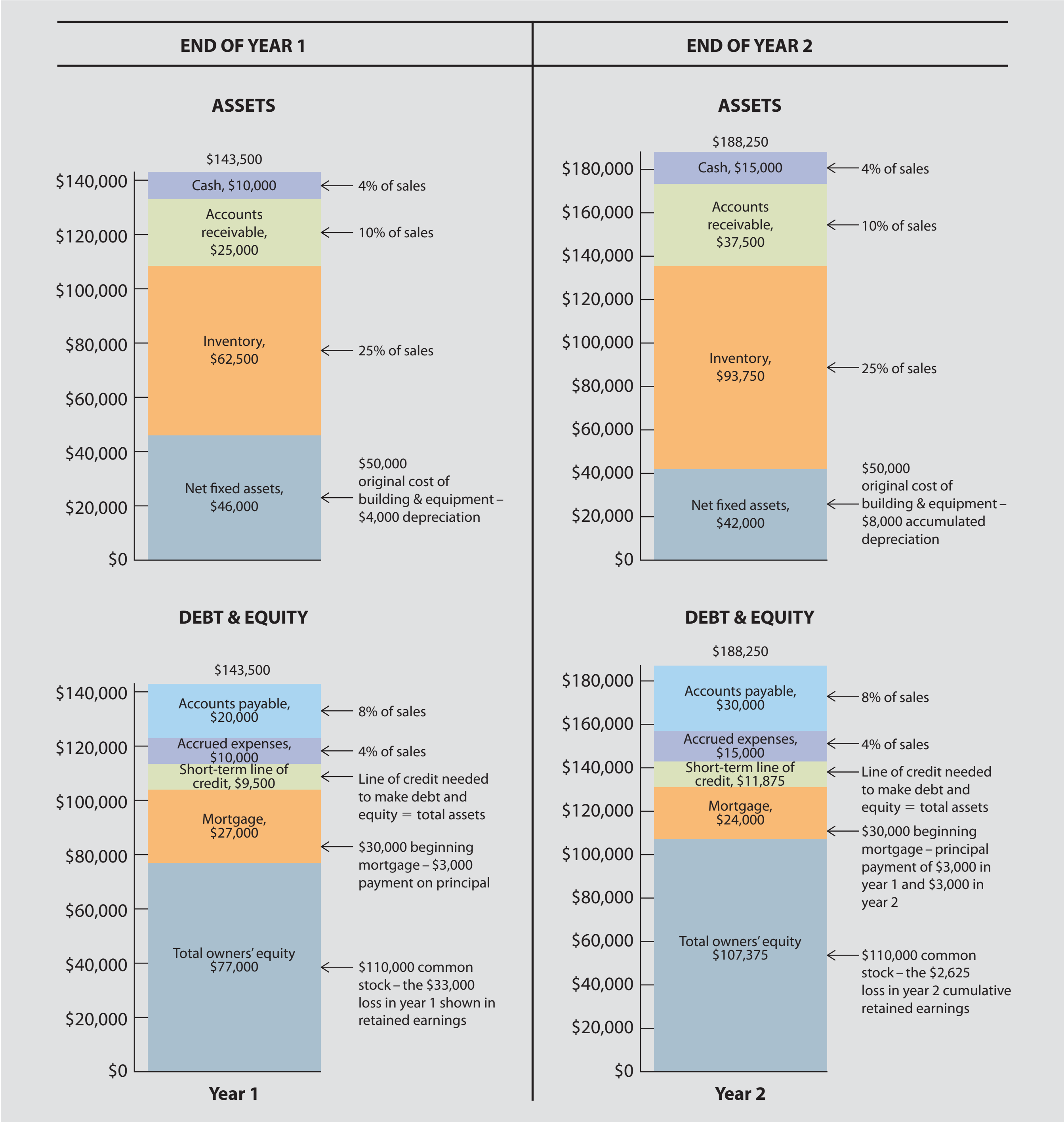
Exhibit 11.4 Graphic Presentation of Pro Forma Balance Sheets for D&R Products, Inc.



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the numbers, and the actual balance sheets, as developed in a spreadsheet. To help you visualize the results more easily, the balance sheets are also shown graphically in Exhibit 11.4. In looking at this exhibit, you need to remember three things:

1. Total assets and total sources of financing (debt and equity) must always balance. Note that D&R Products' total asset requirements of $143,500 for the first year and $188,250 for the second year are the same as the firm's total debt and equity.

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2. To bring sources of financing into balance with total assets, D&R Products will need to borrow on the company's $25,000 line of credit.
   - By the end of the first year, $9,500 of the line of credit is needed to bring the total debt and equity to $143,500.
   - In the second year, line-of-credit borrowing will increase to $11,875 to gain the $188,250 in total financing needed.
3. Finally, based on Allen's projections, the firm should be able to satisfy the bank's loan restrictions, maintaining both a current ratio of 2.0 or more and a debt ratio of less than 50 percent. The computations as follows:

Ratio	Computation	Year 1	Year 2
Current ratio	$= \frac{\text{Current assets}}{\text{Current liabilities}}$	$= \frac{\$97{,}500}{\$39{,}500} = 2.47$	$= \frac{\$146{,}500}{\$56{,}875} = 2.57$
Debt ratio	$= \frac{\text{Total debt}}{\text{Total assets}}$	$= \frac{\$66{,}500}{\$143{,}500} = 0.46 = 46\%$	$= \frac{\$80{,}375}{\$188{,}250} = 0.43 = 43\%$

We have now completed the process for forecasting a company's profitability and its asset and financing needs, as reflected in the income statement and balance sheets, respectively. Let's now consider the third and final key financing issue: projecting cash flows.

11-4 Forecasting Cash Flows

11-4 Forecast a firm's cash flows.

As we have mentioned numerous times, profits and cash flows are not the same thing. A business can have positive profits and be running out of cash—or it can incur losses, as shown in the income statement, and have positive cash flows. The income statement simply does not give business owners the information they need to know about the firm's cash flows. Forecasting cash flows is *critical* for the small business owner. If the business runs out of money, the consequences will be devastating.

11-4a An Overview of Forecasting Cash Flows

Projecting a company's cash flows can be accomplished in one of two ways:

1. The information from the pro forma income statement and balance sheets can be used to develop a pro forma statement of cash flows (similar to how ACE's cash flows were computed in Chapter 10).
2. A cash budget can be prepared (usually on a monthly, quarterly, or annual basis).

In forecasting cash flows, an owner must consider the time period used for projections. In a statement of cash flows that covers an entire year, everything may look great on paper, but the firm could very well run out of cash during certain months in that year.

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This scenario is particularly true for a business whose sales are seasonal. For instance, a wholesale sunglass company orders inventory in the spring, but most of its sales occur in the summer. Furthermore, the company will extend credit to its customers and not be paid until the end of the summer. If we look at the company's cash flows on an annual basis, all may be well. But during the spring and early summer, there will be large investments in accounts receivable and inventory, putting extreme pressure on the firm's cash flows. In this instance, the owner would want to forecast cash flows on a monthly basis—maybe even on a weekly basis.

To illustrate how to forecast cash flows, we'll first prepare pro forma statements of annual cash flows for D&R Products, Inc. Then, we will describe and illustrate how to prepare a monthly cash budget.

11-4b D&R Products, Inc.: Forecasting Cash Flows Illustrated

The pro forma income statement and balance sheets for D&R Products, Inc., that we prepared earlier will now be used to prepare a pro forma statement of cash flows, as shown in Exhibit 11.5. (Recall that the process for preparing the *historical* statement of cash flows was explained in Chapter 10.)

As you look at Exhibit 11.5, pay particular attention to (1) cash flows from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities.

Looking at these numbers, we can see that in the first year:

- The business is expected to have negative cash flows from operations of $86,500 and will be investing $50,000 in the building and equipment.

Exhibit 11.5 Pro Forma Cash Flow Statements for D&R Products, Inc.

		Year 1		Year 2	Sources of Information
Operating activities:					
Net profits		($ 33,000)		$30,375	***Pro forma income statement***
Depreciation		4,000		4,000	***Pro forma income statement***
Increase in accounts receivable (cash outflow)		($ 25,000)		($12,500)	***Changes in projected balance sheets from founding of business to year 1 and from year 1 to year 2***
Increase in inventory (cash outflow)	($62,500)		($31,250)		
Increase in accounts payable (cash inflow)	$20,000		$10,000		
Cash payments for inventory (cash outflow)		($ 42,500)		($21,250)	
Increase in accrued expenses (cash inflow)		10,000		5,000	
Cash flows from operations		**($ 86,500)**		**$5,625**	
Investing activities:					
Increase in gross fixed assets (cash outflow)		($ 50,000)		$ 0	
Cash flows from investing		**($50,000)**		**$ 0**	
Financing activities:					
Increase in short-term line of credit		**$ 9,500**		**$ 2,375**	
Increase (decrease) in mortgage		27,000		(3,000)	
Increase in stock		110,000		0	
Cash flows from financing		$146,500		($625)	
Increase (decrease) in cash		$ 10,000		$5,000	
Beginning cash		$ 0		$10,000	
Ending cash (as shown in the balance sheets)		$ 10,000		$15,000	

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- To cover these negative cash flows, Allen expects to raise $146,500 in financing from his personal investment of $110,000, $9,500 from the line of credit from the bank, and $27,000 from the mortgage on the building after making the annual $3,000 payment on the principal.
- The firm would end the year with $10,000 in cash.

In the second year:

- The company's cash flows from operations are expected to be $5,625. (Notice that while the business is expected to have $5,625 in cash flows from operations, Allen anticipates having profits of $30,375. Remember, *cash flows and profits are not the same thing*.)
- There are no plans to invest in fixed assets in the second year.
- Given his underlying assumptions, Allen would need to increase the line of credit (short-term debt) from the bank from $9,500 in year 1 to $11,875 in year 2, for an increase of $2,375, and pay $3,000 on the mortgage.
- The resulting balance of all the cash flows would be a $5,000 increase in cash, for an ending cash balance of $15,000.

Allen now has a good sense of the cash flows for each year as a whole and an idea of what contributes to the cash inflows and outflows. But there is also a need to track the firm's cash flows for shorter time periods.

11-4c An Overview of the Cash Budget

The **cash budget** is one of the primary tools that a small business owner can use to manage cash flows. The budget is concerned specifically with dollars both received and paid out during a relatively short time period, such as week or a month. *No single planning document is more important in the life of a small company, either for avoiding cash flow problems when cash runs short or for anticipating short-term investment opportunities if excess cash becomes available.*

11-4d D&R Products, Inc.: The Cash Budget Illustrated

To help you understand the process of preparing a monthly cash budget, let's continue with the example of D&R Products. In the previous section, we prepared a pro forma statement of cash flows for the year. But Allen realizes that he also needs to have a sense of the timing of the cash flows throughout the year, so he has decided to prepare a monthly cash budget for the first year of operations. We will look at the first three months of the cash budget in order to understand how it was prepared.

While Allen predicts that the firm will have $250,000 in annual sales in the first year, his sales projections for the first three months are as follows:

January	$4,000
February	$6,000
March	$9,000

In addition, the following assumptions will be made:

1. Of the firm's sales dollars, 40 percent is expected to be collected the month of the sale, 30 percent one month after the sale, and the remaining 30 percent two months after the sale.
2. Inventory purchases will equal 60 percent of projected sales in the following month.

cash budget
A listing of cash receipts and cash disbursements, usually for a relatively short time period, such as a week or a month.

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3. Inventory will be purchased one month in advance of the expected sale and will be paid for in the month in which it is sold.
4. The firm will spend $3,000 each month for advertising.
5. Salaries and utilities for the first three months are estimated as follows:

	Salaries	Utilities
January	$5,000	$150
February	$6,000	$200
March	$6,000	$200

6. Allen will be investing $110,000 in the business from his personal savings.
7. The firm will be investing $10,000 for needed equipment and $40,000 for the purchase of a building, for a total investment of $50,000. However, the bank has agreed to finance $30,000 of the building purchase price in the form of a mortgage.

Based on this information, Allen has prepared a monthly cash budget for the three-month period ending March 31. Exhibit 11.6 shows the results of his computations, which involve the following steps:

Step 1. Determine the amount of collections each month, based on the projected sales patterns just provided.

Step 2. Estimate the amount and timing of the following cash disbursements:

a. *Inventory purchases and payments.* The amount of the purchases is shown in the boxed area at the top of the table. However, the actual payment for inventory will not be made until one month later.

b. *Advertising, wages and salaries, and utilities.* These items are paid for in the month that the charges are incurred.

Step 3. Calculate the *cash flows from operating activities*, which equals the cash receipts (collections from sales) less cash disbursements.

Step 4. Recognize the $110,000 investment in the business by Allen.

Step 5. Note the $50,000 investment in the building and equipment.

Step 6. Show the $30,000 loan from the bank to help pay for the building.

Step 7. Determine the beginning-of-month cash balance (ending cash balance from the prior month).

Step 8. Compute the end-of-month cash balance.

Based on the cash budget, Allen now has an idea of what to expect for the first three months of operations, which could not be determined from the annual pro forma statement of cash flows from operations presented in Exhibit 11.5. Allen can now anticipate the following:

- The business will be "burning" somewhere between $8,000 and $9,200 of cash per month (often called the *cash burn rate*) for the first three months of operations.
- Given that he will have almost $64,000 in cash remaining at the end of March, he will run out of cash in about seven or eight months if the cash flows from operations continue to be negative $8,000 or $9,000 each month. At that time, he will have to start borrowing on the bank line of credit.

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Exhibit 11.6 Three-Month Cash Budget for D&R Product, Inc., for January–March

Assumptions:

Anticipated sales collections:

In the month of sale	40%
1 month later	30%
2 months later	30%

	December	January	February	March
Monthly Sales	$ 0	$4,000	$6,000	$9,000
Inventory purchases on credit	$2,400	$3,600	$5,400	

		December	January	February	March
	Monthly Sales	$0	*$ 4,000	$ 6,000	$ 9,000
	Cash receipt				
Step 1:	Collection of sales				
	In month of sale		$ 1,600	$ 2,400	$ 3,600
	1 month later			1,200	1,800
	2 months later				1,200
	Total cash receipts		$ 1,600	$ 3,600	$ 6,600
Step 2:	**Operating cash disbursements**				
Step 2a:	Payments on inventory purchases		$ 2,400	$ 3,600	$ 5,400
Step 2b:	Advertising		3,000	3,000	3,000
	Wages and salaries		5,000	6,000	6,000
	Utilities		150	200	200
	Total operating cash disbursements		$10,550	$12,800	$14,600
Step 3:	**Cash flows from operations**		($ 8,950)	($ 9,200)	($ 8,000)
Step 4:	Allen's personal investment		110,000		
Step 5:	Purchases of equipment and building		(50,000)		
Step 6:	Mortgage (loan from the bank to buy the building)		30,000		
Step 7:	Beginning cash balance		0	81,050	71,850
Step 8:	**Ending cash balance**		$81,050	$71,850	$ 63,850

*For example, January sales of $4,000 are collected as follows: (40%) $1,600 in January, (30%) $1,200 in February, (30%) $1,200 in March.

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11-5 Use Good Judgment When Forecasting

11-5 Provide suggestions for effective financial forecasting.

The forecasting process requires an entrepreneur to exercise good judgment in planning, particularly when the planning provides the basis for raising capital. The overall approach to forecasting is straightforward—entrepreneurs make assumptions and, based on those assumptions, determine financing requirements. But entrepreneurs may be tempted to overstate their expectations to acquire much needed financing. How do you get it right? Here are some practical suggestions about making financial forecasts:

1. *Develop realistic sales projections.* Entrepreneurs often think they can accomplish more than they actually are able to, especially when it comes to forecasting future sales. On a graph, their sales projections for a new venture often resemble a hockey stick—the sales numbers are flat or rise slightly at first (like the blade of a hockey stick) and then soar upward (like a hockey stick's handle). Such

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projections are always suspect—only the most astonishing changes in a business or market can justify such a sudden, rocket-like performance.

2. *Consider different scenarios.* When it comes to forecasting, you should typically prepare at least three scenarios—one with an aggressive forecast for sales increases, another using more conservative assumptions, and a third with worst-case situations. This is particularly important in an environment where future demand is unclear.
3. *Build projections from clear assumptions about marketing and pricing plans.* Don't be vague, and don't guess. Spell out the kinds of marketing you plan to do—for example, state specifically how many customers you expect to attract.
4. *Do not use unrealistic profit margins.* Projections are immediately suspect if profit margins (profits divided by sales) or expenses are significantly higher or lower than the average figures reported by firms in the industry with similar revenues and numbers of employees. In general, a new business should not expect to exceed the industry average in profit margins. Entrepreneurs frequently assume that as their company grows it will achieve economies of scale, and gross and operating profit margins will improve. In fact, as the business grows and increases its fixed costs, its operating profit margins are likely to suffer in the short run. If you insist in your projections that the economies can be achieved quickly, you will need to explain your position.
5. *Don't limit your projections to an income statement*. Entrepreneurs frequently resist providing projected balance sheets and cash flow statements. They feel comfortable projecting sales and profits but do not like having to commit to assumptions about the sources and uses of capital needed to grow the business. Investors, however, want to see those assumptions in print. They are particularly interested in the firm's cash flows—and you should be as well.
6. *Provide monthly data for the upcoming year, quarterly data for the second year, and annual data for succeeding years.* Many entrepreneurs prepare projections using only monthly data or annual data for an entire three- or five-year period. Given the difficulty in forecasting accurately beyond a year, monthly data for the later years are not particularly believable. From year 2 on, annual projections are adequate.
7. *Avoid providing too much financial information*. Computer spreadsheets are extremely valuable in making projections and showing how different assumptions affect the firm's financials. But do not be tempted to overuse this tool. Instead, limit your projections to two cases: the most-likely (base) case and the break-even case. The base case should show what you realistically expect the business to do; the break-even case should show what level of sales is required to break even.
8. *Be certain that the numbers reconcile—and not by simply plugging in a figure*. All too often, entrepreneurs plug a figure into equity to make things work out. While everyone makes mistakes, that's one you want to avoid because it can result in a loss of credibility.
9. *Be flexible*. Entrepreneurship is about seeking opportunities, and there is a real danger that a cash budget may lead to inflexibility. Once a budget has been prepared, a business owner must decide how to use it. A strict cost-containment strategy in order to "make the budget" can discourage owners from being creative and shifting their approach when it makes sense to do so.

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10. *Communicate with suppliers.* Budget preparation is a good time to scrutinize vendor relationships. Your suppliers may be mapping out their expectations for the year as well, and you can help them do so by providing the firm's outlook. Depending on the closeness of the relationship, you might share the budget and the possible scenarios you might face with suppliers to see whether they can handle each level of demand.
11. *Provide for your personal living expenses.* While our focus is on ascertaining the financial needs of the business, a small business owner should not disregard personal finances. Particularly during the early stages of the business, the owner may have to make some significant personal sacrifices and assume some personal risks. Even so, personal living expenses have to be considered alongside the financing needs of the business, even if at a minimal level. Inadequate provision for your living expenses could lead to the temptation of diverting assets from the business for personal needs and a departure from the plan.

These suggestions, if followed, will help you avoid overpromising and underdelivering when starting a business. But even then, you may simply have to have faith that you will be able to deliver on what you promise, even though it may not be clear exactly how this will be accomplished. Risk is part of the equation, and often things will not go as planned. But integrity requires that you honor your commitments, and that cannot be done if you have made unrealistic projections about what you can accomplish.

The information on financial planning provided in this chapter and in Chapter 10 will serve as a foundation for the examination of an entrepreneur's search for specific sources of financing in Chapter 12.

11-1. Describe the purpose of financial forecasting.

- The purpose of pro forma financial statements is to determine (1) future profitability based on projected sales levels and expected sales-expenses relationships, (2) how much and what type of financing will be needed, and (3) whether the firm will have adequate cash flows.
- Accurate financial forecasting is important not only for ensuring that a firm has the resources it needs to grow, but also for managing growth.

11-2. Develop a pro forma income statement to forecast a new venture's profitability.

- In order to develop a pro forma income statement, an entrepreneur must understand the drivers of a firm's profits, which include (1) amount of sales, (2) cost of goods sold, (3) operating expenses, (4) interest expense, and (5) taxes.
- An entrepreneur should evaluate potential revenue models and cost structures when thinking about how to build an economically viable company.

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- In a real-world situation, an entrepreneur should project the profits of a company for at least three years into the future.

11-3. Determine a company's asset and financing requirements using a pro forma balance sheet.

- The amount and type of assets required for a venture will vary according to the nature of the business. However, most firms need to understand how much working capital (current assets) and fixed assets will be required.
- An entrepreneur should try to bootstrap as many resources as possible in order to minimize a firm's investment while simultaneously ensuring adequate resources.
- A direct relationship exists between sales growth and asset needs: As sales increase, more assets are required.
- For every dollar of assets, there must be a corresponding dollar of financing.
- To forecast a firm's financing requirements, an entrepreneur must understand (1) its asset requirements, (2) the need to maintain adequate liquidity, (3) the debt ratio, (4) sources of spontaneous debt financing, and (5) cash flows available from operations to be reinvested in a firm's future growth.

11-4. Forecast a firm's cash flows.

- Forecasting cash flows can be accomplished in two ways: (1) by preparing a pro forma statement of cash flows, and/or (2) by developing a cash budget. Ideally, an entrepreneur would do both.
- A firm's cash flows involve three activities: operating, investing, and financing activities.
- A cash budget is concerned specifically with dollars both received and paid out during a relatively short time period.
- A cash budget should not only help the entrepreneur avoid cash flow problems, but also anticipate short-term investment opportunities if excess cash becomes available. The entrepreneurial process is all about seizing opportunity.

11-5. Provide suggestions for effective financial forecasting.

- Develop realistic sales projections. Do not inflate the numbers to impress lenders and investors!
- Consider different scenarios.
- Build projections from clear assumptions about marketing and pricing plans.
- Do not use unrealistic profit margins. In general, new businesses do not exceed industry average profit margins in their early years.
- Do not limit your projections to an income statement. Investors want to see pro forma balance sheets and a pro forma cash flow statement as well.
- Provide monthly data for the upcoming year, quarterly data for the second year, and annual data for succeeding years.
- Avoid providing too much financial information. Limit projections to the most-likely case (base case) and the break-even case.
- Be certain that the numbers reconcile.
- Be flexible.
- Communicate with suppliers.
- Funding for a new venture should cover asset requirements and the personal living expenses of the owner.

Key Terms

cash budget p. 293
line of credit p. 288
net working capital p. 284
percentage-of-sales technique p. 286
pro forma financial statements p. 278
spontaneous debt financing p. 287

Discussion Questions

1. What determines a company's profitability?
2. Discuss how asset and financing requirements might differ among a retail business, a service company, and an information system–based venture.
3. Why is it important to consider an entrepreneur's personal finances when conducting short- and long-term financial forecasts for a firm?
4. Describe the process for estimating the amount of assets required for a new venture.
5. What are some of the basic principles that govern the financing of a firm? Why are they important?
6. How are a start-up's financing requirements estimated?
7. Describe two ways for projecting a venture's cash flows, and discuss when each is appropriate to use.
8. When forecasting cash flows, why is it important to consider the time period covered by the forecast? What issues should the entrepreneur consider when doing financial forecasts?

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9. Why is it important for an entrepreneur not only to create a cash budget, but also to decide how it will be used within the firm?
10. Choose three of the practical suggestions for making financial forecasts. Discuss their importance, as well as the potential consequences of ignoring these suggestions.

You Make the Call

Situation 1

D&R Products, Inc., used as an example in this chapter, is an actual firm (although some of the facts were changed to maintain confidentiality). David Allen bought the firm from its founding owners and moved its operations to his hometown. Although he has estimated the firm's asset needs and financing requirements, he cannot be certain that these projections will be realized. The figures merely represent the most-likely case. Allen also made some projections that he considers to be the worst-case and best-case sales and profit figures. If things do not go well, the firm might have sales of only $200,000 in its first year. However, if the potential of the business is realized, Allen believes that sales could be as high as $325,000. If he needs any additional financing beyond the existing line of credit, he could conceivably borrow another $5,000 in short-term debt from the bank by pledging some personal investments. Any additional financing would need to come from Allen himself, thereby increasing his equity stake in the business.

Question If all of D&R Products' other relationships hold, how will Allen's worst-case and best-case projections affect the income statement and balance sheet in the first year? To help you in your analysis, D&R Product's pro forma statements, as presented in Exhibits 11.1, 11.3, and 11.4, are available at CengageBrain.com (select the Longenecker text).

Situation 2

Philip Spencer of the Spencer Corporation wants you to forecast the firm's financing needs over the fourth quarter (October through December). He has made the following observations relative to planned cash receipts and disbursements:

- Interest on a $75,000 bank note (principal due next March) at an 8 percent annual rate is payable in December for the three-month period just ended.
- The firm follows a policy of paying no cash dividends.
- Actual historical and future predicted sales are as follows:

Historical Sales		Predicted Sales	
August	$150,000	October	$200,000
September	175,000	November	220,000
		December	180,000
		January	200,000

- The firm has a monthly rental expense of $5,000.
- Wages and salaries for the coming months are estimated at $25,000 per month.
- Of the firm's sales, 25 percent is collected in the month of the sale, 35 percent one month after the sale, and the remaining 40 percent two months after the sale.
- Merchandise is purchased one month before the sales month and is paid for in the month it is sold. Purchases equal 75 percent of sales.
- Tax prepayments are made quarterly, with a prepayment of $10,000 in October based on earnings for the quarter ended September 30.
- Utility costs for the firm average 3 percent of sales and are paid in the month they are incurred.
- Depreciation expense is $20,000 annually.

Question 1 Prepare a monthly cash budget for the three-month period ending in December.

Question 2 If the firm's beginning cash balance for the budget period is $7,000, and this is its desired minimum balance, determine when and how much the firm will need to borrow during the budget period. The firm has a $50,000 line of credit with its bank, with interest (10 percent annual rate) paid monthly. For example, interest on a loan taken out at the end of September would be paid at the end of October and every month thereafter, as long as the loan was outstanding.

Situation 3

Karen Lamont is in the process of starting a new business and wants to forecast the first year's income statement and balance sheet. She has made a number of assumptions:

1. Lamont has projected the firm's sales will be $1 million in the first year.
2. She believes that the operating and gross profit margins will be 20 percent and 50 percent, respectively.
3. For working capital, Lamont has estimated the following:
   - Accounts receivable as a percentage of sales: 12%
   - Inventory as a percentage of sales: 15%
   - Accounts payable as a percentage of sales: 7%
   - Accruals as a percentage of sales: 5%
4. A bank has agreed to lend her $300,000, consisting of $100,000 in short-term debt and $200,000 in long-term debt. Both loans will have an 8 percent interest rate.
5. The firm's tax rate will be 30 percent.
6. Lamont will need to purchase $350,000 in plant, property, and equipment.

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Lamont will provide any other financing needed.

Question 1 Based on Lamont's assumptions, prepare a pro forma income statement and balance sheet.

Question 2 If her estimates are correct, what will be the firm's current ratio and debt ratio? Explain the meaning of these ratios.

Experiential Exercises

1. Create a new business idea for practice and develop a pro forma income statement to forecast the new venture's profitability.
2. Find an existing business's financials, and forecast the firm's cash flows for the next year.
3. List and describe at least five suggestions to follow in order to effectively forecast financials.

Business Plan

LAYING THE FOUNDATION

As part of laying the foundation to prepare your own business plan, you will need to develop the following:

1. A business model that recognizes the different revenue streams, cost structures, and key resources to grow the business.
2. Historical financial statements (if applicable) and three to five years of pro forma financial statements, including balance sheets, income statements, and statements of cash flows.
3. Monthly cash budgets for the first year and quarterly cash budgets for the second year.
4. The rationale and explanation for the underlying assumptions for your pro forma financial statements.
5. Current and planned financing to be provided by the owners and other investors.
6. Justification of the intended use of funds being raised from lenders and investors.
7. Profit and cash flow break-even analysis. (See Chapter 16 for an explanation of break-even analysis.)

Chapter 11 Case

Please see Appendix A for the Chapter 11 Case Study.

Endnotes

1. This example is based on an actual situation. However, the name of the founder and company have been changed, as have some of the numbers.
2. Investors also look to financial projections to determine the sales level necessary for the firm to break even. A firm's break-even point, while important from a financial perspective, is also important for pricing its products or services. The issue of pricing and the break-even point are discussed in Chapter 16.
3. In Chapter 10, we used the current ratio to measure a company's ability to meet maturing obligations, which was measured as current assets divided by current liabilities. Thus, the current ratio is a relative measure (current assets relative to current liabilities), which allows us to compare firms of different sizes. Net working capital (current assets less current liabilities) is an absolute dollar measure of liquidity used by many bankers.
4. Personal communication with Cecilia Levine, April 25, 2019.
5. As you will see in Chapter 12, banks frequently will not lend anything to a start-up that has no proven cash flow history, unless the owner has collateral to secure the loan.
6. Thirty days' credit means that Allen must pay on accounts payable 12 times per year. So, accounts receivable would be 1/12th of sales, and 1/12 = .0833 = 8.33%.

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Chapter

12

Financing the Small Business

Learning Objectives

The primary purpose of the Financing the Small Business chapter is to help you determine whether to use debt or equity to finance your business, as well as learn about the different sources of financing that are available to a small business owner. By studying this chapter, you should be able to . . .

12-1 Describe how a firm's characteristics affect its available financing sources.

12-2 Evaluate the choice between debt financing and equity financing.

12-3 Describe the starting point for financing a small business.

12-4 Discuss the basic process for acquiring and structuring a bank loan.

12-5 Explain how business relationships can be used to finance a small firm.

12-6 Describe the two types of private equity investors who offer financing to small firms.

12-7 Describe how crowdfunding can be used by some small businesses to raise capital.

12-8 Distinguish among the different government loan programs available to small companies.

12-9 Explain when large companies and public stock offerings can be sources of financing.

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Spotlight on Small Business

Ready, Set, Food!

https://readysetfood.com

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Founded by Daniel Zakowski and Dr. Andrew Leitner in 2017, Ready, Set, Food! set out to help prevent childhood food allergies. With children, food allergies are often discovered too late. Parents feed a child a small portion of food, and an allergic reaction occurs seemingly out of nowhere, often an alarming experience for the family.

When the Ready, Set, Food! founders discovered there were methods that could reduce the likelihood of food allergies developing in young children, they wanted to be proactive about it. So, Zakowski and Leitner founded their company with the mission to provide a safe, science-based approach to exposing a baby to common potential allergies.

As most start-up teams experience, finding the capital needed to begin a business can be a major problem. It is particularly difficult for a young entrepreneur who does not have sufficient personal net worth to finance a business. Other investors want to see that an owner has some "skin in the game" before they will invest.

As it turned out, Zakowski and Leitner were highly effective in raising money for their business. Their financing process follows:

- *Limited owners' investment*. The young entrepreneurs were only able to invest $50,000 of their own money before going to other sources of capital.
- *Friends and family*. The two entrepreneurs next reached out to friends and family, who had little knowledge about the business and industry and invested based on their personal relationships. anywhere from $10,000 to $150,000 in total.
- *Business angels*. Soon after friends and family had invested, Zakowski and Leitner approached former business owners who like to invest in start-ups and early-stage companies. These investors are known as *business angels*
- *Venture capitalists*. If a firm's growth accelerates rapidly, the founders may seek larger investors, possibly *venture capitalists*. These investors make large investments in companies that they believe will change the way we live. But rarely do small companies ever have the need or opportunity to attract such investors. Nevertheless, Ready, Set, Food! was able to raise $2.2 million from a select group of venture capitalists, led by Amplify.LA, based in Los Angeles, California.
- *Strategic investors*. Finally, Ready, Set, Food! received $3 million from Danone, a world-leading nutrition company, and other investors, such as Shark Tank's Mark Cuban, owner of the Dallas Mavericks and a successful entrepreneur and investor.

The company's fundraising process does not represent what generally happens in the world of small business, but it does describe the experience of a start-up business that captures a really large market.

Sources: "Daniel Zakowski, CEO at Ready, Set, Food!, Is on a Mission to Save 200,000 Babies from Severe Food Allergies Every Year, September 30, 2020, https://startup.info/daniel-zakowski-ready-set-food/, accessed August 1, 2021; and "Ready, Set, Food! Announces $3 Million in New Funding Round Led by Danone Manifesto Ventures and Mark Cuban," July 20, 2020, https://www.prnewswire.com/news-releases/ready-set-food-announces-3-million-in-new-funding-round-led-by-danone-manifesto-ventures-and-mark-cuban-301095923.html, accessed August 1, 2021.

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In Chapter 11, we addressed *how much* financing is needed. In this chapter, we describe the different sources of financing. But first, it's important to understand how a firm's characteristics affect the way in which it will be financed.

12-1 Firm Characteristics and Sources of Financing

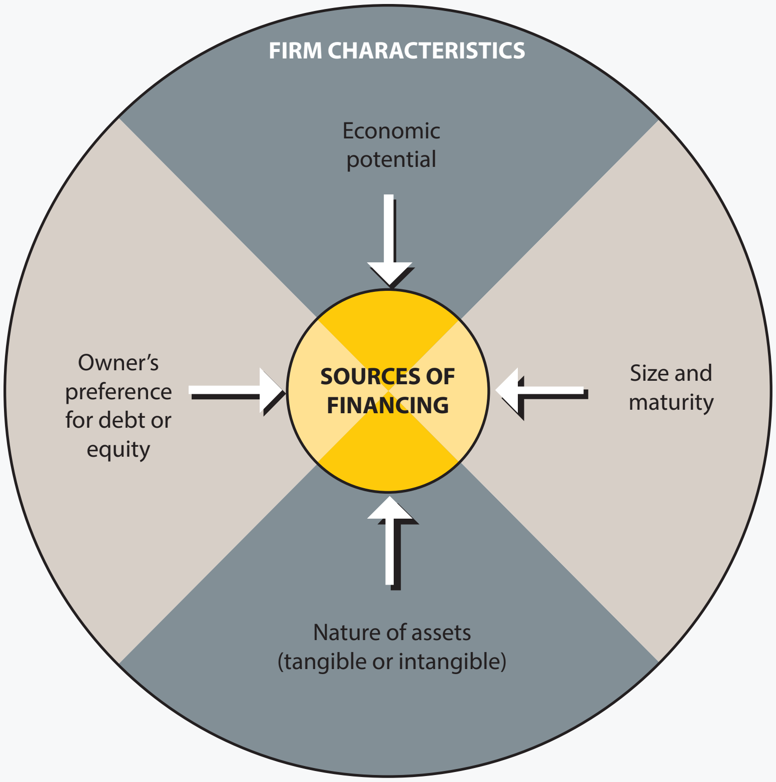
12-1 Describe how a firm's characteristics affect its available financing sources.

Four basic firm characteristics significantly affect how a business is financed (refer to Exhibit 12.1):

1. The firm's economic potential.
2. The size and maturity of the company.
3. The nature of its assets.
4. The owner's personal preference with respect to using debt or equity, which can affect a firm's risk.

Without understanding how these characteristics come into play in financing your business, you stand little chance of getting appropriate financing.

Exhibit 12.1 **Firm Characteristics and Available Sources of Financing**



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12-1a A Firm's Economic Potential

In terms of profitability and possibilities for growth, the ways in which the economic potential of a business affects financing choices can be stated simply:

- A company that provides a comfortable lifestyle for its owner but insufficient profits to attract outside investors will find its options for alternative sources of financing limited.
- A firm with potential for high growth and large profits has more possible sources of financing. In fact, most investors are looking for firms that can be sold in five to ten years at five to ten times their original investment.

12-1b Company Size and Maturity

Larger and older firms have access to bank credit that may not be available to younger and smaller companies. Also, smaller firms tend to rely more on personal loans and credit cards for financing. In the early years of a business, most entrepreneurs bootstrap their financing—that is, they depend on their own initiative to come up with the necessary capital. Only after the business has an established track record will most bankers and other financial institutions be willing to provide financing.

You have probably read about venture capitalists who helped finance firms, suchs as Yahoo, eBay, and Apple. However, even venture capitalists limit how much they will invest in start-up companies. Many such investors believe the additional risk associated with start-ups is too great relative to the returns they can expect to receive. On average, about three-quarters of a venture capitalist's investments are in later-stage businesses—only a few focus heavily on start-ups. Similarly, bankers demand evidence that the business will be able to repay a loan—which is usually based on what the firm has done in the past and not what the owner says it will achieve in the future. So, a firm's life-cycle position is a critical factor in raising capital.

12-1c The Nature of a Firm's Assets

A banker specifically considers two types of assets when evaluating a firm for a loan: tangible assets and intangible assets. Tangible assets, which are physical assets or property, include inventory, equipment, and buildings. The cost of tangible assets appears on the firm's balance sheet, which the banker receives as part of the firm's financial statements.

Tangible assets are great collateral when a firm is requesting a bank loan. While intangible assets, such as goodwill or past investments in research and development, are important to an investor, they have little value as collateral when it comes to getting a loan. As a result, companies with substantial tangible assets have a much easier time borrowing money than do companies with intangible assets.

12-1d Owner Preferences for Debt or Equity

The owner of a company faces the question "Should I finance with debt or equity, or some mix of the two?" The answer depends on the situation. But in part, it is affected by trade-offs that a business owner will have to make depending on their personal preferences.

Understand that there is no single right or wrong answer here. What is right for one person may be wrong for another, depending on their personal preferences for assuming

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risk. Only time will tell whether the choice was a good one. In the next section, we will consider the trade-offs faced in choosing between debt and equity financing.

12-2 Choosing Between Debt and Equity Financing

12-2 Evaluate the choice between debt financing and equity financing.

Most providers of financial capital specialize *either* in debt financing *or* equity financing. Furthermore, the choice between debt and equity financing must be made early in a firm's life cycle and may have long-term financial consequences. To make an informed decision, a small business owner needs to understand the trade-offs between debt and equity regarding the following three factors:

- The potential profitability for the owners.
- The business's financial risk.
- Who will have voting control of the business.

Let's consider each factor in turn.

12-2a Potential Profitability

Those who own a business want it to provide a good return on their investment. To understand how the choice between debt and equity affects the return on an owner's equity investment, consider the Davis Corporation, a new business. Its owner, Cate Slayton Davis, is still in the process of raising needed capital. Davis has already invested \$100,000 of her own money in the new business. To complete the financing, she needs another \$100,000. She is considering two options for raising the additional \$100,000:

1. Adding equity investors (common stockholders), who would provide \$100,000 for a 30 percent share of the firm's outstanding stock.
2. Getting a bank loan at an interest rate of 8 percent—the interest expense each year would be \$8,000 $(\$8,000 = 0.08 \times \$100,000)$.

In the first instance, Davis would have to give up 30 percent of the company's ownership. On the other hand, if debt financing is used, there would be no loss of ownership. However, the firm would have a fixed annual interest cost of \$8,000, no matter how well the business does.

Davis expects that the firm's *operating profits* (earnings before interest expense and taxes are paid) will be \$28,000.

With the additional \$100,000 in financing, the firm's total assets would be \$200,000 (\$100,000 original equity plus \$100,000 in additional financing).

Based on the projected operating profits of \$28,000 and total assets of \$200,000, the firm expects to earn a 14 percent return on assets, computed as follows:

$$\text{Return on assets} = \frac{\text{Operating profits}}{\text{Total assets}} = \frac{\$28,000}{\$200,000} = 0.14 = 14\%$$

If the firm raises the additional \$100,000 in equity from a new investor, its balance sheet will appear as follows:

Total assets	\$200,000
Debt	\$ 0
Equity (from Davis and new equity investors)	200,000
Total debt and equity	\$200,000

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However, if the firm instead borrows $100,000, the balance sheet will look like this:

Total assets	$200,000
Debt (8% interest rate)	$100,000
Equity (from Davis)	100,000
Total debt and equity	$200,000

If we assume that the firm pays no taxes (just to keep matters simple), we can use the information above to project the firm's net profits when the additional $100,000 is financed by either equity or debt:

	Equity	**Debt**	
Operating profits	$28,000	$28,000	
Interest expense	0	(8,000)	= (0.08 × $100,000)
Net profits	$28,000	$20,000	

From these computations, we see that net profits are greater if the firm finances with equity ($28,000 in net profits) than with debt ($20,000 in net profits). Twice as much money ($200,000 rather than $100,000) would have to be invested to avoid the $8,000 interest expense and get the higher net profits.

Should Davis finance with equity to get higher net profits—in this case, an increase of $8,000? Not necessarily. The return on the owner's investment, or *return on equity*, is a better measure of performance than the absolute dollar amount of net profits. Remember from Chapter 10 that an owner's return on equity is calculated as follows:

$$\text{Return on equity} = \frac{\text{Net profits}}{\text{Total owner's equity}}$$

So, when the firm uses *all equity* financing, the return on equity is 14 percent, computed as follows:

$$\textit{Return on equity if using all equity} = \frac{\textit{Net profits}}{\textit{Total owner's equity}} = \frac{\$28{,}000}{\$200{,}000} = 0.14 = 14\%$$

But if the additional financing comes from *debt*, leading to an interest expense of $8,000 with an equity investment of only $100,000, the rate of return on equity is 20 percent, calculated as follows:

$$\textit{Return on equity if using debt} = \frac{\textit{Net profits}}{\textit{Total owner's equity}} = \frac{\$20{,}000}{\$100{,}000} = 0.20 = 20\%$$

Thus, Davis's return on equity is higher if half of the firm's financing comes from equity and half from debt.

- By using equity, the owners will earn $0.14 for every $1 of equity invested.
- By using debt, Davis, the sole owner, will earn $0.20 for every $1 of equity invested.

So, in terms of a rate of return on her personal investment, Davis gets a better return by borrowing money at 8 percent interest than by bringing in new equity investors who will want to share the profits equally. Because the firm is earning 14 percent on all the assets of $200,000, but only paying creditors an 8 percent rate on the loan of $100,000, Davis will benefit from the difference. These relationships are shown in Exhibit 12.2.

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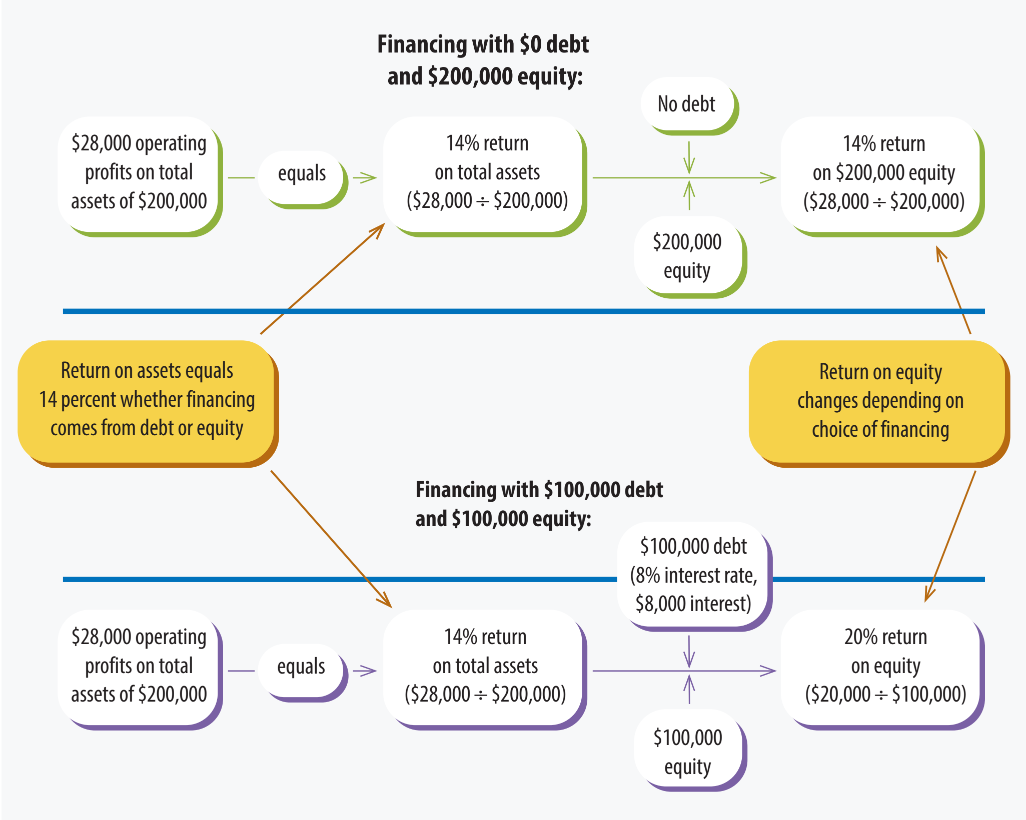
Exhibit 12.2 Davis Corporation: Choosing Between Debt and Equity



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You have now learned a core principle of finance:

> If a firm's return on its assets (operating profits ÷ total assets) is greater than the cost of the debt (interest rate), the owner's return on equity will increase as the firm uses more debt.

Our recommendation to you: **Never ever forget this principle!**

12-2b Financial Risk

If debt is so beneficial in terms of producing a higher rate of return for owners, why shouldn't Davis use as much debt as possible—even 100 percent debt—if she can? Then her rate of return on the equity investment would be even higher—unlimited, in fact, if she does not have to invest any money.

That's the good news. The bad news: *Debt is risky*. If the firm fails to earn profits, creditors still insist on being repaid, regardless of the firm's actual performance. In extreme cases, a creditor can force a firm into bankruptcy if it fails to honor the terms of a loan.

Equity, on the other hand, is less demanding. If a firm is not profitable, an equity investor must accept the disappointing results and hope for better results next year. Equity investors cannot demand more than what is earned.

Another way to view the negative side of debt is to contemplate what happens to the return on equity if a business has a bad year. For example, suppose that instead of earning

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14 percent on its assets, or $28,000 in operating profits, the Davis Corporation earns a mere $2,000—only 1 percent on its assets of $200,000 $\left(1\% = .01 = \$2,000 \div \$200,000\right)$.

The return on equity would again depend on whether the firm used debt or equity to finance the second $100,000 investment in the company. The results would be as follows:

	Equity	**Debt**	
Operating profits	$2,000	$2,000	
Interest expense	0	(8,000)	= (0.08 × $100,000)
Net profits	$2,000	($6,000)	

If the added financing came in the form of equity, the return on equity would be a disappointing 1 percent:

$$\textit{Return on equity if using all equity} = \frac{\textit{Net profits}}{\textit{Total owner's equity}} = \frac{\$2,000}{\$200,000} = 0.01 = 1\%$$

But if debt was used, the return on equity would be a painful negative 6%:

$$\textit{Return on equity if using debt} = \frac{\textit{Net profits}}{\textit{Total owner's equity}} = \frac{(\$6,000)}{\$100,000} = (0.06) = (6\%)$$

Therefore, even if only 1 percent is earned on the firm's assets, Davis would be better off by financing solely with equity. This example makes it clear that debt can be a double-edged sword.

If debt financing is used and things go well, they will go *very* well for the owners. But if things go badly, they will go *very* badly for the owners. In short, *debt financing increases the firm's financial risk*.

You now have a more complete understanding of the core financial principle we described earlier. We can take another perspective on this principle and expand it further:

> If a firm's return on its assets (operating profits ÷ total assets) is less than the cost of the debt (interest rate), the owner's return on equity will decrease as the firm uses more debt.

Again, our recommendation to you: **Forget this principle, and you may pay a price you will regret!**

12-2c Voting Control

The third issue in choosing between debt and equity is the degree of control retained by owners. Raising new capital through equity financing would mean giving up a part of the firm's ownership, and most owners of small firms resist giving up control to outsiders. They do not want to be accountable in any way to minority owners, much less take the chance of possibly losing control of the business.

Out of an aversion to losing control, many small business owners choose to finance with debt rather than with equity. Although they realize that debt increases risk, it permits them to retain full ownership of the firm.

To visualize the trade-offs that we have described, refer to Exhibit 12.3. Carefully studying the exhibit should help you grasp the effects of debt and equity financing on the business owner.

With an understanding of the basic trade-offs to be considered when choosing between debt and equity, let's now look at specific sources of financing that are

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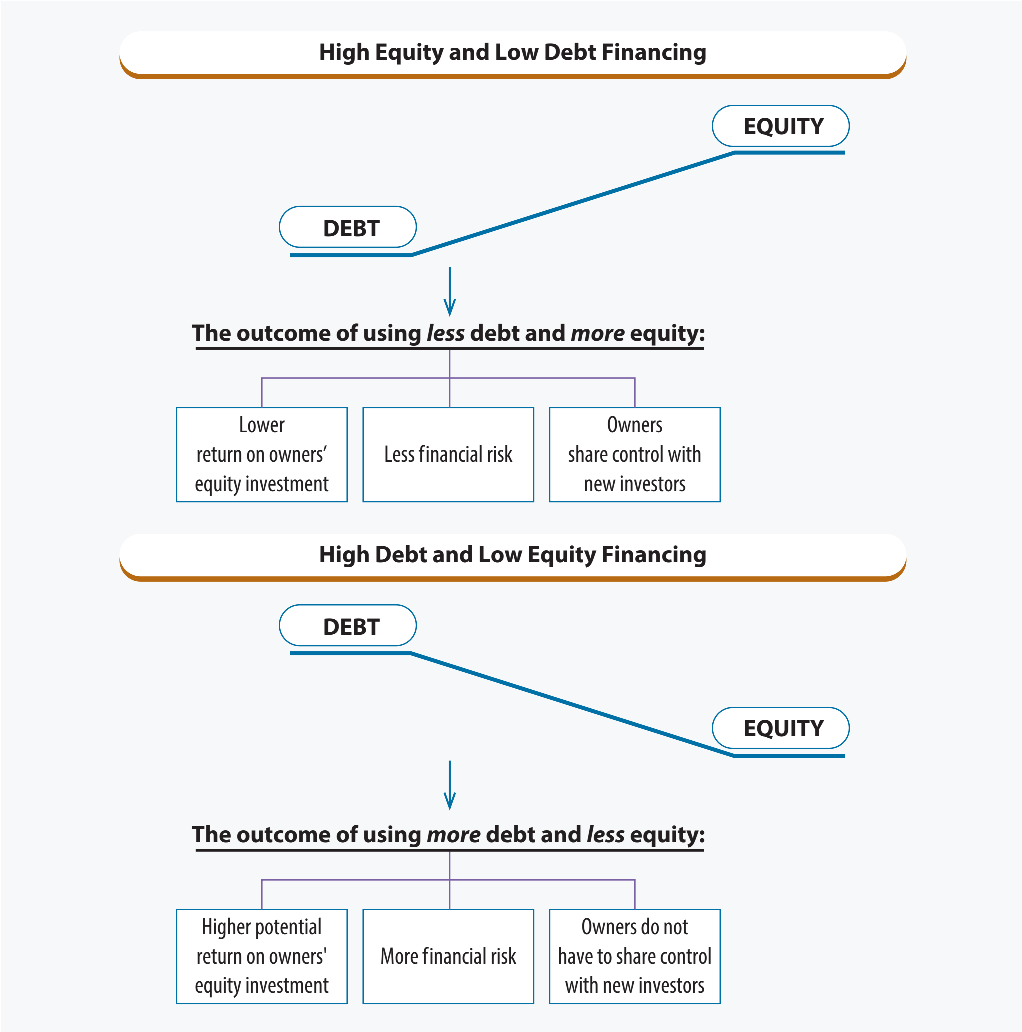
Exhibit 12.3 Trade-Offs Between Debt and Equity



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available to a small business owner. Where do small business owners go to find the money to finance their companies?

12-3 Sources of Small Business Financing: The Starting Point

12-3 Describe the starting point for financing a small business.

When financing a small business, an owner almost always relies first on personal savings, followed by investments from family and friends, and maybe a credit card or two. If these sources are inadequate, the owner may in certain circumstances turn to more formal channels of financing, such as banks and outside investors.

Exhibit 12.4 gives an overview of the potential sources of financing for smaller companies. Be sure to note the following:

- Some sources of financing offer only debt financing. These sources include banks, business suppliers, asset-based lenders, the government, and community-based financial institutions.
- Equity financing for most small business owners primarily comes from personal savings and, in rare instances, from selling stock to the public.

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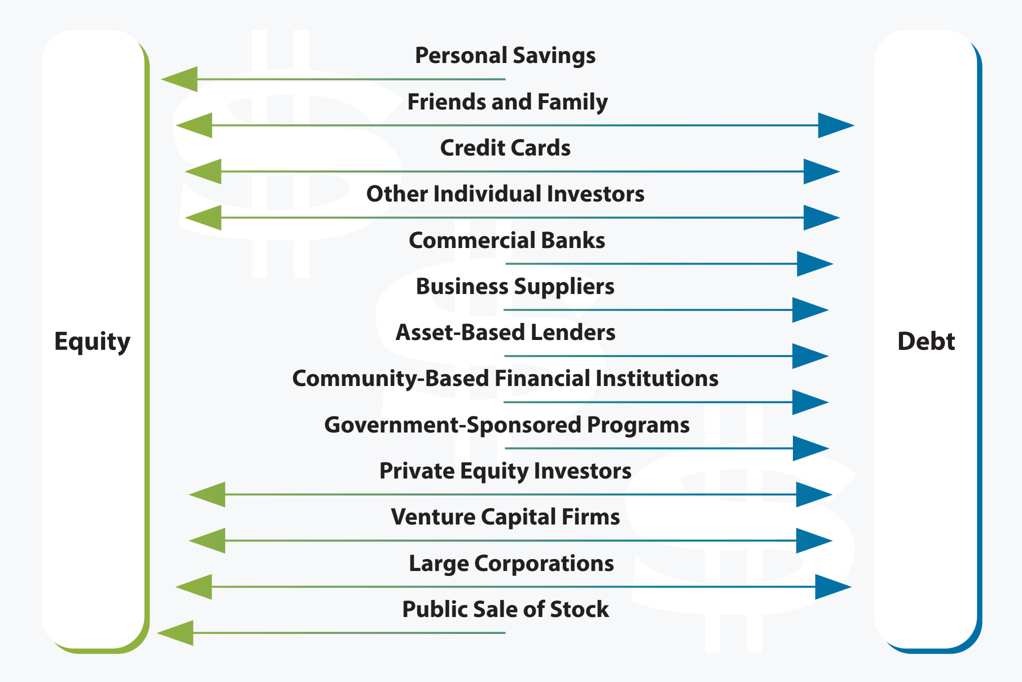
Exhibit 12.4 Sources of Funds



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- Other sources—including friends and family, private equity investors (rarely), and large corporations—may provide either debt or equity financing, depending on the situation.

Let's now consider these different sources of financing for smaller companies, beginning with sources "close to home"—personal savings, friends and family, and credit cards.

12-3a Personal Savings

It is imperative that entrepreneurs personally invest in their business, and that investment typically comes from their own savings. Indeed, personal savings is by far the most common source of equity used to finance a small business.

Both lenders and investors are unlikely to lend money or invest in the business if the owner does not have their own money at risk. Also, in the early years, a firm can rarely afford large, fixed loan payments for debt repayment.

A problem for many people who want to start a business is that they lack sufficient personal savings for this purpose. It can be very discouraging when the banker asks, "How much will you be investing in the business?" or "What do you have for collateral to secure the loan you want?"

There is no easy solution to this problem, which is faced by an untold number of entrepreneurs. Nonetheless, many individuals who lack personal savings for a start-up find ways to own their own companies without spending large amounts of money. And they figure out how to grow the business—perhaps by using the cash flows generated from the firm's operations, by using other people's resources, or by finding a partner or friends and relatives who will provide the necessary financing.

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12-3b Friends and Family

While personal savings serve as the *primary* source of financing for most small businesses, friends and family are a distant second. They provide almost 80 percent of start-up capital beyond the entrepreneur's personal savings.

Entrepreneurs who acquire financing from friends and family are putting more than just their financial futures on the line—they are putting personal relationships at risk. For that reason, you should think of it as a high-risk source of money, especially if not done right. Seeking advice from an experienced entrepreneur who has raised such funds in the past would be time well spent.

At times, loans from friends or relatives may be the only available source of new financing. These loans can often be obtained quickly because they are based more on personal relationships than on financial analyses. *But you should accept money from a friend or relative only if that person will not be hurt financially to any significant extent if the entire amount is lost.*

In other words: Do not borrow money from your brother if he cannot afford the loss, much less from your grandmother's retirement savings. Friends and relatives who provide business loans sometimes feel that they have the right to offer suggestions concerning the management of the business. And hard business times may strain the relationship. But if relatives and friends are the only available source of financing, the entrepreneur may have no other alternative.

To minimize the chance of damaging important personal relationships, the entrepreneur should plan to repay such loans as soon as possible. In addition, any agreements should be put in writing. It is best to clarify expectations up front in writing, rather than be disappointed or angry later when memories differ about what was agreed upon.

So, borrow from friends and family very cautiously. Do it if necessary, but do it carefully and meticulously clarify expectations.

12-3c Credit Cards

Using credit cards to help finance a small business has become increasingly common among entrepreneurs. It has been estimated that approximately half of all entrepreneurs have used credit cards at one time or another to finance a new venture or business expansion.

For someone who cannot acquire traditional financing like a bank loan, credit card financing may be an option—not a great option, but a necessary one. The interest costs can become overwhelming over time, especially because of the tendency to borrow beyond the ability to repay. So, it is essential that an entrepreneur using credit card financing be extremely self-disciplined to avoid becoming overextended.

So, why use credit cards? At times the only option for a small business entrepreneur, credit cards also have the advantage of speed. A lender at a bank must be convinced of the merits of the business opportunity, and that involves

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extensive preparation on the part of the entrepreneur. Credit card financing, on the other hand, requires no justification for the use of the money.

In practice, credit cards are a significant source of financing for many entrepreneurs, particularly in the early stages. But, remember:

> The eventual goal is to use credit cards as a method of payment and not as a source of credit. The sooner you can pay your credit card balance in full each month, the sooner you can grow a profitable business.

12-4 Discuss the basic process for acquiring and structuring a bank loan.

12-4 Bank Financing

While commercial banks are primary providers of debt capital to established firms, they are generally less interested in financing start-up businesses. Quite simply, bankers want firms with proven track records and plenty of collateral in the form of hard assets. They are understandably reluctant to lend money to finance losses, which are characteristic of early-stage companies.

Neither are they very interested in financing research and development (R&D) expenses, marketing campaigns, and other "soft" assets. Such expenditures usually must be financed by equity sources. Nevertheless, it is wise to cultivate a relationship with a banker sooner rather than later, and well in advance of making a loan request.

12-4a Types of Bank Loans

Bankers primarily make business loans in one of three forms: lines of credit, term loans, or mortgages.

Lines of Credit

A **line of credit** is an informal agreement or understanding between a borrower and a bank as to the maximum amount of funds the bank will provide the borrower at any one time. Under this type of agreement, the bank has no legal obligation to provide the capital. (A similar arrangement that does legally commit the bank is a *revolving credit agreement*.) The entrepreneur should arrange for a line of credit in advance of an actual need, as banks are reluctant to extend credit on the spur of the moment.

Term Loans

Under certain circumstances, banks will lend money on a five- to ten-year term. Such **term loans** are generally used to finance equipment with a useful life corresponding to the loan's term. Since the economic benefits of investing in such equipment extend beyond a single year, banks can be persuaded to lend on terms that more closely match the cash flows to be received from the investment. For example, if an equipment has a useful life of seven years, it might be possible to repay the money needed to purchase the equipment over, say, five years.

Understand that it would be a mistake for a firm to borrow money for a short term, such as six months, when the equipment being purchased is expected to last for seven years. *Failure to match the loan's payment terms with the expected cash inflows from the investment is a frequent cause of financial problems for small firms.* The importance of synchronizing cash inflows with cash outflows when structuring the terms of a loan cannot be overemphasized.

line of credit
An informal agreement between a borrower and a bank as to the maximum amount of funds the bank will provide at any one time.

term loan
Money lent for a five- to ten-year term, corresponding to the length of time an investment will contribute to profits.

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Some loans call for term payments that include principal and interest, and others for interest only with lump sum principal reductions. If in doubt, ask your banker for advice: "I want to expand. Here's the loan I think I need. What do you think?"

Mortgages

Mortgages, which represent a long-term source of debt capital, can be one of two types: chattel mortgages and real estate mortgages. A **chattel mortgage** is a loan for which certain items of inventory or other movable property serve as collateral. The borrower retains title to the inventory but cannot sell it without the banker's consent. A **real estate mortgage** is a loan for which real property, such as land or a building, provides the collateral. Typically, these mortgages extend up to 25 or 30 years.


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12-4b Understanding a Banker's Perspective

To be effective in acquiring a loan, an entrepreneur needs to understand that a banker has three priorities when making a loan. In order of importance to the banker, these priorities are as follows:

1. *Recouping the principal of the loan*. A banker is not rewarded adequately to assume large amounts of risk and will, therefore, design loan agreements to reduce the risk to the bank. First and foremost, the banker must protect depositors' capital.
2. *Determining the amount of income the loan will provide the bank*. The banker needs to determine both the interest income and other forms of income, such as fees.
3. *Helping the borrower be successful and become a larger customer*. Only if the relationship is a win-win for both parties will the bank do well.

In making a lending decision, bankers give serious consideration to what they call the "five Cs of credit":

1. The borrower's *character.*
2. The borrower's *capacity* to repay the loan.
3. The *capital* being invested in the venture by the borrower.
4. The *collateral* available to secure the loan.
5. The *conditions* of the industry and economy.

Of course, no banker would ever make a loan to a borrower whose character is in question. Here, the borrower's relationships and credit scores are used as indicators. But while good character is vital, it is not sufficient to receive a loan. In fact, members of a loan committee will spend little time talking about a prospective borrower's character unless they become aware of some reason to question it. The conversation about the person will more likely center on their ability and achievements, and the nature of the borrower's relationship with the bank.

Exhibit 12.5 represents graphically the coming together of the five Cs for a banker's decision. While we place character at the center, all the five criteria are important, as reflected in the exhibit.

chattel mortgage
A loan for which items of inventory or other movable property serve as collateral.

real estate mortgage
A long-term loan with real property held as collateral.

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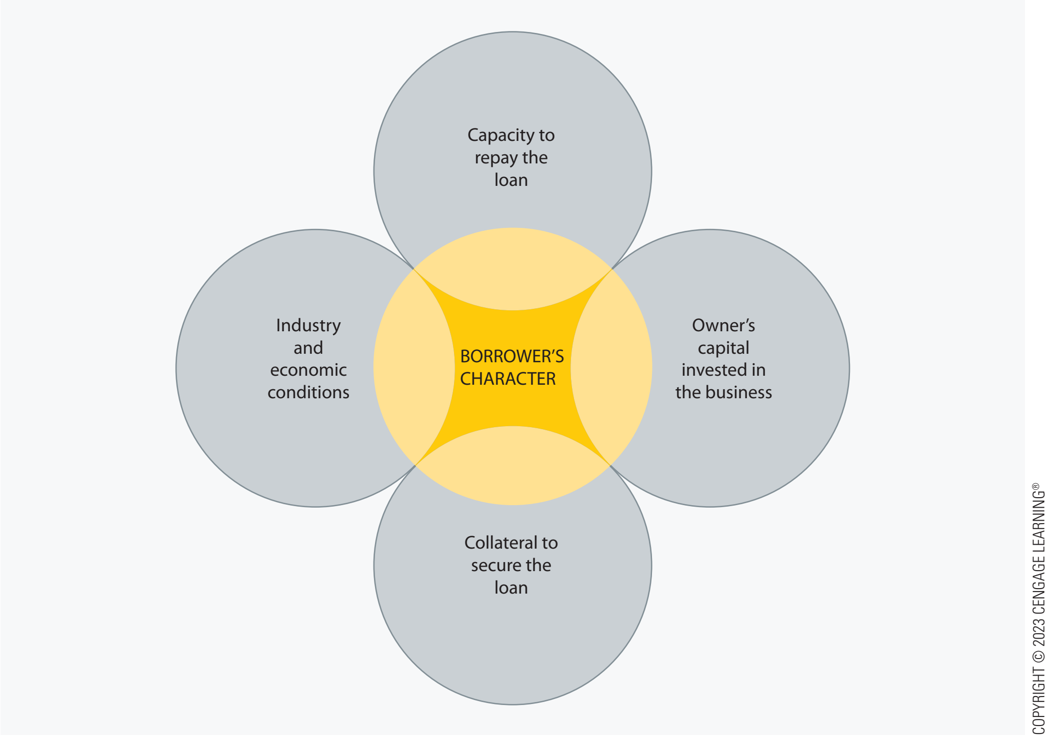
Exhibit 12.5 Five Cs: The Foundation for Getting a Loan



The five Cs are apparent in the six questions that Jack Griggs, a banker, and longtime lender to small businesses, wants answered before he will make a loan:[2]

1. Does the borrower have strong character and reasonable ability? Have they invested personal savings in the venture?
2. Do the purpose and amount of the loan make sense, both for the bank and for the borrower? For example, the loan may be too small to be profitable for the bank or may be in an industry in which the bank has no lending experience.
3. Does the loan have a certain primary source of repayment? This usually means proven cash flows.
4. Does the loan have a certain secondary source of repayment? This would be the collateral that the borrower can offer in case the loan cannot be repaid.
5. Can the loan be priced profitably for the customer and for the bank?
6. Are the loan and the relationship good for both the customer and the bank?

12-4c A Banker's Information Requirements

A banker's review of a loan request includes an analysis of financial considerations. When seeking a loan, a small business owner will be required to provide certain information in support of the request. Failure to provide this information will almost certainly result in rejection by the banker. Presenting inaccurate information or not being able to justify assumptions made in forecasting financial results is sure to make the banker question the entrepreneur's business acumen.

A well-prepared loan request reflects the entrepreneur's ability to capture the firm's history and future in writing, suggesting that the entrepreneur has given thought to

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where the firm has been and where it is going. As part of the presentation, the banker will want to know early on the answers to the following questions:

- How much money is needed?
- What is the venture going to do with the money?
- When is the money needed?
- When and how will the money be paid back?

An example of a written loan request is provided in Exhibit 12.6. A banker also will want to know, if possible, the following detailed financial information:

- Three years of the firm's historical financial statements, if available, including balance sheets, income statements, cash flow statements, and monthly statements for the past 12 months.
- The firm's pro forma financial statements (balance sheets, income statements, and cash flow statements), in which the timing and amounts of the debt repayment are included as part of the forecasts.
- Personal financial statements showing the borrower's net worth $\left(\text{net worth} = \text{assets} - \text{debt}\right)$ and estimated annual income. A banker simply will not make a loan without knowing the personal financial strength of the borrower.

Exhibit 12.6 Sample Written Loan Request

Date of Request:	December 15, 2012	
Borrower:	Prestige & DeLay, Inc.	
Amount:	$1,000,000	
Use of Proceeds:	Accounts receivable	$ 400,000
	Inventory	200,000
	Marketing	100,000
	Officer loans due	175,000
	Salaries	75,000
	Contingencies	50,000
		$1,000,000
Type of Loan	Revolving Line of Credit	
Closing Date	January 3, 2013	
Term	12 months	
Rate	8.5%	
Takedown	$400,000 at closing	
	$300,000 at March 1, 2013	
	$200,000 at June 1, 2013	
	$100,000 on September 1, 2013	
Collateral	70 percent of accounts receivable under 90 days	
	50 percent of current inventory	
Guarantees	Guarantees to be provided by Prestige & DeLay	
Repayment Schedule	Principal and all accrued interest due on anniversary of note	
Source of Funds for Repayment	a. Excess cash from operations (see cash flow)	
	b. Renewable and increase of line if growth is profitable	
	c. Conversion to three-year note	
Contingency Source	Sale and leaseback of equipment	

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Before making the final decision, bankers also like to see a business plan and to be advised of your backup plan to repay the bank if the projections aren't proven correct.

12-4d Selecting a Banker

For a typical small firm, the provision of checking-account facilities and the extension of short-term (and possibly long-term) loans are the two most important services of a bank. Normally, loans are negotiated with the same bank in which the firm maintains its checking account. In addition, the firm may use the bank's safe-deposit vault or its services in collecting notes or securing credit information. An experienced banker can also provide management advice, particularly in financial matters, to a new entrepreneur.

For convenience in making deposits and conferring about loans and other matters, a bank should be in the same general vicinity as the firm. All banks are interested in their home communities and, therefore, tend to be sympathetic to the needs of local business firms. Except in very small communities, two or more local banks are usually available, thus permitting some freedom of choice.

Banks' lending policies are not uniform. Some bankers are extremely conservative, while others are more willing to accept some limited risks. If a small firm's loan application is neither obviously strong nor patently weak, its prospects for approval depend heavily on the bank's approach to small business accounts. The obvious differences in banks' willingness to lend to small businesses are frequently observed by small business borrowers.

12-4e Negotiating the Loan

In negotiating a bank loan, a small business owner must consider the terms that will accompany the loan. Four key terms are included in all loan agreements: the interest rate, the loan maturity date, the repayment schedule, and the loan covenants.

Interest Rate

The interest rate charged by banks to small companies is usually stated in terms of the prime rate. The **prime rate**, or *base rate*, is the rate of interest charged by commercial banks on loans to their most creditworthy customers. If a banker quotes a rate of "prime plus 2" and the prime rate is 3 percent, the interest rate for the loan will be 5 percent (3% + 2%). Alternatively, a banker might state the rate as "prime plus 200 basis points." A **basis point** is 1/100th of 1 percent; thus, 200 basis points are the same as 2 percent.

The interest rate can be a floating rate that varies over the loan's life—that is, as the prime rate changes, the interest rate on the loan changes—or it can be fixed for the duration of the loan. A banker may also impose a floor on the interest rate so that it cannot go below a given rate. For instance, the floor might be set at 3.5 percent, no matter the prime rate. If a banker does impose a floor, you should request a ceiling that the rate cannot go above. If the bank agrees to a ceiling of 6.5 percent, for example, your interest rate cannot go any higher than that.

Although a small firm should always seek a competitive interest rate, concern about the interest rate should not override consideration of the loan's maturity date, its repayment schedule, and any loan covenants.

prime rate
The interest rate charged by commercial banks on loans to their most creditworthy customers; also known as the *base rate*.

basis point
1/100th of 1 percent when quoting an interest rate.

Loan Maturity Date

As already noted, a loan's term should coincide with the use of the money—short-term needs require short-term financing, while long-term needs demand long-term financing.

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For example, since a line of credit is intended to help a firm with only its short-term needs, it is generally limited to one year.

Some banks require that a firm "clean up" a line of credit one month each year. Because such a loan can be outstanding for only 11 months, the borrower can use the money to finance seasonal needs but cannot use it to provide permanent increases in working capital, such as accounts receivable and inventory.

Repayment Schedule

With a term loan, the loan is set to be repaid over five to ten years, depending on the type of assets used for collateral. However, the banker may have the option of imposing a **balloon payment** before the loan is fully repaid.

A balloon payment allows the bank to require the borrower to pay off the balance of the loan in full at a specified time, rather than waiting the full term for the loan to be repaid. As an example, assume the following:

- You borrow $50,000 at an interest rate of 6 percent, and the loan is to be repaid in equal monthly repayments over 84 months (seven years).
- The amount of each payment is determined to be $730.43, to pay off the loan in full by the end of the seven years.[3]
- The banker also includes a term in the loan agreement giving the bank the right to "call" the loan at the end of three years, meaning that you might have to pay off what is still owed at that time, which would be $31,100.[4]
- The banker could either require you to pay off the $31,100 at the end of the third year or allow you the remaining four years to pay off the loan. This provision permits the banker to reassess the borrower's creditworthiness at the end of the third year if the business is not doing well.

Loan Covenants

In addition to setting the interest rate and specifying when and how the loan is to be repaid, a bank normally imposes other restrictions on the borrower. These restrictions, or **loan covenants**, require certain activities (positive covenants) and limit other activities (negative covenants) of the borrower to increase the chance that the borrower will be able to repay the loan. Some types of loan covenants that a borrower might encounter include the following:

1. The company must provide financial statements to the bank monthly or, at the very least, quarterly (positive covenant).
2. To restrict a firm's management from siphoning cash out of the business, the bank may limit managers' salaries. It also may prohibit any personal loans from the business to the owners (negative covenant).
3. A bank may put limits on various financial ratios to make certain that a firm can handle its loan payments. For example, to ensure sufficient liquidity, the bank may require the firm's current ratio (current assets ÷ current liabilities) be above a given level. Or the bank might limit the amount of debt the firm can borrow in the future, as measured by the debt ratio (total debt ÷ total assets) (negative covenant).
4. The borrower will normally be required to personally guarantee the firm's loan. A banker wants the right to use both the firm's assets and the owner's personal assets as collateral. Even when a business is structured as a corporation and the owner can escape personal liability for the firm's debts—that is, the owner has *limited liability*—most banks still require the owner's personal guarantee (negative covenant).

balloon payment
A very large payment required about halfway through the term over which payments were calculated, repaying the loan balance in full.

loan covenants
Bank-imposed restrictions on a borrower that enhance the chance of timely repayment of a loan.

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It is imperative that you pay close attention to the loan covenants being imposed by a banker. Ask for a list of the covenants before the closing date, and make certain that you can live with the terms. If you have an existing company, determine whether you could have complied with the covenants, especially key ratios, if the loan had been in place during the recent past. Then, if necessary, negotiate with your banker and suggest more realistic covenants. Bankers will negotiate, although they may sometimes try to convince you otherwise. After all, making loans is a primary source of profits for the bank.

You also need to be aware of what happens when you violate a loan covenant. Ultimately, the banker can make you repay the loan in full immediately. More often, the banker will increase the interest rate or require you to repay the loan in a shorter period. What happens will also depend on which covenant is violated. As Jack Griggs noted, "Some covenants are like yield signs,[5] while others are stop signs." In other words, bankers use covenants as warning lights to address any potential problems before they become fatal.

12-5 Explain how business relationships can be used to finance a small firm.

12-5 Business Suppliers and Asset-Based Lenders

Companies that have business dealings with your firm may be possible sources of funds for financing inventory and equipment. Both wholesalers and equipment manufacturers/suppliers may provide accounts payable (trade credit) or equipment loans and leases.

12-5a Accounts Payable (Trade Credit)

Credit extended by suppliers is very important to a start-up. In fact, trade (or mercantile) credit is the source of short-term funds most widely used by small firms. As mentioned in Chapter 10, accounts payable (trade credit) is of short duration—30 days is the customary credit period. Most commonly, this type of credit involves an unsecured, open-book account. The supplier (seller) sends merchandise to the purchasing firm; the buyer then sets up an account payable for the purchase.

The amount of trade credit available to a new company depends on the type of business and the supplier's confidence in the firm. For example, wholesale distributors of sunglasses—a very seasonal product line—often provide trade credit to retailers by granting extended payment terms on sales made at the start of a season. Sunglass retailers, in turn, sell to their customers during the season and make the bulk of their payments to the wholesalers after they have sold and collected the cash for the sunglasses. Thus, the retailer obtains cash from sales before paying the supplier. More often, however, a firm must pay its suppliers prior to receiving cash from its customers. This can be a serious problem for many small firms, particularly those that sell to large companies. (This issue will be addressed in a discussion of asset management in Chapter 22.)

12-5b Equipment Loans and Leases

Some small businesses, such as restaurants, use equipment that is purchased on an installment basis through an **equipment loan**. A down payment of 25 to 35 percent is usually required, and the contract period normally runs from three to five years. The equipment manufacturer or supplier typically extends credit based on a conditional sales contract (or chattel mortgage) on the equipment. During the loan period, the equipment cannot serve as collateral for another loan.

equipment loan
An installment loan from a seller of machinery used by a business.

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Instead of borrowing money from suppliers to purchase equipment, some small businesses choose to lease equipment, especially computers and printers. Leases typically run for 36 to 60 months and cover the complete cost of the asset being leased, with a fixed rate of interest included in the lease payments. However, manufacturers of computers and industrial machinery, working hand in hand with banks or financing companies, are generally receptive to tailoring lease packages to the needs of customers.

It has been estimated that 80 percent of all firms lease some or all their business equipment. Three reasons are commonly given for the popularity of leasing:

1. The firm's cash remains free for other purposes.
2. Available lines of credit can be used for other purposes.
3. Leasing provides a hedge against equipment obsolescence.

Making a good decision to lease requires carefully comparing the interest charged on a loan to the implied interest cost of a lease, calculating the tax consequences of leasing versus borrowing, and examining the significance of the obsolescence factor. Also, the owner must be careful about contracting for so much equipment that it becomes difficult to meet installment or lease payments.

12-5c Asset-Based Lending

As its name implies, an **asset-based loan** is a line of credit secured by working capital assets, such as accounts receivable, inventory, or both. The lender cushions its risk by advancing only a percentage of the value of a firm's assets—generally, 65 to 85 percent on accounts receivable and up to 55 percent on inventory. Also, assets such as equipment (if not leased) and real estate can be used as collateral for an asset-based loan. Asset-based lending is a viable option for young, growing businesses.

Of the several categories of asset-based lending, the most frequently used is factoring. **Factoring** is an option that makes cash available to a business before accounts receivable payments are received from customers. Under this option, a factor (an entity often owned by a bank holding company) purchases the accounts receivable, advancing to the business 70 to 90 percent of the amount of an invoice. The factor, however, has the option of refusing to advance cash on any invoice it considers questionable.

The factor charges a servicing fee, usually 2 percent of the value of the accounts receivable, and an interest charge on the money advanced prior to collection of the receivables. The interest charge may range from 2 to 3 percent above the prime rate.

Another way to finance working capital is to sell purchase orders. With **purchase-order financing**, the lender advances the amount of the borrower's cost of goods sold for a specific customer order less a fee, typically somewhere between 3 percent and 8 percent. For instance, for a purchase order of $20,000, with the cost of goods sold being $12,000, the lender will advance the $12,000 less the fee charged.

With a signed purchase order from a creditworthy customer, a business owner can often get financing for almost the entire process, provided the gross profit margin (gross profits ÷ sales) is at least 35 percent. Although the fee is not insignificant, it makes sense when the entrepreneur would not otherwise be able to accept an order from a large customer.

We will next look at sources of equity financing for some smaller companies that have the potential to provide high rates of returns for investors.

asset-based loan
A line of credit secured by working capital assets.

factoring
Obtaining cash by selling accounts receivable to another firm.

purchase-order financing
Obtaining cash from a lender who, for a fee, advances the amount of the borrower's cost of goods sold for a specific customer order.

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12-6 Describe the two types of private equity investors who offer financing to small firms.

12-6 Private Equity Investors

Over the past several decades, private equity markets have been the fastest-growing source of financing, especially for entrepreneurial ventures with high-growth potential. For an entrepreneur, these investors fall into two categories: business angels and venture capitalists.

12-6a Business Angels

Business angels are private individuals who invest in early-stage companies.[6] (We briefly discussed business angels in the Spotlight feature in this chapter.) The type of financing they provide has come to be known as **informal venture capital** because no established marketplace exists in which business angels regularly invest.

Business angels share the following characteristics:[7]

- Business angels provide 90 percent of all outside equity capital.
- Individual angels typically invest between $10,000 and $30,000.
- When business angels invest as part of a group, the average total amount invested is about $350,000.
- Over 80 percent of business angels invest in start-up firms with fewer than 20 employees.
- Business angels often invest locally, usually no more than 50 miles from their homes.
- Fifty-five percent of angels were previously founders or CEOs of their own companies.

Along with providing needed money, business angels frequently contribute know-how to new businesses. Because many of these individuals invest only in the types of businesses in which they have had experience, they can be very demanding. While they are generally more "friendly" as investors than some venture capitalists, initially their personal relationship with the entrepreneur has little impact on their decision to invest. Angels generally try to limit the length of their investment to between five and seven years, though it is frequently closer to ten years before they can cash out.

The traditional way to find informal investors is through contacts with business associates, accountants, and lawyers. Other entrepreneurs are also a primary source of help in identifying prospective investors.

Business angel networks and alliances are now located in many cities and often have their own websites, both in the United States and abroad. Each network has its own process for evaluating deals. Some require entrepreneurs who are seeking funding to post their business plan on proseeder.com, a global platform for start-up funding.

In general, the networks screen the plans and select the entrepreneurs who will be allowed to present to the group. If the investors continue to have an interest in a business after the presentation, they will begin a **due diligence process**, where an in-depth checklist of issues is addressed in their continuing analysis of the company and its team. The following list provides a few examples of items on the checklist of issues:

1. Getting to know the management team well.
2. Having discussions with a select group of customers (existing and/or potential).
3. Understanding the firm's business model.

business angel
A private individual who invests in early-stage companies.

informal venture capital
Funds provided by private individuals to new ventures.

due diligence process
Process used by investors to conduct in-depth research on a prospective investment.

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4. Analyzing the company's financials, both historical and projected.
5. Learning the status of any intellectual property owned by the company.
6. Searching for possible litigation outstanding against the company or its owners.

If an investment is made, the angels receive the right to own a percentage of the entrepreneur's business. Historically, investments have taken the form of preferred stock convertible to common stock upon certain events. In this way, business angels have a senior claim over the owners and other equity investors in the event that a firm is liquidated, but they also can convert to common stock and participate in the increased value of the business if it is successful.

Reaching agreement on the exact percentage of ownership often involves considerable negotiation, especially given the early stage of many companies raising venture funding. The primary issues are the firm's uncertain profits in future years and the angels' required rate of return on their investments. Business angels have learned that the more time spent on due diligence, the more likely it is they will get a good return on their investment.

12-6b Venture Capital Firms

In addition to business angels who provide informal venture capital, small businesses may also seek funding from venture capital firms. These firms consist of groups of individuals, called **venture capitalists (VCs),** who form limited partnerships for the purpose of raising capital from large institutional investors, such as pension plans and university endowments. The venture capitalists serve as general partners, with the institutional investors comprising the limited partners. As limited partners, such investors have the benefit of limited liability.

The venture capitalists attempt to raise a predetermined amount of money, called a *fund*. When the money has been committed by the investors, the venture capitalists evaluate investment opportunities in high-potential start-ups and early-stage firms and decide where to invest. Once the fund is fully invested, they will start raising money for another fund. Typically, a number of funds are managed, and the total market value of these assets is called **assets under management**. For example, the Sevin Rosen Funds raised $600 million for the Sevin Rosen Fund VIII. The money was then used to invest in a portfolio of companies.

When making an investment, a venture capitalist firm will negotiate the right to own a certain percentage of the entrepreneur's business, much like business angels do. This percentage of ownership is largely determined by the firm's expected profits in future years and the venture capitalist's required rate of return in light of the risk of an investment. Once an investment has been made, the VC firm carefully monitors the company, usually through a representative who serves on the firm's board.

Most often, investments by venture capitalists take the form of preferred stock that can be converted to common stock if the investors so desire. In this way, VC firms ensure that they have senior claim over the owners and other equity investors in the event the firm is liquidated, but can convert to common stock and participate in the increased value of the business if it is successful. Like business angels, VC firms generally try to limit the length of their investments to between five and ten years.

Although venture capital as a source of financing receives significant coverage in the business media, *few small companies, especially start-ups, ever receive this kind*

venture capitalists (VCs)
Individuals who form limited partnerships for the purpose of raising capital from large institutional investors.

assets under management
The total market value of all assets that a venture capital firm controls.

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Living the Dream

Collaborative Lending

When Hayley Groll, a professional hairstylist, was given the opportunity to buy an existing hair salon, she jumped at it. Groll had only one problem: she did not have the money required to make the purchase.

Groll first tried to borrow the money from an online lender, but to no avail. She then approached Able Lending, and within three weeks she was granted a $105,000 loan with a 9 percent interest rate, to be repaid over three years. The money gave her enough to buy the business and extend her building lease well into the future.

Will Davis and Evan Baehr, the founders of Able Lending, describe themselves as "collaborative lenders," offering business owners loans for up to three years for amounts between $25,000 and $1 million. But here is the catch—borrowers must raise the first 25 percent of the loan from friends and family. Davis says that Able Lending is trying to find the people who are being missed by traditional banks and even nontraditional online lenders. The concept is described on the company's website:

> Able helps entrepreneurs grow their small business through a collaborative loan involving Backers—those friends and family who are willing to help fund your Able loan. Three to five Backers fund 25% of the total loan amount, which unlocks the remaining 75% from Able and lets us lend to you at lower rates than other lenders.

After a business owner completes an online application, Able uses its proprietary technology to assess the company's bank accounts, cash flows, and credit history. Then, taking a unique path, Able tracks a company's social media presence on Yelp, Facebook, Twitter, and LinkedIn. Davis doesn't reveal how a business's online footprint helps to evaluate an applicant, but he does claim that Able receives a more complete picture of a company's creditworthiness than any bank can acquire.

Depending on how fast the borrower can line up backers, funding can arrive within two weeks of applying—"much quicker than traditional bank financing," Davis says. Loans are given to growing small businesses with revenues of at least $100,000, who have been in operation for at least one year.

Able Lending has secured $100 million to provide loans to small businesses. Founded in Austin, Texas, the firm now operates in 44 states and has lent a total of $30 million without any defaults. Companies typically use the loans for working capital, inventory purchases, personnel or location expansion, marketing expenditures, even as a bridge before an equity round. Able Lending has received millions of dollars in loan requests nationwide and plans to fund approximately 500 small businesses in the United States.

Sources: Adapted from Michelle Goodman, "This Startup Will Give You a Loan—But There's a Twist," *Entrepreneur*, November 3, 2014, p. 86; Lori Hawkins, "Austin-Based Able Lending Secures $100 million to Make Small Business Loans," *statesman.com*, September 24, 2018, https://www.statesman.com/news/20161006/austin-based-able-lending-secures-100-million-to-make-small-business-loans, accessed August 1, 2021; and http://blog.ablelending.com, accessed August 1, 2021.

of funding. No more than 1 to 2 percent of the business plans received by any venture capitalist are eventually funded—not exactly an encouraging statistic.

Failure to receive funding from a venture capitalist firm, however, does not indicate that the venture lacks potential. Often, the venture is simply not a good fit for the investor. So, before trying to compete for venture capital financing, an entrepreneur should assess whether their firm and its management team are suitable for a particular investor.

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12-7 Crowdfunding

12-7 Describe how crowdfunding can be used by some small businesses to raise capital.

If you need $50,000 to fund a new business project and have tried the conventional sources of financing without success, you may want to look into crowdfunding. **Crowdfunding** is the process of raising money online, frequently in small amounts per investor, but from many investors. It has mushroomed with the advent of crowdfunding websites, also called *portals* or *platforms*. In 2020, over $13 billion was raised by crowdfunding, far more than the funds provided by both business angels and venture capitalists.[8]

There are four basic approaches to crowdfunding: donations, rewards, pre-purchases, and equity investing. The first three approaches are not considered investments. The contributors are not lending the firm money, nor are they receiving any ownership in the business. Only the last approach provides investors with equity ownership in the business.

1. *Donations.* In this case, individuals donate (contribute) to support a given project without receiving anything tangible in return. This approach is more akin to a charitable contribution than an investment. Interestingly, there are people who enjoy helping a business at times, without any promise of something in return.
2. *Rewards.* With the rewards approach, supporters make a monetary contribution in return for a reward of some type. For example, BodBot, a start-up providing exercise and nutrition recommendations online, set a goal to raise $20,000 by crowdfunding. (It ultimately raised $43,210 from 795 participants.) In return for participating, depending on the amount of the contribution, the company offered different packages of workouts and other benefits, beginning at $20 and continuing up to $15,000!
3. *Pre-Purchase.* Similar to the rewards approach, the financial contribution in a pre-purchase is essentially the conditional purchase of the entrepreneur's planned product. If the product launch is successful, contributors are sent the actual product.
4. *Equity Investing.* This approach offers ownership in a business. Since the participants are investors, the company is subject to securities laws. Under rules adopted by the Securities and Exchange Commission (SEC), the public now can participate in the early capital-raising activities of start-up and early-stage businesses through crowdfunding.[9]

There are limitations on how much companies can raise, and individuals can invest based on the amount of their income and net worth. Also, an individual can invest only through the company's website or through the mobile app of a broker-dealer or a funding portal. Several portals that focus on equity-based crowdfunding are IndieGoGo, AngelList, Republic, Wefunder, and Crowdfunder.

The SEC also has requirements that must be met by companies wanting to raise money on an equity-based crowdfunding portal:

- Companies may not offer crowdfunding investments directly to investors—they must use a broker-dealer mobile app or funding portal.
- The broker-dealer mobile app or funding portal—a crowdfunding intermediary—must be registered with the SEC and be a member of the Financial Industry Regulatory Authority (FINRA).

An entrepreneur who is considering crowdfunding to raise money can also use Kickstarter and similar websites. However, Kickstarter only facilitates crowdfunding based on donations, rewards, and pre-purchases, choosing not to provide the option of equity via crowdfunding.

crowdfunding
The process of raising small amounts of money online from a large number of investors.

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Small businesses that raise equity through crowdfunding should be aware of potential problems. First, if crowdfunding investors receive voting rights, that fact may act as a deterrent to raising money from business angels and venture capitalists in the future. Such investors usually would not be interested in sharing voting rights with a large group of small, often inexperienced investors. Second, a company should be very cautious when sharing detailed financial information and trade secrets with a multitude of crowdfunding investors.

When it is a good fit, crowdfunding is an increasingly viable option for small businesses that need to raise capital, especially since the SEC has raised the maximum amount a firm can raise within a 12-month period from $1.07 million to $5 million.

12-8 Distinguish among the different government loan programs available to small companies.

12-8 Government Loan Programs

Over the past decade, federal and state governments have allocated increasing amounts of money to finance new businesses. Local governments have likewise increased their involvement in providing financial support to start-ups in their areas. Although funds from government agencies are available, they are not always easy to acquire. Time and patience on the part of the entrepreneur are required.

Let's look at some of the more familiar government loan programs offered by various agencies.

12-8a The Small Business Administration

The federal government has a long history of helping new businesses get started, primarily through the programs and agencies of the Small Business Administration (SBA). For the most part, the SBA does not lend money but serves as a guarantor of loans made by financial institutions. According to Mitchell Horner, senior vice president of Independent Financial, an active lender to small businesses:[10]

> If done well, SBA-backed loans can be some of the most desirable loans in the loan portfolio of a bank due to the guaranty. For that reason, entrepreneurs can get more desirable terms on a loan (up to 10 years in some cases). Really a win-win for the banks and entrepreneurs.

The five primary SBA programs are (1) the 7(a) Loan Guaranty Program, (2) the Certified Development Company (CDC) (504) Loan Program, (3) 7(m) Microloan Program, (4) small business investment companies (SBICs), and (5) the Small Business Innovation Research (SBIR) Program. Let's take a closer look at each of these SBA programs.

1. The **7(a) Loan Guaranty Program** serves as the SBA's primary business loan program to help qualified small businesses obtain financing when they might not be eligible for business loans through normal lending channels. Guaranty loans are made by private lenders, usually commercial banks, and may be for as much as $5 million. The SBA guarantees 85 percent of loans not exceeding $150,000 and 75 percent up to $3.75 million.

   To obtain a guaranty loan, a small business must submit a loan application to a lender, such as a bank. After an initial review, the lender forwards the application to the SBA. Once the loan has been approved by the SBA, the lender disburses the funds.

7(a) Loan Guaranty Program
A loan program that helps small companies obtain financing through a guaranty provided by the SBA.

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The loan proceeds can be used for working capital, machinery and equipment, furniture and fixtures, land and building, leasehold improvements, and debt refinancing (under special conditions). Loan maturity is up to 10 years for working capital and generally up to 25 years for fixed assets.

When seeking guaranty loans, entrepreneurs should look for a bank that is part of the **Preferred Lender Program**. Under the program, the SBA gives select lenders the authority to process, close, service, and liquidate SBA-guaranteed loans.

2. The **Certified Development Company (CDC) (504) Loan Program** provides long-term, fixed-rate financing for small businesses to acquire real estate or machinery and equipment for expansion or modernization. The borrower must provide 10 percent of the cost of the property, with the remaining amount coming from a bank and a certified development company funded by the SBA.
3. The **7(m) Microloan Program** grants short-term loans of up to $50,000 to small businesses and not-for-profit child-care centers for working capital or the purchase of inventory, supplies, furniture, fixtures, and machinery and equipment. The SBA makes or guarantees a loan to an intermediary, which in turn makes the microloan to the applicant. As an added benefit, the lender provides business training and support programs to its microloan borrowers.

   Most banks regard microloans as too costly to administer directly to small business owners. Therefore, some nonprofit organizations work with banks and foundations to make these microloans.
4. **Small business investment companies (SBICs)** are privately owned banks that provide long-term loans and/or equity capital to small businesses. SBICs are licensed and regulated by the SBA, from which they frequently obtain a substantial part of their capital at attractive rates of interest. SBICs invest in businesses with fewer than 500 employees, a net worth of no more than $18 million, and after-tax income not exceeding $6 million during the two most recent years.
5. The **Small Business Innovation Research (SBIR) Program** helps finance small firms that plan to transform laboratory research into marketable products. Eligibility for the program is based less on the potential profitability of a venture than on the likelihood that the firm will provide a product of interest to a federal agency.

12-8b State and Local Government Assistance

State and local governments have become more active in financing new businesses. The nature of the financing varies, but each program is generally geared to augment other sources of funding. Most of these loans are made in conjunction with a bank, which enables the bank to make riskier loans to entrepreneurs who might not qualify for traditional financing.

Examples of such programs include the Golden Circle Loan Guaranty Fund, established by the city government of Des Moines, Iowa, to guarantee bank loans of up to $250,000 to small companies, and loans made to business owners by the New Jersey Economic Development Authority at the U.S. Treasury rate, significantly lower than interest rates typically charged at banks. These programs may also require a lower down payment, where the borrower must provide only a 10 percent down payment, compared to the 20 or 25 percent typically required by bankers.

While such government programs may be attractive to an entrepreneur, they are frequently designed to enhance specific industries or to facilitate certain community goals. Consequently, you need to determine that a program is in sync with your specific business objectives.

Preferred Lender Program
A program through which the SBA gives select lenders the authority to process, close, service, and liquidate SBA guaranteed loans.

Certified Development Company (CDC) (504) Loan Program
An SBA loan program that provides long-term financing for small businesses to acquire real estate or machinery and equipment for expansion or modernization.

7(m) Microloan Program
An SBA loan program that provides short-term loans of up to $50,000 to small businesses and not-for-profit child-care centers.

small business investment company (SBIC)
A privately owned bank, regulated by the SBA, that provides long-term loans and/or equity capital to small businesses.

Small Business Innovation Research (SBIR) Program
An SBA program that helps to finance small companies that plan to transform laboratory research into marketable products.

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12-8c Community-Based Financial Institutions

Community-based financial institutions are lenders that serve low-income communities and receive funds from federal, state, and private sources. They are increasingly becoming a source of financing for small companies that otherwise would have little or no access to start-up funding. Typically, community-based lenders provide capital to businesses that are unable to attract outside investors but do have the potential to make modest profits, serve the community, and create jobs. An example of a community-based financial institution is the Delaware Valley Community Reinvestment Fund, which provides financing for small companies in Philadelphia's inner-city area.

12-9 Explain when large companies and public stock offerings can be sources of financing.

12-9 Additional Sources of Financing

The sources of financing that have been described thus far represent the primary avenues for obtaining money for small firms. The remaining sources are generally of less importance but should not be ignored by a small business owner in search of financing.

12-9a Large Corporations

Large corporations sometimes make funds available for investment in smaller firms when it is in their best interest to maintain a close relationship with such a firm. For instance, some large high-tech firms, such as Intel and Microsoft, prefer to invest in smaller firms that are conducting research of interest, rather than conduct the research themselves.

12-9b Stock Sales

Another way to obtain capital is by selling stock to outside individual investors through either private placement or public sale. Finding outside stockholders can be difficult when a new firm is not known and has no ready market for its securities, however. In most cases, a business must have a history of profitability before its stock can be sold successfully.

Whether it is best to raise outside equity financing depends on the firm's long-range prospects. If there is opportunity for substantial expansion on a continuing basis and if other sources are inadequate, the owner may logically decide to bring in other owners. Owning part of a larger business may be more profitable than owning all of a smaller business.

community-based financial institution
A lender that uses funds from federal, state, and private sources to provide financing to small businesses in low-income communities.

private placement
The sale of a firm's capital stock to select individuals.

initial public offering (IPO)
The issuance of stock to be traded in public financial markets.

Private Placement

One way to sell common stock is through a **private placement**, in which the firm's stock is sold to select individuals—usually the firm's employees, the owner's acquaintances, members of the local community, customers, and suppliers. When a stock sale is restricted to private placement, an entrepreneur can avoid many of the demanding requirements of the securities laws.

Public Sale

When small firms—typically, larger small firms—make their stock available to the public, this is called going public, or making an **initial public offering (IPO)**.

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The reason often cited for a public sale is the need for additional capital to grow the business.

For most small businesses, going public is not an option. Also, in undertaking a public sale of its stock, a small firm subjects itself to much greater governmental regulation and reporting requirements, which significantly increases the cost of doing business. In 2010, Congress enacted the Dodd-Frank Act for averting a financial crisis like the one experienced in 2008–2009. The legislation primarily related to financial institutions but also included strict regulations for all companies to ensure transparency and accountability, again increasing costs for smaller businesses. Some of these regulations, however, were removed in 2017, providing a bit of relief to some small firms.

Finally, publicly traded firms are required to report their financial results quarterly in 10Q reports and annually in 10K reports to the Securities and Exchange Commission (SEC). The SEC scrutinizes these reports before they can be made available to the public. At times, SEC requirements can be very burdensome.

Common stock may also be sold to underwriters, which guarantee the sale of securities. Compensation and fees paid to underwriters typically make the sale of securities in this manner expensive. Fees frequently range from 20 to 25 percent (or higher) of the value of the total stock issued. The reasons for the high costs are the uncertainty and risk associated with public offerings of the stock of small, relatively unknown firms.

12-1. Describe how a firm's characteristics affect its available financing sources.

- Four basic firm characteristics determine how a firm is financed: (1) the firm's economic potential, (2) the size and maturity of the company, (3) the nature of the firm's assets, and (4) the personal preferences of the owners with respect to the trade-offs between debt and equity.
- An entrepreneurial firm with high-growth economic potential has more possible sources of financing than does a firm that provides a good lifestyle for its owner but little in the way of attractive returns to investors.
- Most investors are looking for firms that can be sold in five to ten years at five to ten times their original investment.
- Older and larger companies have more access to bank financing, while smaller firms tend to rely more on personal loans and credit cards.
- Tangible assets serve as great collateral when a business is requesting a bank loan, while intangible assets have little value as collateral for lenders.

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12-2. Evaluate the choice between debt financing and equity financing.

- The choice between debt and equity financing involves trade-offs regarding potential profitability, financial risk, and voting control.
- Borrowing money (debt) rather than issuing common stock (owners' equity) creates the potential for higher rates of return to the owners and allows them to retain voting control of the company, but it also exposes them to greater financial risk.
- Bringing in equity investors rather than borrowing money results in lower potential rates of return to the owners and the loss of some voting control, but it does reduce their financial risk.

12-3. Describe the starting point for financing a small business.

- The aspiring entrepreneur tends to stay "close to home" for sources of financing, which include (1) personal savings, (2) friends and family, and (3) credit cards.
- The primary source of equity financing used in starting a new business is personal savings. A banker or other lender is unlikely to lend venture money if the entrepreneur does not have her or his own money at risk.
- Loans from friends and family may be the only available source of financing and are often easy and fast to obtain, although such borrowing can place the entrepreneur's most important personal relationships in jeopardy.
- Credit card financing provides easily accessible financing, but the high interest costs may be overwhelming at times.

12-4. Discuss the basic process for acquiring and structuring a bank loan.

- Bankers primarily make business loans in one of three forms: lines of credit, term loans, and mortgages.
- The priorities of a banker when making a loan are (1) recouping the principal of the loan, (2) determining the amount of income the loan will provide the bank, and (3) helping the borrower be successful and become a larger customer.
- In making a loan decision, a banker always considers the "five Cs of credit": (1) the borrower's *character*, (2) the borrower's *capacity* to repay the loan, (3) the *capital* being invested in the venture by the borrower, (4) the *collateral* available to secure the loan, and (5) the *conditions* of the industry and economy.
- Obtaining a bank loan requires a well-prepared loan request that addresses (1) how much money is needed, (2) what the venture is going to do with the money, (3) when the money is needed, and (4) when and how the money will be paid back.
- A banker may request other detailed financial information, including three years of the firm's historical financial statements, the firm's pro forma financial statements, and personal financial statements showing the borrower's net worth and estimated annual income.
- An entrepreneur should carefully evaluate available banks before choosing one, basing the decision on factors such as the bank's location, the services provided, and the bank's lending policies.
- In negotiating a bank loan, the owner must consider the accompanying terms, which typically include the interest rate, the loan maturity date, the repayment schedule, and the loan covenants.

12-5. Explain how business relationships can be used to finance a small firm.

- Business suppliers may offer trade credit (accounts payable), which is the source of short-term funds most widely used by small firms.
- Suppliers may also offer equipment loans and leases, which allow small businesses to use equipment purchased on an installment basis.
- An asset-based loan is financing secured by working capital assets, such as accounts receivable, inventory, or both.

12-6. Describe the two types of private equity investors who offer financing to small firms.

- Business angels are private individuals, generally with substantial business experience, who invest in early-stage ventures.
- Venture capital firms structured as limited partnerships form funds for raising capital from large institutional investors. The money is then invested in high-potential start-ups and existing firms for an ownership share.

12-7. Describe how crowdfunding can be used by some small businesses to raise capital.

- Crowdfunding is the process of raising money online (frequently, small amounts per investor) from a large number of investors.
- There are four basic approaches to crowdfunding: (1) donations, (2) rewards, (3) pre-purchases, and (4) equity investing.

12-8. Distinguish among the different government loan programs available to small companies.

- The federal government helps new businesses get started through the programs and agencies of the Small Business Administration (SBA), which include

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the 7(a) Loan Guaranty Program, the Certified Development Company (CDC) (504) Loan Program, the 7(m) Microloan Program, small business investment companies (SBICs), and the Small Business Innovation Research (SBIR) Program.

- State and local governments finance new businesses with programs that are generally geared to augmenting other sources of funding.
- Community-based financial institutions are lenders that use funds from federal, state, and private sources to serve low-income communities and small companies that otherwise would have little or no access to start-up funding.

12-9. Explain when large companies and public stock offerings can be sources of financing.

- Large corporations may finance smaller businesses when it is in their self-interest to have a close relationship with the smaller company.
- Stock sales, in the form of either private placements or public sales, may provide a few high-potential ventures with equity capital.

Key Terms

7(a) Loan Guaranty Program p. 324
7(m) Microloan Program p. 325
asset-based loan p. 319
assets under management p. 321
balloon payment p. 317
basis point p. 316
business angel p. 320
Certified Development Company (CDC) (504) Loan Program p. 325
chattel mortgage p. 313
community-based financial institution p. 326
crowdfunding p. 323
due diligence process p. 320
equipment loan p. 318
factoring p. 319
informal venture capital p. 320
initial public offering (IPO) p. 326
line of credit p. 312
loan covenants p. 317
Preferred Lenders Program p. 325
prime rate p. 316
private placement p. 326
purchase-order financing p.319
real estate mortgage p. 313
Small Business Innovation Research (SBIR) Program p. 325
small business investment company (SBIC) p. 325
term loan p. 312
venture capitalists (VCs) p. 321

Discussion Questions

1. How does the nature of a business affect its sources of financing?
2. How is debt different from equity?
3. Explain the three trade-offs that guide the choice between debt financing and equity financing.
4. Assume that you are starting a business for the first time. What do you believe are the greatest personal obstacles to obtaining funds for the new venture? Why?
5. If you were starting a new business, where would you start looking for capital?
6. Explain how trade credit and equipment loans can provide initial capital funding.
7. a. Describe the different types of loans made by a commercial bank.
   b. What does a banker need to know about a new venture and its owners in order to decide whether to make a loan?
8. Distinguish between informal venture capital and formal venture capital.
9. In what ways can the federal government help with initial financing for small businesses?
10. What advice would you give an entrepreneur who was trying to finance a start-up?

You Make the Call

Situation 1

David Bernstein needs help financing his six-year-old, $3.5 million company Access Direct, Inc. "We're ready to get to the next level," says Bernstein, "but we're not sure which way to go." Access Direct cleans and then sells used computer equipment for corporations. It is looking for up to $2 million in order to expand. "Venture capitalists, individual investors, or banks," says Bernstein, who owns the company with four partners, "we've thought about them all."

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Question 1 What is your impression of Bernstein's perspective on raising capital to "get to the next level"?

Question 2 What advice would you offer Bernstein as to both appropriate and inappropriate sources of financing in his situation?

Situation 2

John Dalton is well on his way to starting a new venture—Max, Inc. He has projected a need for $350,000 in initial capital. He plans to invest $150,000 himself and either borrow the additional $200,000 or find a partner who will buy stock in the company. If Dalton borrows the money, the interest rate will be 6 percent. If, on the other hand, another equity investor is found, he expects to have to give up 60 percent of the company's stock. Dalton has forecasted earnings of about 16 percent in operating profits on the firm's total assets.

Question 1 Compare the two financing options in terms of projected return on the owner's equity investment. Ignore any effect from income taxes.

Question 2 What if Dalton is wrong, and the company earns only 4 percent in operating profits on total assets?

Question 3 What should Dalton consider in choosing a source of financing?

Situation 3

Mike Smith seeks your counsel about a problem that has grown out of a decision he made three years earlier to buy a warehouse. Up until then, he had rented three warehouses, where he stored containers and did pick-and-pack for retailers importing goods from abroad. Figuring it was time to consolidate, Smith found a building, negotiated a price of $3.5 million, put down $300,000, and borrowed $3.2 million from a bank at 7 percent interest.

It seemed like a good idea at the time. Then a recession hit. As his sales dropped, he struggled to make his monthly payment of $27,000. At present, he's behind in his payments and scared. Furthermore, the situation seems unlikely to improve anytime soon. To make matters worse, he signed a personal guarantee on the loan and thinks he might lose his house. The bank is assessing the situation to decide what to do.

In a panic, Smith tells you, "I'm going to tell the bank I need eight months. It can take the money I'll owe for that time, plus what I owe now, and tack it onto the end of the mortgage. What do you think?"

"How do you know that's what the bank is looking for?" you ask.

"I have to offer them something," Smith says. "My wife and I could lose everything!"

"You aren't going to lose everything," you say, "and you're making a mistake to assume that you know what the bank wants."

Question 1 What guidance will you give Smith in negotiating with the bank?

Question 2 Why might you advise him not to go into a meeting with bank officers with a plan already in mind?

Experiential Exercises

1. Interview a local small business owner to determine how funds were obtained to start the business. Be sure you phrase questions so that they are not overly personal, and do not ask for specific dollar amounts. Write a brief report on your findings.
2. Interview a local banker about lending policies for small business loans. Ask the banker to comment on the importance of a business plan to the bank's decision to lend money to a small firm. Write a brief report on your findings.
3. Review recent issues of *Entrepreneur* and *Inc.,* and report to the class on the financing arrangements of firms featured in these magazines.
4. Interview a stockbroker or investment analyst on their views regarding the sale of common stock by a small business. Write a brief report on your findings.

Business Plan

LAYING THE FOUNDATION

As part of laying the foundation for your own business plan, respond to the following questions regarding the financing of your venture:

1. What is the total financing required to start the business?
2. How much money do you plan to invest in the venture? What is the source of this money?
3. Will you need financing beyond what you personally plan to invest?

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4. If additional financing is needed for the start-up, how will you raise it? How will the financing be structured—will you use debt or equity? What will the terms be for investors?
5. According to your pro forma financial statements, will there be a need for additional financing within the first five years of the firm's life? If so, where will it come from?

Chapter 12 Case

Please see Appendix A for the Chapter 12 Case Study.

Endnotes

1. We discussed return on assets and how it is computed in Chapter 10 (return on assets = operating profits ÷ total assets). Note that operating profits (earnings before interest and taxes) are used in the numerator, instead of net profits. Operating profits represent income from investing in the firm's assets before distribution to the lenders and owners and are, therefore, a better measure of the firm's overall profitability on the assets.
2. Personal conversation with Jack Griggs, president and CEO of Southwestern Bancorp, Inc., and chairman of the board of Texas Heritage Bank, November 20, 2020.
3. To compute the monthly payment, you can use a financial calculator or a computer spreadsheet:

   PV (present value) = \$50,000 (current loan)
   N (number of payments) = 84 (7 years × 12 months = 84)
   I/yr (interest rate/month) = 0.5% (6% interest rate per year ÷ 12 months = 0.005 = 0.5%)
   FV (future value) = 0 (in 7 years)
   PMT (payment) = \$730.43
4. The \$31,100 was determined by using an Excel spreadsheet.
5. Comment by Jack Griggs, December 1, 2020.
6. For an excellent source on business angels, see Bill Payne, "The Definitive Guide to Raising Money from Angels," http://billpayne.com/services/definitive-guide-raising-money-from-angel-investors, accessed April 27, 2021.
7. The American Angel Campaign, November 2017, www.theamericanangel.org, accessed June 12, 2021.
8. Maddie Shepherd, "Crowdfunding Statistics (2021): Market Size and Growth," December 16, 2020, https://www.fundera.com/resources/crowdfunding-statistics, accessed August 1, 2021.
9. For the Securities and Exchange Commission (SEC) regulations related to crowdfunding, go to "Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers," https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm, accessed July 1, 2021.
10. Personal conversation with Mitchell Horner, June 13, 2021.

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Chapter 13

Planning for the Harvest

Looking Ahead

Learning Objectives

If you have created a successful business with economic value, you will need to understand the harvesting process for exiting your enterprise, which is the purpose of the Planning for the Harvest chapter. By studying this chapter, you should be able to . . .

13-1 **Explain the importance of having a harvest, or exit, plan.**

13-2 **Describe the options available for harvesting a business.**

13-3 **Explain the issues in valuing a firm that is being harvested and deciding on the method of payment.**

13-4 **Provide advice on developing an effective harvest plan.**

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Spotlight on Small Business

Will There Still Be Life after Selling Your Business?


STEFAN DAHL/DREAMSTIME.COM

Jeff Weiner

You might wonder why we're discussing selling your business when there is still so much to learn about managing a small firm. As we will explain in this chapter, the question about how you will handle the harvesting of your business needs to be asked sooner, rather than later, in the entrepreneurial journey. It is a significant event for anyone who has owned a business for a number of years.

Many entrepreneurs do not seriously consider what life will be like after leaving their business. Two entrepreneurs, Jeff Weiner and Jeremy Greven, describe in their own words how choosing to sell their firms was a life-changing decision.

> And just like that, with one final signature, I changed the course of my life.
>
> I didn't come to the decision to sell my company lightly, but rather it was a decision I made in January of 2017 when I realized that I had many unaccomplished goals and that I was still young enough to accomplish those goals. And with that fateful decision 16 months ago, I started down the path of figuring out how to divest myself from my company.
>
> It's easy to get into a routine of complacency, and after 26 years I was in that routine. Yes, business was good, and yes, for the most part, I loved what I did. And then I realized that there's more to life after selling your business, and many unfulfilled passions.
>
> What I have come to realize about myself is that I am an entrepreneur on the hunt for the next opportunity.
>
> In the last two years since I sold my company, I've had the opportunity to speak with at least two dozen other entrepreneurs who have also sold their businesses. The good news is that, of all the people who I have spoken with, none have regretted their decision, although some are struggling with life after selling their business.
>
> Some are waiting on the sidelines trying to figure out what they're going to do next. They're taking a lot of vacations, having the occasional meeting, and, it seems, buying time.
>
> In most cases, of the entrepreneurs who I know, all of them have enough money to never have to work again, but they choose to continue working or keep busy because you can only play so much golf and hang around the beach or pool for so long.
>
> You need a bigger purpose in life, and the purpose needs to transcend making more money. Not having to work for money, and having enough, is a hard concept to grasp, especially if worrying about not having enough has been in your entrepreneurial DNA for many years.
>
> You come to define yourself as an entrepreneur, and as someone who has worried about payroll, keeping customers happy, staff engaged, and the lights on for many years, and you don't change who you are fundamentally just because you sold your business.
>
> Most entrepreneurs are hard-driving AND assertive individuals who know how to get what they want. That doesn't change just because you've sold your company.

These two entrepreneurs represent an untold number of small business owners who had similar experiences when they sold their businesses.

Source: Excerpts from Jeff Weiner, *The Kickass Entrepreneur's Guide to Investing* (2018), https://www.thekickassentrepreneur.com/life-after-selling-your-business/m, accessed October 2, 2021.

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As you will learn in this chapter, exiting your business, or what we call the *harvest*, can be the best of times and the worst of times. It all depends on how well you understand yourself and your business, and what is required to exit your business effectively.

We are addressing the issue of exiting a business early in the text, choosing to delay instruction on managing a firm to subsequent chapters. As mentioned earlier, we do so because of our strong conviction that it is better for an entrepreneur to consider the exit sooner rather than later.

In previous chapters, we discussed how to recognize business opportunities and develop strategies for capturing these opportunities. Such activities represent the cornerstone of everything an entrepreneur does. However, that's not the end of the story.

Experience suggests that an entrepreneur who is developing a company strategy should think about more than just starting (founding or acquiring) and growing a business. The entrepreneurial process is not complete until the owners and any other investors have exited the venture and captured the value created by the business. This final—but extremely important—phase can be enhanced through an effective harvest, or exit, plan. In other words, the goal is to create value during the entrepreneurial journey by making a difference—*and then finishing well!*

13-1 Explain the importance of having a harvest, or exit, plan.

13-1 The Importance of the Harvest

Most small business owners do not like to think about the harvest, even though few events in the life of an entrepreneur, and of the firm itself, are more significant. Consequently, the decision to harvest is frequently the result of an unexpected event, possibly a financial crisis, rather than a well-conceived strategy.

Harvesting, or *exiting,* is the method that owners and investors use to get out of a business and, ideally, reap the value of their investment in the firm. Many entrepreneurs successfully grow their businesses but fail to develop effective harvest plans. As a result, they are unable to capture the full value of the business they have worked so hard to create.

An entrepreneur needs to understand that harvesting encompasses more than merely selling and leaving a business. It involves capturing value (cash flows), reducing risk, and creating future options. (This is the reason we prefer the term *harvest* over *exit*.)

In addition, there are personal, nonfinancial considerations for entrepreneurs. Owners may receive a lot of money for their firms but still be disappointed with the harvest if they are not prepared for a change in lifestyle. Thus, carefully designing an intentional harvest strategy is as essential to an entrepreneur's personal success as it is to their financial success.

In this chapter, we offer suggestions for achieving a "successful" harvest. It is a mistake to define success only in terms of the harvest; the entrepreneurial journey should be successful as well. So, throughout the chapter, we encourage you to think about what success means to you. Arriving at the end of the journey only to discover that your ladder was leaning against the wrong wall can be one of life's greatest disappointments.

harvesting
The process used by entrepreneurs and investors to reap the value of their investment in a business when they leave it; also known as *exiting*.

The harvest is vitally important to a firm's investors as well as to its founder. Investors who provide high-risk capital—particularly angels and venture capitalists—generally insist on a well-thought-out harvest strategy. They realize that it is easy to put money into a business but difficult to get it out. As a result, a firm's appeal to investors is driven, in part, by the availability of harvest options. If investors are not convinced that harvesting opportunities will exist, they will be unlikely to invest.

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While it is important to think sooner rather than later about the harvest, don't lose focus on the business itself. Attention must always be on running the business, including continuing to deliver high-quality products and services, providing extraordinary customer service, and creating a great workplace environment. A well-balanced business plan takes exit planning into account while simultaneously contemplating market entry and developing financial strategies.

The earlier you begin planning for a harvest, the more successful your eventual exit will most likely be. In fact, some of the steps involved in planning for the harvest, such as fine-tuning your company's strategies, focusing on internal growth, improving your financial systems, and creating an independent board, are the same as those required to build a successful company.

13-2 Methods of Harvesting a Business

13-2 Describe the options available for harvesting a business.

Four basic ways to harvest an investment in a privately owned company follow:

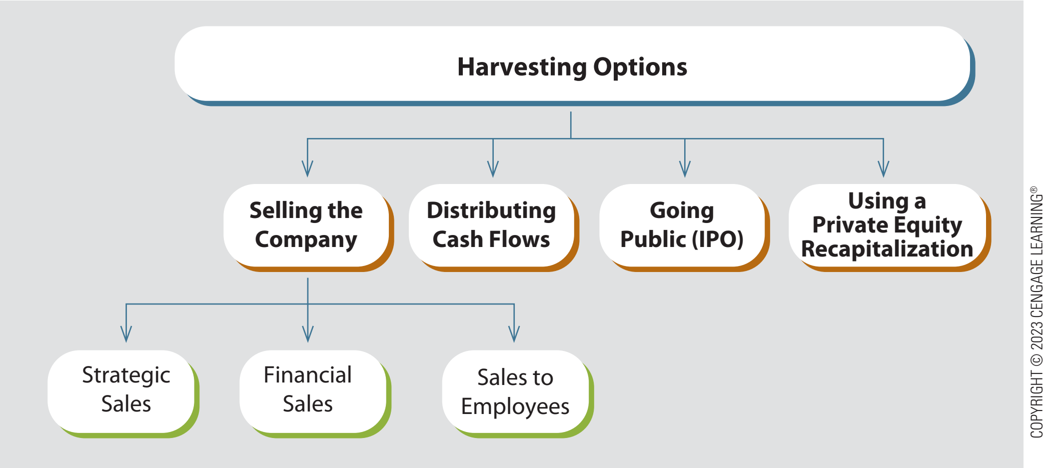
1. Sell the firm.
2. Distribute the cash flows generated by the business to its owners instead of reinvesting the cash.
3. Offer stock to the public through an initial public offering (IPO).
4. Use a private equity recapitalization.

These options are shown graphically in Exhibit 13.1.

13-2a Selling the Firm

In any harvest strategy, financial questions associated with the sale of a firm include how to value the firm and how to structure the payment for the business. Most frequently, an entrepreneur's motivation for selling a company relates to retirement and estate planning and a desire to diversify investments. Thus, in choosing a possible buyer, entrepreneurs should understand what they want to accomplish from the sale.

Exhibit 13.1 **Methods for Harvesting a Business**



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Potential buyers for a company can come from several places, including customers, suppliers, employees, friends and family, and even a competitor. An owner may also want to use a business broker.

A **business broker** is a professional who assists in the buying and selling of a business. In addition to finding possible buyers, a business broker can provide valuable guidance to the selling entrepreneur and help facilitate the negotiations. Brokers can, however, be relatively expensive, charging 5 to 10 percent of the selling price. Also, care must be taken when selecting a broker. Not all brokers act professionally, and some make false claims regarding their qualifications. It is not unusual for an entrepreneur to be disappointed with a broker's contribution to the sale.

For example, when Robert Hall hired a business broker to help sell his business, he gave the broker the firm's latest financial information, which reported a downturn in sales in the previous month. Hall felt that ethics required that the buyer be given this information. The broker, as Hall learned later, chose not to give the information to the buyer so that the deal would not be adversely affected. After all, the broker received a fee only if the sale was consummated.

In the search for potential buyers, it is essential that the selling entrepreneur understand the different types of buyers. In the sections that follow, we will look at three buyer groups in particular: strategic buyers, financial buyers, and employees.

Selling to Strategic Buyers

Usually, a strategic buyer is a firm in a similar line of business in a different market or in need of new products and services to sell to existing customers. Another possibility is that the strategic buyer is in an unrelated business that wants to acquire the seller's strengths to help the buyer's existing business. For example, IBM acquired privately owned Healthlink, Inc., which provided information technology to the healthcare industry. Since IBM had not developed a presence in this niche area, acquiring Healthlink quickly gave it a way to compete in that space.

Strategic buyers value a business, in large part, based on the mutual advantages they think they can create by combining the acquired firm with another business. Since the value of a business to a buyer is derived from both its stand-alone characteristics and its synergies, strategic buyers may pay a higher price than would other buyers, who value the business only as a separate entity. Thus, in strategic acquisitions, the critical issue is the degree of strategic fit between the firm to be harvested and the potential buyer's other business interests. If the prospective buyer is a current rival and if the acquisition would provide long-term, sustainable competitive advantages (such as lower production costs or superior product quality), the buyer may be willing to pay a premium for the company.

Selling to Financial Buyers

Unlike strategic buyers, financial buyers look primarily to a firm's stand-alone, cash-generating potential as its source of value. A financial buyer hopes to increase future sales growth, reduce costs, or both. This fact has an important implication for the owner of the business being purchased. The financial buyer often will make changes in the firm's operations that translate into greater pressures on the firm's personnel, resulting in layoffs that the current owner might find objectionable.

A **leveraged buyout (LBO)** is a financial acquisition involving a very high level of debt financing, where the future cash flows of the target company are expected to be sufficient to meet debt repayments. In the past, acquisitions frequently were financed with $9 in debt for every $1 in equity—thus, the name *leveraged buyout*. The LBO has sometimes been called a **bust-up LBO**, in which the new owners pay the debt down rapidly by selling off the acquired firm's assets.

business broker
A professional who assists in the buying and selling of a business.

leveraged buyout (LBO)
A purchase heavily financed with debt, where the future cash flows of the target company are expected to be sufficient to meet debt repayments.

bust-up LBO
A leveraged buyout involving the purchase of a company with the intent of selling off its assets.

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Because financial buyers rely heavily on debt to finance the acquisition, the acquired company must have the following characteristics:

1. Steady earnings over time.
2. Attractive growth rates.
3. An effective management team already in place.
4. Assets that can be used as collateral on the debt—otherwise, the risk is too great, and the transaction simply will not work.

Consider Robert Hall's company, Visador Corporation, which was sold to a financial buyer for $67 million. The buyer financed the purchase as a leveraged buyout, incurring a lot of debt. The firm's total assets and debt and equity before and after the sale are presented in the balance sheet that follows.

	Before the Sale		**After the Sale**	
	Dollars	**%**	**Dollars**	**%**
Total assets	$18,000,000	100%	$67,000,000	100%
Total debt	$ 5,000,000	28%	$60,000,000	90%
Equity	13,000,000	72%	7,000,000	10%
Total debt and equity	$18,000,000	100%	$67,000,000	100%

Visador's before-sale and after-sale numbers differ in two important respects:

1. The total assets (and total debt and equity) increased from $18 million to $67 million. In other words, the founders of Visador had invested just over $18 million in the firm during their years of ownership, up to the point of the acquisition. However, the buyer was willing to pay $67 million for the business, based on future cash flows that were expected to be generated.
2. Before the sale, the assets were financed with 28 percent debt ($5 million total debt ÷ $18 million total assets) compared to approximately 90 percent debt ($60 million total debt ÷ $67 million total assets) after the sale.

Consequently, the firm was exposed to significantly more financial risk. If sales had decreased, the company may not have been able to service its debt. This is typical for bust-up leveraged buyouts.

More recently, the bust-up LBO has been replaced by the build-up LBO. As the name suggests, a **build-up LBO** involves pulling together a group of small firms to create a larger enterprise that might eventually be sold or taken public via an initial public offering.

The process of a build-up LBO begins with the acquisition of a company, which then acquires a number of small businesses that in some way complement it. These subsequent acquisitions may expand capacity in related or completely different businesses.

The newly formed combination is operated privately for five years or so to establish a successful track record, and then it is sold or taken public. These acquisitions continue to rely heavily on debt financing, but to a lesser extent than bust-up LBOs. Build-up LBOs have occurred in a number of industries where small companies frequently operate, such as funeral services and automobile sales.

Sometimes, the selling firm's own management initiates an LBO to buy the business from the entrepreneur—in which case the arrangement is referred to as a **management buyout (MBO)**. An MBO can contribute significantly to a firm's operating performance by increasing top management's focus and intensity. Thus, an MBO is a potentially viable means of transferring ownership from the founder to the management team.

build-up LBO
A leveraged buyout involving the purchase of a group of small companies with the intent of making the firms into one larger company for eventual sale or to be taken public.

management buyout (MBO)
A leveraged buyout in which the firm's top managers become significant shareholders in the acquired firm.

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In many entrepreneurial businesses, top managers have a strong incentive to become owners but lack the financial capacity to acquire the firm. An MBO can solve this problem by using debt financing, which is often underwritten in part by the entrepreneur/seller.

PIXELDARKROOM/SHUTTERSTOCK.COM

Consider Visador Corporation, designer/producer of residential staircases, which was sold to a financial buyer for $67 million. The buyer financed the purchase as a leveraged buyout.

Selling to Employees

Established by Congress, **employee stock ownership plans (ESOPs)** set up trust funds for employees and contribute either cash to buy company stock, contribute shares directly to the plan, or have the plan borrow money to buy shares. As part of a plan, owners can sell all or part of their stock to an ESOP. If the plan borrows money to buy stock, the company makes contributions to the plan to enable it to repay the loan.

Owner can sell all of their stock to an ESOP and still retain a management position with the firm, thereby effectively maintaining control of the business. An ESOP can also create significant tax advantages for the seller. For instance, if the entrepreneur sells at least 30 percent of the company, taxes that may be owed because of the sale can frequently be deferred and not paid until a later date—in some cases, indefinitely.

After the owner-managers of BFW Construction Company created an ESOP, they sold the business and rolled over the money from the shares into their personal retirement accounts. As a result, they have not paid taxes from the time the shares were put into the ESOP, and they will not have to pay them until they are required to begin withdrawing the money, when they are 70½ years old.[1]

A reason frequently given for selling to employees is to create an incentive for them to work harder—by giving them a piece of the profits. However, employee ownership is not a panacea. Although advocates maintain that employee ownership improves motivation, leading to greater effort and reduced waste, the value of increased employee effort resulting from improved motivation varies significantly from firm to firm.

Selling all or part of a firm to employees works only if the company's employees have an owner's mentality—that is, they do not think in "9-to-5" terms. An ESOP may provide a way for the owner to sell the business, but if the employees lack the required mindset, it will not serve the business well in the future.

Employee education is necessary if an ESOP is to be effective. Consider the experience of Mick Slinger, retired CFO of Van Meter Industrial, Inc., who thought his company's employee stock program was a great perk for employees. However, at a company meeting, an employee said he didn't care at all about the stock fund, asking, "Why don't you just give me a couple hundred bucks for beer and cigarettes?"

It was a wake-up call for Slinger, who says that many employees at the 100-percent employee-owned company "didn't know what stock was, didn't know what an [employee] owner was. I made the mistake of thinking that everyone thinks like me." So, the company created an employee committee to raise awareness of stock ownership and how it affects employees' net worth.

employee stock ownership plan (ESOP)
A profit-sharing plan that sets up trust funds that hold shares of company stock for employees.

Today, employees are much more engaged in the program, and the firm's management believes it has made a significant contribution to increasing its stock price and lowering employee turnover. However, it required a lot of effort to make the plan work as desired.[2]

The approaches to selling a company that have been described in this section represent the primary ways in which small business owners exit their businesses. But the opportunity

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to sell a business can be affected by market conditions. For instance, during a recession, there may not be many buyers—but neither will there be many sellers. So, entrepreneurs who have been considering an exit may be holding back in the hope of an economic recovery.

After a recession, the number of willing buyers increases considerably and those buyers make more attractive offers. However, it may continue to be difficult for buyers to get financing from traditional sources. As a result, **seller financing**, in which a seller lends the buyer part of the purchase price of the business, has become more prevalent.

For instance, an entrepreneur purchased a business for $3.5 million and paid $2.7 million in cash, with the seller taking a note for the remaining $800,000 to be paid off over the next seven years. The $2.7 million in cash came from a bank loan of $2 million and $700,000 of the buyer's personal money. The loan from the seller was subordinated to the bank loan, so that if the buyer missed a payment to the bank, they could not make any payments to the seller until the bank loan was current.

13-2b Distributing the Firm's Cash Flows

A second harvest strategy involves the orderly withdrawal of the owners' investment in the form of the firm's cash flows. The withdrawal process could be immediate if the owners simply sold off the assets of the firm and liquidated the business. However, for a value-creating firm—one that earns attractive rates of return for its investors—this does not make economic sense.

The mere fact that a firm is earning high rates of return on its assets is an argument against liquidation. Instead, the owners might simply stop growing the business. By doing so, they would increase the cash flows that could be returned to them. If they decide to adopt this approach, only the amount of cash necessary to maintain current markets is retained and reinvested. There is little, if any, effort to grow the present markets or expand into new markets.

Harvesting by slowly withdrawing a firm's cash from the business has two important advantages:

1. The owners can retain control of the business while they harvest their investment.
2. They do not have to look for a buyer or incur the expenses associated with consummating a sale.

There are also some disadvantages. Reducing investment when a firm faces valuable growth opportunities could leave the firm unable to sustain its competitive advantage. The result may be an unintended reduction in the value of the business. Also, there may be tax disadvantages to an orderly liquidation, compared with other harvest methods. For example, if a corporation distributes cash as dividends, both the company and the stockholders are taxed on the income; this is known as **double taxation**. (Note, however, that this is not the case for a sole proprietorship, partnership, limited liability company, or S corporation.)

Finally, for the entrepreneur who is simply tired of day-to-day operations, siphoning off the cash flows over time may require too much patience. Unless other people in the firm are qualified to manage it, this strategy may be destined to fail.

seller financing
Financing in which the seller accepts a note (in lieu of cash) from a buyer in partial payment for a business.

double taxation
Taxation of income first as corporate earnings and then, a second time, as stockholder dividends.

13-2c Conducting an Initial Public Offering (IPO)

A third method of harvesting a firm is conducting an initial public offering. As briefly discussed in Chapter 12, an initial public offering (IPO) occurs when a private firm sells its shares for the first time to the public.

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Living the Dream

Finishing Well

© BOB KNORR

Bob Knorr, Founder and CEO, Tapestry Medical, Inc.

The following story of Tapestry Medical, Inc., is told by Robert Knorr, its founder and CEO. He discusses building the company and then "finishing well" by executing what proved to be a successful harvest.

For as long as I can remember, I felt called to become an entrepreneur. In the early part of my professional career, this calling was fulfilled by creating new businesses for my employer, Johnson & Johnson.

Within the security of a corporate environment, I had easy access to funding and talented people who helped me create several successful new businesses. Although in many ways I operated as an entrepreneur within a large corporation, ultimately Johnson & Johnson bore all the risks AND received all the rewards of each new business I created.

After almost 20 years, I decided to leave Johnson & Johnson and venture out on my own. At that point in my career, I had the industry knowledge to start my own company in the healthcare field. I also had the confidence to use my own money to fund my company that began in my garage.

By "bootstrapping" my company, my management team and I were able to retain tight control of the company's ownership and determine the company's strategic direction without outside interference. However, I would also bear all the inherent risks in order to receive the rewards of my new business [Tapestry Medical]. Within a few years, Tapestry had established itself as the market leader in the small but rapidly growing field of remote patient monitoring. In fact, within four years Tapestry was among the fastest-growing private healthcare companies in the nation and had created the nation's first ever "pay-for-performance" business model approved by the U.S. government.

In order to sustain Tapestry's rapid growth, it became clear that we needed additional working capital beyond what I could provide. This situation required that we either seek a large equity investment from a private-equity firm or sell our business to a publicly traded company.

Following the financial crisis of late 2008, I decided to sell Tapestry to a larger healthcare company with the resources to take the business to the next level. Potential acquirers included existing competitors as well as larger healthcare companies interested in entering the marketplace that Tapestry had created.

At the time, Tapestry was still a privately funded startup company, competing against three large, well-funded publicly traded companies. However, just prior to putting Tapestry up for sale, I signed a strategic co-marketing agreement with a leading healthcare software company that provided access to a pipeline of 500,000 potential new customers.

With impressive past results and a promising future, I engaged an investment banker who helped negotiate the best acquisition terms. After several months of intense negotiations, Tapestry was eventually acquired by its principal competitor, a leading healthcare company that had made several other acquisitions in this industry.

After Tapestry was acquired, I agreed to remain on board and assumed responsibility for merging Tapestry into the acquiring company's operations. The first year after the acquisition, sales of the new combined entity rose dramatically as a result of adopting best practices across both organizations and leveraging customer relationships.

Although Tapestry was founded and then sold within five years, there were periods of great uncertainty and personal risk. Looking back on the company sale, Knorr offers three pieces of advice:

- Detach yourself emotionally from selling your company by using outside advisers.

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- Establish a short list of "must haves" prior to beginning negotiations, and remain flexible on all secondary points.
- Remember to thank and reward everyone who helped you achieve your goals.

Knorr's positive experience in selling Tapestry and then becoming an executive of the acquiring firm is not the norm, at least not without a lot of frustration. Being prepared for the harvest process and life after exiting your business is something that deserves your thoughtful attention.

Source: Personal communication with Robert Knorr, founder and CEO, Tapestry Medical, Inc., July 1, 2021.

An IPO requires registering the stock issue with the Securities and Exchange Commission (SEC) and adhering to "blue sky laws" that govern the public offering at a state level. The purpose of these federal and state laws is to ensure adequate disclosure to investors and to prevent fraud. Businesses intending to conduct an IPO must file a detailed registration statement with the SEC, including in-depth financial, management, and operational information.

Entrepreneurs frequently consider the prospect of an initial public offering to be the ultimate outcome for their efforts, bringing with it increased prestige in many business circles. Some entrepreneurs think of it as the "holy grail" of entrepreneurial success. However, that may not be the case today, especially for smaller IPOs.

Reasons for Going Public

The purpose of the IPO process is to create a ready market for publicly trading the company's stock. An IPO offers several benefits:

1. It can enhance the reputation of the business, if done successfully.
2. It provides an additional source of capital to grow the business.
3. A stock that is publicly traded can create an ongoing interest in the company and its continued development.
4. Publicly traded stock is more attractive to key personnel whose incentive pay includes shares of the firm's stock.

While there are several reasons for going public, the primary reason is to raise capital. In most cases, money raised from selling a firm's stock to the public is used for expansion, paying down debt, and increasing the firm's liquidity (cash).

In fewer instances, initial public offerings result from entrepreneurs' desire to sell their stock. Thus, IPOs are seldom intended as an *immediate* exit strategy but rather to raise capital for growth. In fact, company insiders, such as the management team, are usually prevented from selling any stock for 90 to 180 days after the IPO. Eventually, however, entrepreneurs can and frequently do sell their shares to cash out of their companies.

The Costs of Managing an IPO

Entrepreneurs must consider more than just the initial costs of an IPO, which can be as much as 20 percent of the stock issued. They must also think hard about the costs of running a publicly traded company, which include significant ongoing costs associated with reporting its financial results to investors and to the SEC. As mentioned in Chapter 12, the Dodd-Frank Act, which was primarily aimed at banks and other financial institutions to help avoid a repeat of the 2007–2008 financial crisis, added regulatory

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costs for all publicly traded companies. These costly requirements can cripple a small firm and have a significant impact on the decision to go public.

13-2d Private Equity Recapitalization

A fourth method of harvesting is a **private equity recapitalization**, also called a *private equity recap*, where private equity investors provide a combination of debt and equity to the business that allows entrepreneurs to cash out part of their investment in a company. The entrepreneur will most likely continue to manage the business.

Private equity investors offer two key advantages that public investors do not: immediacy and flexibility. With private equity, entrepreneurs can sell most of their stock immediately, an option not available when a company is taken public. Also, private equity investors can be more flexible in structuring their investment to meet an entrepreneur's needs.

A private equity recap can be particularly effective for family-owned businesses that need to transfer ownership to the next generation. In that transfer of ownership, there may be trade-offs around three important goals:

1. The need for a liquidating event (cash for retirement) for the exiting family members.
2. Continued financing for the company's future growth.
3. The desire of the younger generation to maintain control of the firm.

In other words, the older generation wants to get cash out of the business, while the younger generation wants to retain the cash needed to finance the firm's growth and yet not lose ownership control.

To illustrate how a private equity recap might work in such a situation, consider the Fojtasek Companies located in Dallas, Texas. The founder, Joe Fojtasek, wanted to retire. While he needed money for retirement, he also wanted to pass control of the business to his adult children. After considering several options, he decided to go with one of two possible choices:

1. Sell the business to Bear Sterns, a financial buyer.
   a. The selling price would be $20 million.
   b. The $20 million purchase price would be financed with $16 million in debt and $4 million in equity; that is, 80 percent debt ($16,000,000 ÷ $20,000,000) and 20 percent equity ($4,000,000 ÷ $20,000,000)
   c. Fojtasek was willing to sell for $20 million but was hesitant to subject the company to such a large amount of debt financing—even though he would no longer own the business.
   d. With the leveraged buyout, the family would probably lose control of the business.
2. Sell to Heritage Partners (now New Heritage Capital), a private equity firm in Boston, structuring the deal as a *private equity recapitalization*.
   a. The selling price would be $18 million—10 percent less than the LBO price. Of the $18 million,
      (1) $15 million would go to Fojtasek for his retirement.
      (2) The remaining $3 million would be paid to the younger generation, who would then reinvest the money in the business. For this investment, they would receive 51 percent of the firm's common stock.

private equity recapitalization
Provision of debt and equity by private equity investors that allows entrepreneurs to cash out part of their investment.

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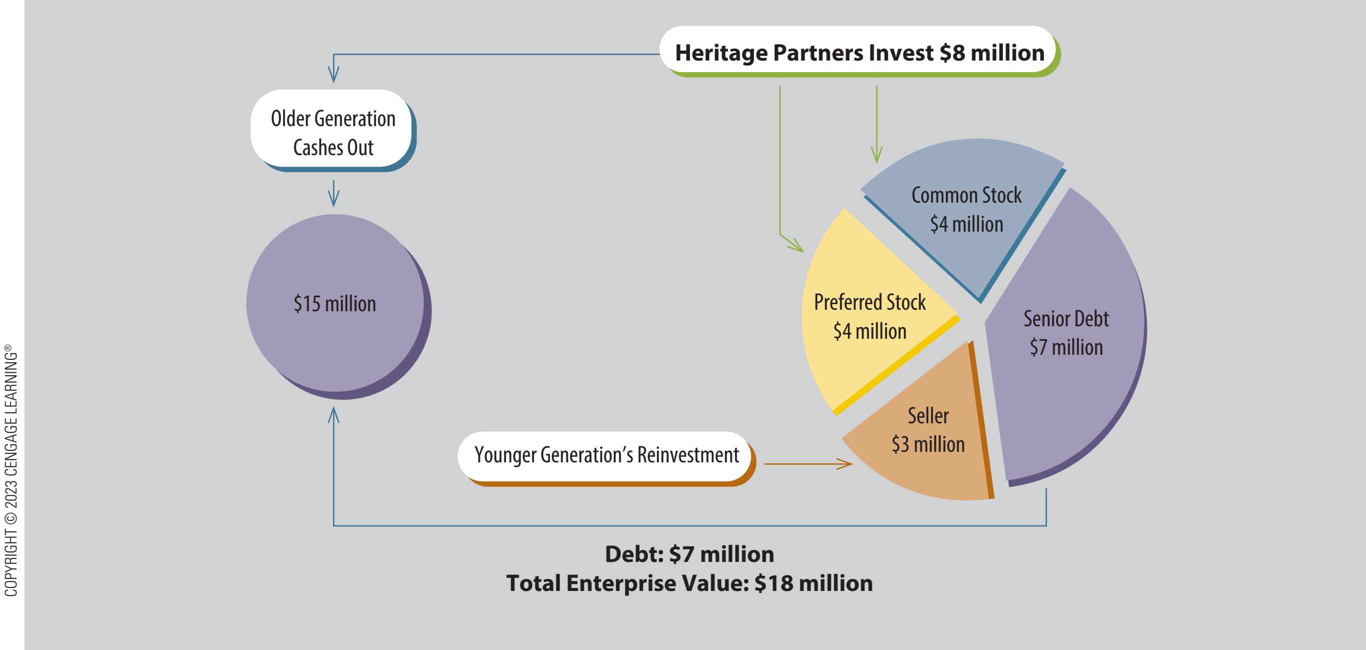
Exhibit 13.2 A Private Equity Recap: The Fojtasek Companies



b. The $15 million needed to pay the older generation would come from bank financing for $7 million, and $8 million from Heritage Partners, giving the buyers 49 percent of the firm's common stock.

Exhibit 13.2 provides a graphic presentation of the proposed financing structure for the sale of the Fojtasek Companies to Heritage Partners.

The differences between the two options being considered by Fojtasek are clear. The debt ratio is much lower with the recapitalization than with the LBO. This would possibly allow for a lower interest rate on the debt, given less risk, and permit the firm's cash flows to be used to grow the firm rather than to pay down debt. This arrangement allows the senior generation of owners to cash out, while the next generation retains control and the cash to grow the firm—a win-win situation. The younger generation also has the potential to realize significant economic gains in the future if the firm performs well after the sale.

13-3 Firm Valuation and Payment Methods

13-3 Explain the issues in valuing a firm that is being harvested and deciding on the method of payment.

As a firm moves toward the harvest, two issues are of primary importance: (1) the harvest value (the firm's selling price) and (2) the method of payment when the business is sold.

13-3a The Harvest Value

Valuing a company may be necessary on numerous occasions during the life of the business, but it is never more important than at the time of the exit. Owners can harvest only what they have created. Value is created when a firm's return on invested capital is greater than the investors' **opportunity cost of funds**, which is the rate of return that could be earned on an investment of similar risk.

opportunity cost of funds
The rate of return that could be earned on another investment of similar risk.

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Growing a company to the point of diminishing returns and then selling it to others who can carry it to the next level is a proven way to create value. How this incremental value is shared between the old and the new owners depends largely on the relative strengths of each party in the negotiations—that is, who wants the deal more or who has the better negotiating skills.

Business valuation is part science and part art, so there is no precise formula for determining the selling price of a private company. Rather, the price is determined by a sometimes-intricate process of negotiation between buyer and seller. Much is left to the negotiating skills of the respective parties. But one thing is certain: There must be a willing buyer. It doesn't matter what a firm's owner believes the business is worth. It is worth only what someone who has the cash is prepared to pay.

13-3b The Method of Payment

The actual value of a firm is only one issue—another is the method of payment. The exiting entrepreneur may prefer to sell the firm's stock so that the gain on the sale will be a capital gain, resulting in lower taxes.[3]

The buyer, on the other hand, may prefer to purchase the firm's assets rather than it's stock. Buying the assets relieves the buyer of responsibility for any of the selling firm's liabilities, known or unknown.

The seller can be paid in cash or in the stock of the acquiring firm, with cash generally being preferred over stock. Entrepreneurs who accept the buyer's stock in payment are frequently disappointed, as they are unable to affect the value of the stock once they have sold the firm. Only entrepreneurs who have great faith in an acquiring firm's management should accept stock in payment, and even then, they are taking a big chance. Having such a large investment in only one stock is risky, to say the least.

13-4 Provide advice on developing an effective harvest plan.

13-4 Developing an Effective Harvest Plan

We have discussed why planning for the harvest is important and described the methods for harvesting. However, understanding what the options are for exiting a company in no way guarantees a successful harvest.

More times than not, owners who harvest their businesses are disappointed with the process and the outcome. In the sections that follow, we provide suggestions for crafting an effective exit strategy.[4]

13-4a Anticipate the Harvest

Entrepreneurs frequently do not appreciate the difficulty of harvesting a company. One investor commented that exiting a business is "like brain surgery—it's done a lot, but there are a lot of things that can go wrong."

Harvesting, whether through a sale or a stock offering, takes a lot of time and energy on the part of the firm's management team and can be very distracting from day-to-day affairs. The result is often a loss of managerial focus and momentum, leading to poor performance in the business.

Uncertainties accompanying an impending sale often lower employee morale. The stress can affect the whole organization, as employees become anxious about the prospect of a new owner. Len Baker offered this advice: "Don't start running the company for the liquidity event. Run the business for the long haul." There is also a risk of becoming so attentive to "playing the harvest game" that an entrepreneur may forget to prioritize business operations.

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Investors are always concerned about how to exit, and entrepreneurs need to have a similar mindset. Jack Kearney indicated that an exit strategy should be formulated in advance, unless "the entrepreneur expects to die in the CEO chair. . . . The worst of all worlds is to realize, for health or other reasons, that you have to sell the company right now." Jim Knister advises entrepreneurs to start thinking two or three years ahead about how they are going to exit so that they can correctly position their companies.

This type of advice is particularly important when the entrepreneur is planning an IPO. Running a public company requires information disclosures to stockholders that are not required of a privately held firm. Specifically, it is important to do the following when planning an IPO:

1. Maintain an accounting process that cleanly separates the business from the entrepreneur's personal life.
2. Select a strong board of directors that can and will offer valuable business advice.
3. Manage the firm in such a way that it will have a successful performance track record.

Having a harvest plan in place is also very important because the window of opportunity can open and close quickly. Remember that the opportunity to exit is triggered by the arrival of a willing and able buyer, not just an interested seller. For an IPO, a hot market may offer a very attractive opportunity, and a seller must be ready to move when the opportunity arises.

In summary, an entrepreneur should always anticipate the harvest. In the words of Ed Cherney, an entrepreneur who has sold two companies, "Don't wait to put your package together until something dramatic happens. Begin thinking about the exit strategy and start going through the motions, so that if something major happens, you will have had time to think through your options."

13-4b Expect Conflict—Emotional and Cultural

Having purchased other companies does not prepare entrepreneurs for the sale of their own company. Entrepreneurs who have been involved in the acquisition of other firms are still ill-prepared for the stress associated with selling their own businesses. Jim Porter, who has been involved in several acquisitions, says, "It's definitely a lot more fun to buy something than it is to be bought." One very real difference between selling and buying comes from entrepreneurs' personal ties to the business that they helped create. A buyer can be quite unemotional and detached, while a seller is likely to be much more concerned about nonfinancial considerations.

For this reason and many others, entrepreneurs frequently do not make good employees. The very qualities that made them successful entrepreneurs can make it difficult for them to work for a new owner. In fact, an entrepreneur who plans to stay with the firm after a sale can become disillusioned quickly and end up leaving prematurely. As Len Baker observed, "There is a danger of culture conflict between the acquiring versus the acquired firm's management. The odds are overwhelming that somebody who's been an entrepreneur is not going to be happy in a corporate culture."

Conflicts occur to varying degrees whenever an entrepreneur remains with the company after the sale. Although the nature of the conflict varies, the intensity of the feelings does not. An entrepreneur who stays with the company should expect culture conflict and be pleasantly surprised if it does not occur.

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13-4c Get Good Advice

Entrepreneurs learn to operate their businesses through experience gained in repeated day-to-day activities. However, they may engage in a harvest transaction only once in a lifetime. It can be an emotional roller-coaster ride. Thus, entrepreneurs have a real need for good advice, both from experienced professionals and from those who have personally been through a harvest.

In seeking advice, be aware that the experts who helped you build and grow your business may not be the best ones to advise you when it's time to sell the company, as they may not have the necessary experience. Choose your advisers carefully.

Jack Furst believes that advisers can give entrepreneurs a reality check. He contends that, without independent advice, entrepreneurs frequently fall prey to thinking they want to sell unconditionally, when in fact they really want to sell only if an unrealistically high price is offered.

Professional advice is vital, but entrepreneurs stress the importance of talking to other entrepreneurs who have sold a firm or taken it public. No one can better describe what to expect—both in events and in emotions—than someone who has had the experience. This perspective nicely complements that of the professional adviser.

Perhaps the greatest misconception among entrepreneurs is that an IPO is the end of the line. The fact is that the entrepreneur will not be able to cash out for some time after the completion of the IPO. Investors in the new stock offering have chosen to back the entrepreneur as the driving force behind the company—that is, they have invested in the entrepreneur, as much as in the firm.

While the daily stock price quotes will let the management team keep score, the business will have to reach another plateau before the founder can think about placing it in the hands of a new team and going fishing. Under these circumstances, getting good advice is a must.

13-4d Understand What Motivates You

For an entrepreneur, harvesting a business that has been an integral part of their life for a long period of time can be a very emotional experience. When entrepreneurs have invested a substantial part of their working life in growing a business, a real sense of loss may accompany the harvest. Walking away from employees, clients, and one's identity as a small business owner may not be the wonderful ride into the sunset that was expected.

So, entrepreneurs should think very carefully about their motives for exiting and what they plan to do after the harvest. Frequently, entrepreneurs have great expectations about what life is going to be like with a lot of liquidity, something many of them have never known. The harvest does provide the long-sought liquidity, but some entrepreneurs find managing money—in contrast to operating their own company—less rewarding than they had expected.

Peter Hermann believes that "seller's remorse" is a major issue for a number of entrepreneurs. His advice: "Search your soul and make a list of what you want to

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achieve with the exit. Is it dollars, health of the company, your management team or an heir apparent taking over?" The answers to these and similar questions determine to a significant extent whether the exit will prove successful in all dimensions of an entrepreneur's life.

Entrepreneurs are also well advised to be aware of potential problems that may arise after the exit. There are stories about people selling a firm or going public and then losing everything. Ed Cherney says, "It is more difficult to handle success than it is to handle struggling. People forget what got them the success—the work ethic, the commitment to family, whatever characteristics work for an entrepreneur. Once the money starts rolling in, people forget and begin having problems."

And for the entrepreneur who believes that it will be easy to adapt to change after the harvest, even possibly to start another company, William Unger paraphrases Machiavelli's *The Prince:* "It should be remembered that nothing is more difficult than to establish a new order of things."

To provide an overview of the issues we have discussed for developing an effective harvest strategy, look at the *harvest framework* provided in Exhibit 13.3. While we cannot address fully all the issues that need to be considered, this framework will hopefully give you a good starting point on which to build.

13-4e What's Next?

Entrepreneurs by their very nature are purpose-driven people. So, after an exit, entrepreneurs who have been driven to build profitable businesses will need something to bring meaning to their lives. Many entrepreneurs have a sense of gratitude for the benefits they have received from working in a capitalist system. As a result, they want to give back, with both their time and their money.

The good news is that there is no limit to the number of worthy charitable causes, including universities, churches, and civic organizations. And it may be that, when all is said and done, the call to help others with a new venture is too strong for an individual with an entrepreneurial mindset to resist. But whatever you decide to do, do it with passion, and let your life benefit others in the process.

Exhibit 13.3 The Harvest Framework

Why do I want to exit?	Is now the right time to sell?	What is the business worth?	How do I decide on the harvest method?	How do I get the best price?	Do I stay with the business?
What are my goals for the harvest?	Why is now the right time to sell?	What is my business worth in the market today? In the long term? To a strategic buyer in a hot market? To me?	What method is best? Why?	How do I make "the pie" bigger?	Why would I want to stay with the business after the harvest?
Whose interests matter most: mine? Those of share-holders? Those of employees?	Why is now not the right time to sell?	What valuation method is most appropriate?	What will it cost financially?	What are the best negotiating tactics?	Why wouldn't I want to stay with the business?
What will I do in the next phase of my life? (Golfing, fishing, and traveling are not adequate answers.)	Has the business been run in a way that makes it an attractive acquisition?	Do we want to be paid in cash or stock?	Will the harvest hurt the company? Will we have to provide access to pro-prietary information?	How do we increase the pressure to close the deal?	If I stay, what role would I want to have? Will I be able to enjoy and contribute to the new culture?

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13-1. Explain the importance of having a harvest, or exit, plan.

- Harvesting, or exiting, is the method that owners and investors use to get out of a business and, ideally, reap the value of their investment in the firm.
- Harvesting is about more than merely selling and leaving a business. It involves capturing value (cash flows), reducing risk, and creating future options.
- A firm's appeal to investors is driven, in part, by the availability of harvest options.

13-2. Describe the options available for harvesting a business.

- There are four basic ways to harvest an investment in a privately owned company: (1) sell the firm, (2) distribute the firm's cash flows to its owners, (3) offer stock to the public through an IPO, or (4) use a private equity recapitalization.
- In a sale to a strategic buyer, the value placed on a business largely depends on the synergies that the buyer believes can be created.
- Financial buyers look primarily to a firm's stand-alone, cash-generating potential as the source of its value.
- In leveraged buyouts (LBOs), high levels of debt financing are used to acquire firms.
- With bust-up LBOs, the assets of the acquired firm are sold to repay the debt.
- With build-up LBOs, a number of related small businesses are acquired to create a larger enterprise, which may eventually be sold or taken public via an initial public offering (IPO).
- A management buyout (MBO) is an LBO in which the firm's top managers are part of the group buying the company.
- An employee stock ownership plan (ESOP) is a profit-sharing plan that sets up trust funds that hold shares of company stock for employees.
- The orderly withdrawal of an owner's investment in the form of the firm's cash flows can be achieved by simply stopping the firm's growth and slowly withdrawing cash from the business.
- An initial public offering (IPO) is used primarily to raise additional equity capital to finance company growth and only secondarily to harvest the owner's investment.
- A private equity recapitalization is a form of outside financing that can allow the original owners to cash out part of their investment but likely continue to operate the business.
- Trying to finance liquidity and growth while retaining control is perhaps the most difficult task facing family firms.

13-3. Explain the issues in valuing a firm that is being harvested and deciding on the method of payment.

- Value is created when a firm's return on invested capital is greater than the investors' opportunity cost of funds.
- If a seller has grown the venture to the point of diminishing returns, the firm will have greater value in the hands of new owners who can take it to the next level.
- Cash is generally preferred over stock and other forms of payment by those selling a firm.

13-4. Provide advice on developing an effective harvest plan.

- Investors are always concerned about an entrepreneur's exit strategy.
- Entrepreneurs should run the business for the long haul and prioritize business operations.
- Entrepreneurs frequently do not appreciate the difficulty of selling or exiting a company. Having purchased other companies does not prepare entrepreneurs for the sale of their own firm.
- The window of opportunity for a harvest can open and close quickly.
- Entrepreneurs who plan to stay with a business after a sale can become disillusioned quickly and end up leaving prematurely.
- Getting good advice is essential, from both experienced professionals and those who have personally been through a harvest.
- Entrepreneurs must carefully consider their motives for exiting and their plans for after the harvest.

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Key Terms

build-up LBO p. 337
business broker p. 336
bust-up LBO p. 336
double taxation p. 339
employee stock ownership plan (ESOP) p. 338
harvesting (exiting) p. 334
leveraged buyout (LBO) p. 336
management buyout (MBO) p. 337
opportunity cost of funds p. 343
private equity recapitalization p. 342
seller financing p. 339

Discussion Questions

1. Explain what is meant by the term *harvesting*. What is involved in harvesting an investment in a privately held firm?
2. Why should an owner of a company plan for eventually harvesting their company?
3. Contrast a sale to a strategic buyer with one to a financial buyer.
4. Explain the term *leveraged buyout*. How is a leveraged buyout different from a management buyout?
5. Distinguish between bust-up LBOs and build-up LBOs.
6. How does an IPO relate to a harvest?
7. Why might an entrepreneur find going public a frustrating process?
8. What determines whether a firm has value to a prospective purchaser?
9. What problems can occur when an entrepreneur sells a firm but continues in the management of the company?
10. How may harvesting a firm affect an entrepreneur's personal identity?

You Make the Call

Situation 1

After multiple conversations with investment bankers, 37-year-old David Sloan, co-owner of Li'l Guy Foods, a family-owned Mexican-food manufacturing business, realized that "there weren't a whole lot of people wanting to jump into this industry."

The small company (35 employees) was facing huge financial pressure from the rising costs of commodities like corn and plastic packaging. "We were under an assault on margins," Sloan says, something that made outside investors nervous. Still, the business enjoyed a strong base of customers that paid a premium for its products.

That was enough to attract the attention of a large, more sophisticated competitor, Tortilla King, Inc., which had hedging policies in place that allowed it to lock in prices, guarding against increases. And since Tortilla King was already familiar with the industry and the company's customer base in the region, it was willing to take risks that outside investors were not. With costs high and consumer spending on the wane, Tortilla King president Juan Guardiola saw the acquisition of Li'l Guy Foods as a way to reduce competition and increase market share. "We were fighting in the market, cutting each other's margins," he says, "so it made a lot of sense to merge."

The two companies hammered out a deal, and a bank agreed to provide financing but backed out just as the deal was about to close—part of the broad pullback in business lending during 2008. So Sloan's company agreed to finance the purchase. Sloan says he would have preferred to walk away without being so invested in the combined company's future but felt it would be too difficult to continue running the small business. He went along with the deal but says, "It wasn't the most ideal transaction for us."

Sources: http://www.lilguyfoods.com, accessed August 9, 2021; and Suzanna Stagemeyer, "Li'l Guy Sells to Tortilla King, Moves Manufacturing to Wichita," *Kansas City Business Journal*, September 14, 2008, http://www.bizjournals.com/kansascity/stories/2008/09/15/story2.html, accessed June 15, 2021.

Question 1 What would be the reasons for and against Sloan working for Tortilla King?

Question 2 What advice would you offer Sloan?

Situation 2

Ed and Barbara Bonneau started their wholesale sunglass distribution firm 30 years ago with $1,000 of their own money and $5,000 borrowed from a banker in Ed's hometown. The firm grew quickly, selling sunglasses and reading glasses to such companies as Walmart, Target, and Phar-Mor.

Although the company did well, the market matured, and profit margins narrowed significantly. Walmart, for example, insisted on better terms, which meant significantly lower profits for the Bonneaus. Previously, Ed had set the prices that he needed to make a good return on his investment. Now, the buyers had consolidated, and they had the power. Ed didn't enjoy running the company as much as he had in the past, and he was finding greater pleasure in other activities, such as serving on a local hospital board and being actively involved in church activities.

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Just as Ed and Barbara began to think about selling the company, they were contacted by a financial buyer, who wanted to use their firm as a platform and then buy up several sunglass companies. After negotiations, the Bonneaus sold their firm for approximately $20 million. In addition, Ed received a retainer fee to serve as a consultant to the buyer. Also, the Bonneaus' son-in-law, who was part of the company's management team, was named the new chief operating officer.

Question 1 Do you agree with the Bonneaus' decision to sell? Why or why not?

Question 2 Why did the buyers retain Ed as a consultant?

Question 3 Do you see any problem with having the Bonneaus' son-in-law become the new chief operating officer?

Situation 3

An entrepreneur addresses the difficult question of when to sell his business:

> I started my telecommunications business when I was 18, and I'm going to be 47 this summer. It's a successful business and provides me with a good living. . . . Yet each day I feel more and more unfulfilled in what I'm doing. . . . I have a lot of business knowledge that I feel is being wasted here, just doing the same thing year after year. I've tried some side ventures. . . . I've also considered selling the business, but it's too large to be bought by a local competitor . . . and too small to attract the attention of large companies. Besides, I don't know what I'd do if I did sell it. And will whatever I do next allow me to earn as much money as I'm earning now? More important, will I like it, or will I regret letting go of the one thing I've had all my adult life?

Source: Quoted from Norm Brodsky, "Street Smarts: Ask Norm," *Inc.*, July 2008, pp. 69–70.

Question 1 Do you agree that the entrepreneur's company is not sellable?

Question 2 Are there any other options for the entrepreneur besides selling his business?

Question 3 What would you recommend the entrepreneur do? Why?

Experiential Exercises

1. Check your local news for a week or so to find a privately held company that has been sold recently. Try to determine the motivation for the sale. Did it have anything to do with the prior owners' desire to cash out of the business? If so, try to find out what happened.
2. Ask a local family business owner about future plans to harvest the business. Has the owner ever been involved in a harvest? If so, ask the owner to describe what happened and how it all worked out, as well as what they learned from the experience. If not, ask whether the owner is aware of any company whose owners cashed out. Visit that company owner to inquire about the exit event.
3. Visit a local CPA to learn about their involvement in helping entrepreneurs cash out of companies.
4. Search a business publication to identify a firm that has successfully completed an initial public offering (IPO). See what you can find out about the event online.

Business Plan

LAYING THE FOUNDATION

As part of laying the foundation to prepare your own business plan, respond to the following questions regarding harvesting your business.

1. What are my goals for the harvest?
2. When will be the right time to harvest?
3. What options are realistic for harvesting my business?
4. Why would a prospective investor be interested in acquiring my company?
5. Who specifically would be interested in acquiring my business?
6. How would an investor value my business?

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Chapter 13 Case

Please see Appendix A for the Chapter 13 Case Study.

Endnotes

1. Personal conversation with Bob Browder, former CEO, BFW Construction, *Inc.*, November 1, 2019.
2. Simona Covel, "How to Get Workers to Think and Act like Owners," *The Wall Street Journal*, February 7, 2008, p. B-1.
3. The capital-gains tax rate as of 2021 may be increased in 2022.
4. The unattributed quotes in this part of the chapter are based largely on the authors' own research and conversations over the years with entrepreneurs and investors who have exited their companies, some of whom are still with their original companies.

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Chapter 14

Building Customer Relationships

Looking Ahead

Learning Objectives

The purpose of the Building Customer Relationships chapter is to help you focus on customer relationship management and to introduce you to the tools and approaches that can help you gain new customers while holding on to existing customers. By studying this chapter, you should be able to . . .

14-1 **Explain the term *customer relationship management (CRM)* and its importance to a small business.**

14-2 **Discuss the significance of providing extraordinary customer service.**

14-3 **Understand how technology can be used to improve customer relationships and the techniques helpful in creating a customer database.**

14-4 **Explain how consumers are decision makers and why this is important in understanding customer relationships.**

14-5 **Identify certain psychological influences on consumer behavior.**

14-6 **Recognize certain sociological influences on consumer behavior.**

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Spotlight on Small Business

Jimyz Automotive

http://jimyzautomotive.com

Almost every business says that its customers are its top priority. But how many actually live up to the claim by going the extra mile to make sure that customers are always pleased with what they get? One small enterprise whose primary aim is to delight its customers—every one of them, always, and as the focus of its day-to-day operations—is Jimyz Automotive of Streetsboro, Ohio.

As the name would suggest, Jimyz Automotive is a full-service garage that offers services ranging from routine auto maintenance to just about any imaginable repair. The business is an independently owned and owner-operated shop that serves not only Streetsboro, but also the nearby cities of Kent, Aurora, and Ravenna—even greater Portage County and beyond. The venture was started in May of 2000 by Jim Shukys, who grew up in the area and knows it well. He also knows what he's doing, having spent his entire 30-year career in the automotive repair industry.

Jimyz Automotive has a hard-earned reputation for honest work, fair pricing, and customer care that exceeds all expectations. One very satisfied customer wrote of the company online, "I have never in my life seen this level of customer service." His comment was in response to the high quality of work that the shop had provided, in addition to the handwritten thank-you note that Shukys had written to the customer, which was also posted:

> Xander, thank you for giving us the chance to work on your car. I truly appreciate your business, and I hope you were satisfied with the level of service we provided. Please don't hesitate to call on us again. Sincerely, Jim Shukys.

Responding to the online post, random commenters added their very favorable two cents. For example, one revealed that they were familiar with Jimyz Automotive and could only give Shukys very high marks: "I used to live in Streetsboro and know exactly who that is. He's a good man, stay with him!" Another expressed that they wished they lived close enough to be able to take their cars to Shukys: "It's little things like this that earn business. If I got this card, I would never use another mechanic in my life." These are just a tiny sample of the glowing reactions Jimyz has received over the years, evidence that the company is doing something extraordinary to build strong relationships with customers. It is especially impressive that Shukys's auto repair business has achieved such a positive reputation, as the industry is better known for its hate mail than for its love letters.

The Better Business Bureau provides additional evidence of the great customer service Jimyz Automotive provides. It reports that the company has received zero customer complaints over its 21 years in business. Jimyz has served thousands of customers over that time, so it is truly remarkable that not a single customer has registered a complaint against the company. Its record proves that small businesses can deliver top-notch customer service. In fact, because they tend to have closer relationships with the people they serve and know them better, these ventures can actually use customer relationship management as a competitive advantage over their large-firm rivals. Once again, bigger isn't necessarily better.

Sources: Better Business Bureau, "Business Profile: Jimyz Automotive," https://www.bbb.org/us/oh/streetsboro/profile/transmission/jimyz-automotive-0272-55000521, accessed May 27, 2021; Gregory Ciotti, "10 Unforgettable Customer Service Stories," *Help Scout*, February 23, 2021, https://www.helpscout.com/10-customer-service-stories, accessed May 27, 2021; and http://jimyzautomotive.com/about_us.html, accessed May 27, 2021.

Customers today are more powerful than ever; they are more demanding and amazingly sophisticated in their purchasing strategies. But savvy small businesses (like Jimyz Automotive, profiled in the Spotlight feature at the beginning of this chapter) are learning how to establish strong and healthy customer relationships and build great companies. You can, too. We will show you how.

It is difficult to overstate the importance of building long-term relationships with customers. Loyal customers usually stay with a company because they trust it, and that

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trust naturally translates to increased sales. Loyal customers tend to buy a company's more expensive products, be less sensitive to price increases, and bring their friends in to do business, too.[1]

One *Inc*. magazine report indicated that while long-standing buyers make up, on average, a mere 8 percent of the customer base of a company, they will contribute 41 percent of its revenue. Increasing customer retention by a mere 5 percent per year can lead to profit growth of more than 25 percent. Furthermore, the $7 that firms spend on average in marketing to existing customers is far less than the $34 it costs to reach a new customer. And it doesn't hurt that repeat customers spend 20 percent more than first-time buyers.[2] Keeping customers is critical to success, so it's essential that small firms do it effectively.

But the best approach to serving customers and maintaining their loyalty can be a moving target. In this age of highly social and very mobile media, customers find it easier to sidestep traditional advertising channels by surveying social networks for advice on their purchases. They can make on-the-go price comparisons with laser-like precision and great convenience, thanks to the wealth of online information and simple technologies like barcode-scanning comparison apps. And if they don't like the way they have been treated by a brand or business, they can quickly report their displeasure to their Facebook friends and through online forums and user review websites like Yelp or PlanetRate. Resourceful small businesses must establish dynamic customer relationships. If they want to stay ahead of the game, they really have no choice.

This chapter shows you how to create and maintain vital connections that will satisfy your customers, enhance the reputation of your business, and generate superior company performance. Chapters 15 through 18 discuss additional marketing topics essential to growth, based on the crucial customer focus that you will learn about in this chapter.

14-1 Explain the term *customer relationship management (CRM)* and its importance to a small business.

14-1 What Is Customer Relationship Management?

Customer relationship management (CRM) means different things to different firms. To some, it means having employees simply smile and say "thank you" and "come again" to customers who have just made a purchase. For others, CRM is nothing short of a complete customization of products or services to fit individual customer needs. The goals of a CRM program for most small companies fall somewhere between these two perspectives.

Formally defined, **customer relationship management (CRM)** is a "company-wide business strategy designed to optimize profitability, revenue, and customer satisfaction by focusing on highly defined and precisely defined customer groups."[3] It is a process that can be used to learn more about the needs and behaviors of customers with the specific purpose of building stronger relationships with them. CRM involves treating customers the way the entrepreneur would want to be treated if they were a customer—the business version of the Golden Rule.

customer relationship management (CRM)
A company-wide business strategy designed to optimize profitability, revenue, and customer satisfaction by focusing on specific customer groups.

Regardless of the level of a firm's commitment to customer relationship management, the central message of every CRM program is this: *Cultivate customers for more than a one-time sale.* For decades, entrepreneurs have recognized the importance of treating customers well. "The customer is king" is, after all, an age-old mantra. What is new, however, is defining the concept more precisely and using the latest techniques and innovative technologies to implement effective customer relationship management practices.

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14-1a Benefits of CRM to a Small Firm

Building relationships with customers is serious business for most small firms. And a survey of customers suggests that the effort to make this happen is paying off. Survey respondents reported that small companies outperform large corporations by a 2-to-1 margin when it comes to reacting quickly to customer-service issues and building a sense of connection with those they serve. Indeed, building relationships with customers is one of the greatest advantages that small businesses enjoy.[4]

As depicted in Exhibit 14.1, a firm's next sale comes from one of two sources—a current customer or a new customer. Marketing efforts devoted to bringing in new customers sometimes leave current customers feeling taken for granted and neglected. Keeping existing customers happy should be a high priority, and CRM programs address this. Small companies that are thinking about employing such programs to maintain relationships with current customers should consider the following potential economic benefits:

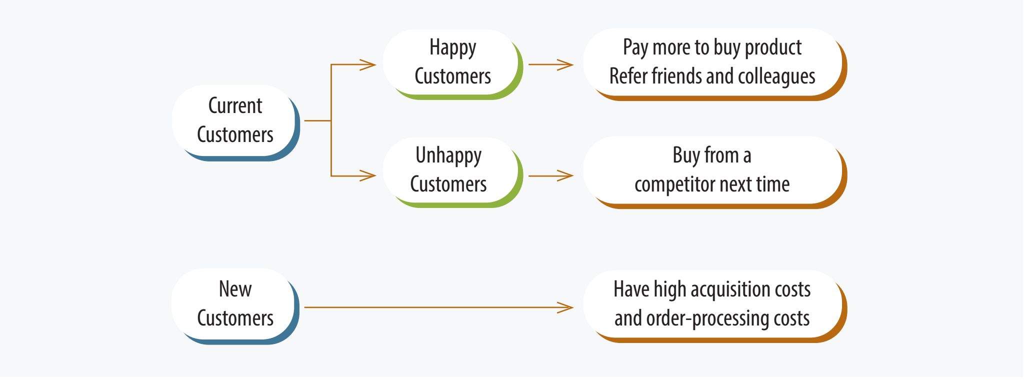
- The cost of acquiring a new customer is much greater than holding on to an old customer.
- Long-time customers trust you and thus tend to spend more money than new customers do.
- Happy customers refer their friends and colleagues, leading to even more sales.
- It costs less to process orders for established customers, because they are already in the system and know how it works.
- Current customers buy without discounts, so they are willing to pay more for products.

These factors contribute to profits and may explain why small firms report that around two-thirds of their business comes from repeat customers.[5]

14-1b Essential Materials for a CRM Program

Assembling a CRM program requires an entrepreneur to understand the basic foundations upon which a successful initiative can be established. In the remainder of this chapter, we consider the two crucial CRM building blocks: (1) outstanding relationships with customers and (2) knowledge of consumer behavior. We will also examine the basic materials from which these building blocks can be constructed, including extraordinary customer service, CRM technology support, customer

Exhibit 14.1 Sources of the Next Sale



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databases, customer decision making, and psychological and sociological influences on customer behavior. Having a grasp of these building blocks can help to ensure that a small business is able to form and maintain relationships with its customers, which is crucial to the success of any enterprise.

14-2 Discuss the significance of providing extraordinary customer service.

14-2 Outstanding Customer Relationships through Extraordinary Service

To be successful in the long run, small companies need to concentrate on building positive transactional relationships with customers (refer to Building Block 1 in Exhibit 14.2). A **transactional relationship** is an association between a business and a customer that begins (or ends) with a purchase or a business exchange. Clearly, the nature of such relationships can vary greatly. But consumers who have positive interactions with a business are much more likely to become loyal customers. Four basic beliefs underlie our emphasis on the importance of providing exceptional customer service:

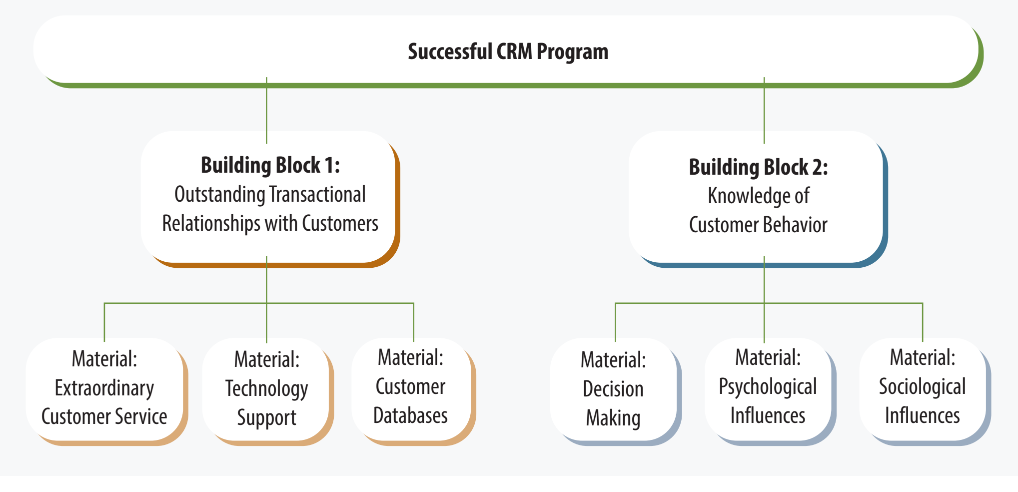
1. Small businesses have the potential to provide superior customer service.
2. Superior customer service leads to customer satisfaction.
3. Customer satisfaction results in positive transactional relationships.
4. Positive transactional relationships lead to increased profits.

As you can see, failure to emphasize customer service jeopardizes any effort to maintain a positive customer relationship. Small companies must take this matter seriously because large companies, like Amazon, are incorporating customer service improvements that can take this potential advantage away from their smaller competitors.

14-2a Managing Customer Satisfaction

Customer satisfaction is vitally important to a company's success. Because happy customers are loyal customers, they are more likely to cross-buy products with higher margins, react less to price increases, encourage their friends to buy the same products, and engage in other behaviors that tend to enhance the firm's profits. In the end, increases in customer satisfaction extend the duration of customer relationships, which

Exhibit 14.2 Essential Materials of a Successful CRM Program



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transactional relationship
An association between a business and a customer that begins (or ends) with a purchase or a business deal.

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translates to significant increases in the amount of revenue generated from those loyal customers over the long term.

Companies control a number of factors that affect customer satisfaction. For example, customers have basic expectations regarding the benefits they should receive from the product or service that your company provides. Your offering must meet these most basic expectations to satisfy customers and earn their repeat business. Beyond that, customers anticipate that your business will provide assistance to them at the time they make a purchase and again later if they should encounter problems. Keep in mind that those who buy prestige products, such as a Louis Vuitton purse or a Rolex watch, will expect more intensive assistance.

Personal Attention

Personal attention is the "gold standard" against which the quality of customer service is judged. Firms that respond best to the specific circumstances and needs of those who come to them to do business are sure to have satisfied and loyal customers—and plenty of them. But such highly personalized service will be an option only for those companies that listen intently to their customers and therefore understand their precise needs.

Because small companies (like flower shops, for example) typically have fewer customers and fewer layers of employees between the customer and the business owner, they are able to build stronger and closer relationships with those they serve and to keep them as customers. But this takes intentional and concerted effort. The following are some common signposts that can guide you to the path of extraordinary, and very personal, customer service:

- *Doing business on a first-name basis.* Small ventures that know their customers by name and greet them as friends establish a bond that is powerful and encourages loyalty.
- *Keeping in touch.* Face-to-face and phone conversations are much more effective than email messages or mass mailings. Asking for feedback during these interactions is helpful to your business and shows that you are committed to getting customers' approval. It also confirms that you care about more than selling.
- *Finding ways to help.* Helping customers doesn't always lead to an immediate sale, but it can be good for business, and at minimal cost. Send them articles and information of interest with a kind note attached, remind them of important dates (like scheduled maintenance on a car, for example), and so on.
- *Customizing your service to meet customer preferences.* By remembering customers' personal preferences and adjusting your service to meet them, you increase the value of what you offer.
- *Addressing problems promptly.* When an issue arises, a successful business takes steps to resolve it quickly. Doing so lets a customer know that they are important to you. If possible, talk to lost customers to find out why they went elsewhere, and use that information to correct deficiencies.


ROBERT KNESCHKE/SHUTTERSTOCK.COM

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It is hard to overstate the importance of building and maintaining personal customer relationships to the success of a small business. Customers like to feel that they are dealing with someone who really cares about their needs. It follows that a customer who receives a prompt and thoughtful response to their requests for information or assistance—whether by phone, email, or through some other channel—will be very likely to continue doing business with the company that provides it.

So, how quick does the response need to be? The obvious answer is the sooner the better. But it also depends on the channel. For example, customers who call on the phone or use live chat naturally will expect real-time interaction. Chatbots (computer programs that can chat in human-like fashion) can help with this, especially outside of normal hours of service.

The typical rule of thumb for customer emails, on the other hand, is that a company should respond within one hour of receiving a message. A 2020 study of more than 3,200 customers found that over 88 percent of those surveyed are satisfied if they hear back within that period of time.[6] Separate research revealed that the average response time, for companies that choose to respond, is 12 hours and 10 minutes. However, 62 percent of the companies in the study did not respond to customer support emails at all![7] This opens up opportunity for those small businesses that are more attentive to the needs of their customers.

Customer Experience Management

Some small business owners have begun to go beyond simple CRM, shifting their attention instead to **customer experience management (CX or CXM)**. This approach recognizes that, with every interaction, customers learn something about a business that will either strengthen or weaken their satisfaction and desire to return, spend more, and recommend the company to others. One marketing expert summed it up this way: "The race to own customer experience is on! Companies are recognizing the importance of delivering experience that makes them stand out from their competition. Some are learning the hard way."[8]

Having a positive experience with a business can actually become part of a firm's value equation—it's almost like money in the bank. One study of 4,000 American consumers found that 75 percent of them lean heavily on their customer experiences to guide their purchasing decisions. But fewer than half of these respondents gave businesses high marks for the experience they deliver.[9]

Digging a little deeper into the findings, 43 percent of respondents said they would pay more for greater convenience, while 42 percent would pay higher prices to receive a friendly, welcoming buying experience. And a surprising 65 percent said they were more swayed by a positive customer experience than by great advertising. When asked which elements of that experience are most important, nearly 80 percent named speed, convenience, knowledgeable help, and friendly service.[10]

At the same time, companies that stumble in this area pay a steep price. An extensive analysis found that 52 percent of consumers had changed to a new provider in the previous year because of poor customer service (68 percent said they would never go back). The total cost to U.S. firms from such switching of customer loyalty was estimated to be a staggering $1.6 trillion. Forty-four percent of those surveyed admitted to posting negative comments online in response to their unsatisfactory experiences, and such comments can mushroom into disastrous financial outcomes.[11]

customer experience management (CX or CXM)
An approach that recognizes that, with every interaction, customers learn something about a company that will affect their desire to do business there in the future.

Relationship-enhancing interactions can begin with very low-tech and inexpensive gestures that customers will perceive as "high touch." Simple changes can add a personal touch, such as having customer-service employees add photos of themselves along with the company logo to their online profiles. This, by itself, would not be enough to create a good experience, but it can certainly help to get the relationship off on the right foot.

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Living the Dream

Excellent Customer Service Can Be a Calling

If personal attention is the gold standard against which the quality of customer service is measured, then Robert Lazarus, Sr., former president of the Columbus, Ohio, department store that bore his family's name, deserves platinum status.

The F&R Lazarus & Company department store (commonly known as Lazarus) had a significant presence in the Ohio capital's downtown shopping scene for more than a century and a half. It was opened in 1851 as a one-room men's clothing store by family patriarch Simon Lazarus. But it was not to remain a small business forever. By hard work, a reputation for honest business dealings, and a relentless focus on its customers, Lazarus came to be recognized in time as much more than a department store. For local shoppers, it had become a beloved institution.

As a result of its pioneering spirit and steadfast attention to customers and their needs, Lazarus became an early adopter of many innovations. For example, it was the first men's store in the city to introduce a "one-price policy" (which eliminated the need to haggle), the first department story in the United States to install escalators (in 1909), and the first store in the country to have air conditioning. Family executives would spend hours every day strolling the aisles of the store to chat with customers and employees (whom they insisted on calling "associates") to learn how to improve their service. They also would sometimes buy items for children in the store and give away merchandise to needy locals. The family had a very special connection to the community and contributed financially and liberally to important causes.

After many years of slow but steady progress, the company grew into a sizeable business. However, its small-store focus on the customer never faded. One powerful story, in particular, revealed how important personal attention to customers was to the family, an attitude that they passed on to others. A shopper and his wife had bought an elegant tea set at Lazarus. They apparently were customers of modest income and had never owned anything like that before, so they were unsure of the proper etiquette for using it. In their uncertainty, the husband decided that he would call the president of the company. At home. At night! Robert Lazarus took the call and patiently walked the gentleman through the steps of having a tea party, describing some of his own experiences with tea receptions. It was a lengthy chat. But before Mr. Lazarus concluded the conversation, he thanked the caller profusely for shopping at the store.

Was Mr. Lazarus bothered by the intrusion to his time at home? Not at all! His son, who witnessed the entire exchange, later reported, "He couldn't have been more pleased. He talked about it with great fondness for the rest of the night." It seems that personal attention and excellent customer care are not really about having a great system or powerful technology tools, as important as these things may be. Rather, it's an attitude, a perspective that can pay great dividends in the form of extreme customer loyalty and all that comes with it. If a large company can create such a profound sense of connection with its customers, then surely small businesses can, too.

Sources: Herb Cook, "How One of the Nation's Greatest Retail Empires Came to an End," *The Columbus Monthly*, June 3, 2019, https://www.columbusmonthly.com/news/20190603/from-archives-end-of-lazarus-dynasty, accessed May 28, 2021; Bob Greene, "When Retailing Was Very Personal," *The Wall Street Journal*, December 18, 2018, p. A17; and Alec MacGillis, *Fulfillment: Winning and Losing in One-Click America* (New York: Farrar, Straus and Giroux, 2021), p. 246.

Companies also need to pay close attention to problems that can jeopardize the customer experience, such as long wait times. The public's tolerance for waiting has decreased significantly over the years, and it is very likely to lead to serious frustration and lost sales—that is, unless you can find a way to shorten these delays or, better yet, turn them into an advantage. That's what Galpin Motors did when it became the first car dealership in the United States to set up a full-service Starbucks café in its waiting area to help customers pass the time more pleasantly.[12] This addition significantly improved customers' experiences and boosted their loyalty to the company and its services, yielding results that flowed to Galpin's bottom line.

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Companies have gotten much better at managing customer experiences through all points of contact, especially as the Internet and then smartphones expanded the range of interactions that are possible. While this is clearly important, it may not be enough to give a business a competitive edge since so many others have adopted similar practices. Competing at the next level will require what consulting giant Accenture and others are calling the *Business of Experience (BX),* which is "a more holistic approach that allows organizations to become customer-obsessed and reignite growth."[13] In a nutshell, this view defines a great experience not as much by what a company offers as how well it helps customers achieve whatever outcomes *they* believe to be important.

This approach includes addressing high-priority social concerns. Research shows that consumers are increasingly calling on companies they buy from to stand for something greater than the products or services they offer. They want to know that their buying decisions support these ideals. This is especially true of Millennials and the generation that follows them, often called Gen Z. Nearly half report that they are more likely to choose a brand if they see in it a commitment to values that are important to them, which typically include causes such as civil rights, educational opportunity for all, and sustainable practices. And more than one-third say they have moved away from companies whose words or actions are inconsistent with social issues that are important to them.[14] The upshot of BX thinking is that companies will create extraordinary customer experiences when they shift their focus to helping customers make a difference with social issues that concern them.

Honest Relationships and Service after the Sale

It's common for sales staff to work hard to cultivate a relationship with a client or customer to get them to buy and then quickly move on once they have earned their commission or sales reward, but this is very shortsighted. Customers are significantly more satisfied and loyal to a company, and tend to give it even more business, if they receive continued attention after a sale—especially if that contact is in person or via the telephone.

Most entrepreneurs truly care about their customers. The problem is that they often get so focused on building their businesses that their minds naturally move on to the next sale. They may not even understand why following up is so important or know how to go about doing it. Fortunately, a number of helpful methods can enhance customer relationships after a sale is completed, including the following:[15]

- Monitoring delivery and installation to ensure the customer is satisfied.
- Checking in with a customer in person or via phone, email, handwritten note, etc.
- Resolving any customer complaints to clear the way for future business.

Remember: *It costs far more to replace customers than to keep the ones you already have*. Providing exceptional customer service gives small firms a competitive edge, regardless of the nature of the business. They typically know their customers' needs better than larger firms do, and they can offer more personalized service. In addition, more tools are available than ever before to make this possible.

14-2b Evaluating a Firm's Customer Service Health

Establishing an effective customer service program begins with determining how well a firm is serving its current customers (sometimes referred to as a firm's *customer service quotient*). Strategies can then be developed to improve the effectiveness of customer service efforts. Exhibit 14.3 lists some of the components of common customer service strategies and provides space for evaluating how well a small firm is currently performing in each area and what it can do to improve its customer service.

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Exhibit 14.3 Customer Service Strategies

Which of the following can be used to support your marketing objectives?	How well is your company doing?	What improvements will you pursue further?
Provide an exceptional experience throughout every transaction. Ensure that customers are acknowledged, appreciated, and find it easy to do business with you. (List the typical chain of contacts between you and your customers, and evaluate your company's performance at each contact point.)		
Provide sales materials that are clear and easy to understand. Include website information, marketing materials, retail displays, etc.		
Respond promptly to customers' requests and concerns. Have a service recovery plan in place.		
Listen to customers, and respond accordingly. Solicit feedback, encourage interaction, stay engaged throughout transactions, and take the appropriate action(s) to please the customer.		
Stand behind products and/or services. Provide guarantees and warranties, assuring customers that you deliver on your promises. Also, create products and deliver services that exceed expectations.		
Treat customers as family members and best friends. Value customers in the same way that you honor those you care most about.		
Stay in the hearts and minds of customers. Don't take customers for granted. Find ways to let them know that you have their best interests in mind.		

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Source: Adapted from Ewing Marion Kauffman Foundation, "Exceptional Customer Experiences Worksheet," http://www.entrepreneurship.org/resource-center/exceptional-customer-experiences-worksheet.aspx, accessed on January 2, 2015.

Although customer service issues may be identified through a formal review process, they often surface via customer complaints in the course of normal daily business operations. When complaints arise, small companies are *potentially* in a much better position than are large firms to respond to such grievances and to achieve greater customer satisfaction as a result.

Many problems can be solved simply by dealing with issues as they come up. Showing respect to customers in this way is often easier for a small company because it has fewer employees and can give each of them the authority to act promptly. Since small business owners are closer to their customers, they are more likely to get accurate feedback, avoiding the information distortion that large firms experience as reports of problems gradually make their way through multiple layers of management. This approach makes possible more timely and accurate responses to problems that may arise. In any case, after shortcomings in product quality and/or customer service are addressed, they should be analyzed more closely to find ways to avoid them in the future.

What do customers do when they are unhappy with a company? They have options for dealing with their dissatisfaction, and these can cut into future sales. For example, they can take the following actions:

- Stop buying the product or service.
- Warn their friends about doing business with the company.
- Spread negative reports about their experience online through social media.
- Privately complain to the company, and seek a refund or other compensation.
- Report their dissatisfaction to a government agency.
- Take legal action against the company, which can make the problem very public.

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Of course, they could also take no action at all, but it is best not to count on that. Small business owners can learn about customer service concerns through personal observation and other research techniques. By talking directly to customers or by playing the customer's role anonymously—for example, by making a telephone call to one's own business to see how customers are treated—an entrepreneur can evaluate service quality. Some restaurants and motels invite feedback on customer service by providing comment cards to those they serve.

More sophisticated assessment tools are available to evaluate the customer experience, and a small business owner would be wise to consider them. Exhibit 14.4

Exhibit 14.4 Evaluating the Customer Experience: Three Popular Assessment Tools

Assessment Tool	What the Tool Does	Further Information
Customer Satisfaction Score (CSAT)	• Common measure of how happy customers are with a company's products, processes, and services. • Should be short (10 questions at most). • Typical question format: "How would you rate your overall satisfaction with the [product/service] you received?" • Can also include questions about usage frequency, demographics, and possible follow-up actions, and should allow the customer to offer open-ended feedback. • Can be administered in-person, through an app, or by email.	https://www.qualtrics.com/experience-management/customer/what-is-csat/
Net Promoter Score (NPS)	• One of the most popular measures of customer loyalty. • Asks how likely customers would be to recommend the business, product, or service to others on a 1–10 scale. • Easier for customers to answer questions about intention of referring (NPS) than express an emotion of satisfaction (CSAT). • Segments customers into three groups based on their responses: *Promoters* (ratings of 9 or 10), *Passives* (ratings of 7 or 8), and *Detractors* (ratings of 6 or lower). • Allows the business to design different campaigns to reach each group.	https://www.qualtrics.com/experience-management/customer/net-promoter-score/
Customer Effort Score (CES)	• Assesses performance of customer service staff. • Asks a customer how much effort was required to resolve an issue. • Should only include one or two questions. • Should be scheduled so that the survey is sent out automatically after critical interactions. • Typical question format: "On a scale of 1 to 5, rate how easy [company/person] made it for you to [accomplish a task]."	https://www.qualtrics.com/experience-management/customer/customer-effort-score/

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profiles three of these tools: the Customer Satisfaction Score (CSAT), the Net Promoter Score (NPS), and the Customer Effort Score (CES). Each provides unique insights into how customers feel about a company and its products or services. An entrepreneur can choose to use one or more of these tools, depending on what they are hoping to learn about their business. Some basic features of all three are outlined in the exhibit, along with resources that will explain how to use them.

Implementation of some simple forms of customer service can be inexpensive—or even free, such as when customer-contact personnel just need to be encouraged to smile and greet visitors warmly. But offering a full program of superior customer service before, during, and after a sale can be a costly undertaking. These costs often can be passed along to the purchaser as part of the price of a product or service. In some other cases, they can be recouped separately, based on the amount of service requested (through extended product warranties, for example). Many customers are willing to pay a premium price, as long as good service is part of the buying experience.

14-3 Using Technology to Support Customer Relationship Management

14-3 Understand how technology can be used to improve customer relationships and the techniques helpful in creating a customer database.

When it comes to analyzing and making use of customer data, a small business has options. A start-up can easily manage the amount of data available, but this situation changes as the company grows and the contacts and accounts become more complex. For that reason, it's best to start thinking about available analytical technologies—from basic spreadsheets to sophisticated CRM software packages—from the very beginning.

Many small companies keep track of their CRM numbers in a simple spreadsheet that can be expanded and updated as the business grows. When the spreadsheet is no longer enough, a database management package like Microsoft Access can be used. This type of software offers greater utility and flexibility, as it can store large amounts of data and match data from multiple tables. Though not created for this purpose, it can certainly help you manage the data needed to guide customer care, basic advertising campaigns, and other marketing-related initiatives.

14-3a Choosing a CRM Software Program

The most powerful tools available for customer relationship management are software programs designed specifically for CRM. According to one survey, 91 percent of businesses with 11 or more employees and 50 percent of those with 10 or fewer employees said they had a CRM system already in place.[16] These packages allow companies to gather all customer contact information into a single data management program. Web-based marketers, in particular, are attracted to such technology, because it helps to make their complex job far more manageable.

Most online shoppers expect to receive excellent customer service, and companies are much better positioned to give it if they use the options for interaction and personal attention that are designed into the software. Experts point out that customers typically appreciate the conveniences that are built into many company websites, but they can quickly become frustrated when the experience does not go exactly as planned. The burden of coordination is greatly eased when software is used to help manage it.

Deciding which marketing activity should get initial CRM support is not always easy. However, the sales department is a popular place to start because its personnel nearly always generate the most customer contact. CRM emphasizes such sales activities as filling orders promptly and accurately, managing follow-up contacts to

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ensure customer satisfaction, and providing user-friendly call centers to handle all inquiries, including complaints. It's a complex mix of tasks, but technologies are available to support all of these activities and many others.

To find the CRM software package that may provide the best fit for you and your business, consider the included features, such as the accessibility of buyer data, and integrated sales and marketing tools; its ease of use; and the help and support provided by the manufacturer. It might be wise to narrow your search from the start by checking recommendations specifically for small businesses, as shown in Exhibit 14.5. The exhibit is based on an independent review that declared Salesforce Essentials to be the best overall pick because it "offers a condensed set of features aimed exactly at what small businesses need from a CRM support platform."[17] But there are a number of other highly recommended alternatives, including niche products that can do precisely what you may need them to do. Examples of these alternative packages include both CAR-Research XRM and DealerSocket, which provide CRM software solutions for car dealers, with high-performance features designed specifically for that industry.

Concerns about having ample resources to support CRM programs have led some small business owners to outsource certain applications. A number have turned to hosted call centers, for instance, which handle phone, email, and other online communications for clients and may be more cost-effective than comparable in-house centers. This is a crucial consideration for many cash-strapped small firms. In addition to cost, a lack of internal expertise can justify using these outside services.

14-3b Choosing an Alternative CRM System

Many companies have decided to control the cost of customer assistance by using online alternatives like automated self-service systems, sometimes called

Exhibit 14.5 Recommended CRM Software Packages for Small Businesses

CRM Package	Summary Description
Salesforce.com	***Best Overall Pick***. Scaled down for small businesses; powerful contact-management tools; backed by Salesforce's deep CRM experience, its high-performing search engine, and countless add-on partners; excellent mobile apps; definitely not the least expensive option.
Freshsales CRM	***Best for Basic CRM Needs***. Simple solution that small businesses can set up and start using quickly; pricing tiers that work for small companies; easy to use, and offers plenty of customization options; includes a proactive AI assistant; figuring out which plan is best suited to a specific small company's needs can take time.
Vtiger	***Most Affordable for Small Businesses***. An all-in-one CRM choice for small businesses; the wide variety of tools included should allow almost any user to find what they need; 24/7 support is responsive to customers; on the downside, the package comes with a unique interface that some find difficult to master.
Onpipeline	***Best for First Timers***. Priced right for small businesses; good choice for companies that are moving from spreadsheets to a true CRM system; design is well organized and easy to use; lacks a mobile app, and doesn't include 24/7 support for the basic plan.
HoneyBook	***Best for Solo Entrepreneurs and Freelancers***. A comprehensive option that is easy to navigate; comes with great support; project tracking, invoicing, automation, and payment features nicely integrated into the system; costs more than some of the other options for small businesses.

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Source: Based on Gadjo Sevilla, "The Best Small Business CRM Software for 2021," *PC Magazine*, May 13, 2021, https://www.pcmag.com/picks/the-best-small-business-crm-software, accessed June 4, 2021.

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customer information management systems. When a call-center customer care representative in the United States or Canada handles telephone calls, it can cost the company anywhere from $25 to $65 an hour. In other cases, the cost depends on the country in which the call center is located and the complexity of the product or service being supported.[18]

The expense is similar for a number of other service channels, including email, regular mail, and click-to-call. These costs can be cut by nearly half, however, when representatives conduct online chats, assuming they can manage to toggle between multiple sessions going on at the same time. But self-service inquiries handled on the Internet are the least-expensive alternative by far. One popular self-service option is to post a list of Frequently Asked Questions (FAQs), but even this simple tool is becoming more sophisticated. For example, a company can buy smart software that recognizes the questions that its website visitors are most interested in and places those questions at the top of the list. Such systems can reduce the cost of serving customers while taking some of the repetition out of tending to their needs.

The list of tools supporting CRM grows longer every day, and they are becoming more user-friendly as time goes on. Executives and managers in enterprises of all sizes are tapping the power of the Internet to set up the blogs, wikis, social media sites, and other online communities that allow people to build social as well as business connections, to share information, and to collaborate on projects. These online communities can provide a rich source of feedback and ideas for product development, in a form that is much faster and cheaper to use than the focus groups and surveys that have been a staple of common marketing practices. But perhaps more important, online tools can be used to give customers a sense of connection with the enterprise, an identity that results from their active participation in the company's business. For this, there is no substitute.

But thinking of this as a "one or the other" approach is short-sighted. Being all-in is now the name of the game. Salesforce.com published findings from an extensive 2020 study that revealed just how much the rules of the service playbook are being rewritten, an ongoing trend that was accelerated during the pandemic:[19]

- *Customer expectations continue to rise.* More than 71 percent of consumers give their loyalty to companies that seem to understand their personal circumstances. This has prompted 83 percent of service professionals to adjust practices to allow the flexibility needed to deal with the increasingly complex cases of customers who are harder to satisfy.
- *Speed and quality of service are both important to achieving results.* Eighty-three percent of customers expect immediate attention when they contact a company, most wanting to deal with only one person in solving their problems. But 63 percent of service personnel find it difficult to balance the demand for speed with outcome quality.
- *The shift to digital service channels has picked up pace.* Nearly nine of ten service professionals say customers turned noticeably to digital channels during the previous year. While most prefer to use the phone for complex cases, 65 percent of customers opt to use self-service options like FAQs and community forums for simple needs. To get ahead of the game, companies are adding options like online chat, messenger apps, and video support. Nearly two-fifths were using chatbots in 2020, and 57 percent believe that voice assistants like Siri and Alexa will become a key service channel.

Firms that ignore these new realities do so at their peril, as failure to offer a robust service program can lead to a significant loss of customer loyalty. In fact, 58 percent of respondents to a 2020 Microsoft survey reported that they will not hesitate to switch brands if they find a company's customer service to be lacking.[20] Getting this right is serious business.

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14-3c Creating a Customer Database

The best way to stay in touch with customers and to identify their needs is to talk to them. Such conversations lead to an understanding of each customer and provide a foundation on which to build a **customer database**. These databases are essential to a successful CRM program and typically include the following categories of information, with examples of specific data items provided:[21]

- *Personal information*. Name, address, phone number, email address, permission status (that is, opt-in consent for follow-up communications), etc.
- *Demographics*. Background information that can be used for market segmentation and other data analysis purposes, such as age, marital status, names and ages of family members, and geographic location.
- *Lifestyle and psychographic data*. Homeowner versus renter status, car ownership (model and year), media preferences, payment methods of choice, recreational interests, etc.
- *Internet use information*. Time spent online, frequency of visits to the company's website, number of visits to other key websites, and other online habits.
- *Transaction data*. Complete transaction history, including details such as prices paid, SKUs (which identifies specific products purchased), form of order (online, phone, in-store, etc.), recency and frequency of purchasing behavior, method of payment, and delivery dates.
- *Profile of past responses*. Sales calls and service requests (including all customer- and company-initiated contacts), responses to past product or service promotions, and incentives redeemed.
- *Complaints*. Complete history of complaints regarding past purchases or service.

Customer data can almost always be collected at any **touch point**, which provides an occasion for contact between the business and its customers, whether in-person or online. Touch points can include interactions resulting from any of the following contact events, among others:

- An online request for product information.
- Completed and returned warranty cards.
- Responses to online surveys.
- A visit from a salesperson.
- Orders placed on the company's website.
- A text message from a customer service representative.

While some small companies prefer to collect data and feedback from customers using comment cards or questionnaires, contact via the Internet is fast becoming the touch point of choice for companies, as well as for the customers they serve. This is mostly because of the speed and convenience it offers, but also because of the usefulness of the information that can be collected:[22]

> Web users can evaluate and purchase products, make reservations, indicate preferential data, and provide customer feedback on services and products. Data from these Web-based interactions are then captured, compiled, and used to segment customers, refine marketing efforts, develop new products, and deliver a high degree of individual customization to improve customer relationships.

customer database
A collection of information about a customer as defined by CRM goals, including personal, demographic, lifestyle, and transaction data; online habits; past responses; and complaint history.

touch point
An interaction between a business and its customers.

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In a CRM system, a customer's selection of a channel for interaction can be an important source of information in itself. For example, if the customer first contacts the company via email, this provides an insight into their preferred method of communication, and the astute firm will consider that in all of its follow-up efforts.

14-3d Using a Customer Database

Your company's customer database should include information on every customer you have ever had, as well as others whom you consider to be high-potential prospects. As time goes on and your database grows, you may want to organize it further according to region, economic status, customer focus, or any other variable that makes sense to your business and its marketing goals. In a nutshell, an effective CRM program will do the following:

1. Capture relevant customer data on interactions across important touch points.
2. Analyze those data to better understand customers.
3. Use the resulting insights to improve relationships with customers so that they are satisfied, loyal to the company and its products or services, and more willing to do business with it.

The Seattle Mariners baseball organization has been using this process to better understand its fans and identify ways to boost attendance at games. The club launched a loyalty card program years ago to collect data from as many touch points as possible. Now, every time a fan uses the card to snag a hotdog and a soda at a concession stand, buy a jersey from the online store, or purchase a bobblehead of a favorite player at a shop in the ballpark, the club is able to track the fan's attendance, as well as their activities and preferences. From collecting these data, the club knows to take measures like sending an email message to a fan who is close to reaching "season ticketholder" status, which boosts sales.[23]

The loyalty program is also useful in monitoring complaints that can flag adjustments needed to boost fan satisfaction. As an example of how specific this can get, the CRM system found that one fan had complained about the smell of garlic fries. Knowing this, the organization was able to relocate him to a section where frequent consumers of garlic fries were not seated.[24] Such programs send a powerful message to customers, who are then inclined to do even more business with the company. But it takes a well-constructed database to get the process started.

customer segmentation strategy
A process of identifying customers who fit into smaller, more homogeneous groups.

On a more general level, you can use these data to set up a **customer segmentation strategy**, a process of identifying customers who fit into smaller, more homogeneous groups. By focusing on those with similar demographic, psychographic, and lifestyle tendencies and sorting them by their previous purchases and payment histories, a marketing appeal can be crafted to meet their specific needs and generate greater sales. For example, a small real estate company could identify young, tech-comfortable customers and reach out to them with an online-intensive sales campaign, while trying to sell upscale homes to older, more affluent prospects using in-person appeals.


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The data gathered can be used in many other ways to form and strengthen relationships with customers and increase sales. One of these builds on the usefulness of the **80/20 principle**, which maintains that 80 percent of a company's sales will come from 20 percent of its customers. These percentages are not meant to be exact, but experience has shown that the idea generally holds true for most businesses. If a company has created a customer database and organized its data appropriately, it then becomes possible to identify the 20 percent of customers who are the most loyal and who also deliver the greatest profitability to the company.

Often, these "best customers" can be identified by running a **recency-frequency-monetary analysis**, which reveals those who are most likely to buy from you in the future because they have made purchases recently, frequently, and in amounts that exceed some appropriate minimum. Whatever method is used to identify them, you should go the extra mile with these customers to keep them happy and coming back to do more business. This might include anticipating their needs and tailoring product or service offerings to suit them, providing intensive customer service, or offering loyalty rewards to build long-term relationships. As for those who require intensive and costly effort but offer little to no potential to generate profits, it is best to find a way to reduce their cost to the company, perhaps by steering them to low-cost, self-service options online. Some businesses may even choose to end the relationship altogether.

It is also very important to estimate the **customer lifetime value (CLV)** of those who buy from your business if you are to create an effective CRM plan. The customer lifetime value is the total profit expected from all future sales to a customer and underscores the *long-term* value of each customer, which can then be communicated to others. Losing a sale today might not seem all that costly—until you factor in the likely loss of all future sales that can result from one interaction gone wrong. And since it can cost a lot more to acquire a new customer than to keep the ones you have, the loss can be greatly compounded. Everyone in the company needs to understand this so that they will be more committed to treating customers well.

The CLV can also give sales and service employees a better idea of how much they should spend to acquire and retain customers. Let's say that you own a pizzeria and one of your loyal diners gets upset over a $15 meal. Before you decide how to handle the situation, keep in mind that their CLV could be more than $3,600. This is calculated from your estimate that they dine at your restaurant twice a month and are likely to continue that pattern over the next 10 years (in simple figures, $30 per month x 120 months). That's why having good data and knowing what to do with them can be so important.

80/20 principle
A principle that maintains that 80 percent of a company's sales will come from 20 percent of its customers.

recency-frequency-monetary analysis
An analysis that reveals customers most likely to buy from a firm in the future because they have made purchases recently, frequently, and in amounts that exceed some established minimum.

customer lifetime value (CLV)
The total profit expected from all future sales to a customer.

14-3e Data Use and Privacy Concerns

Having so much data on customers puts considerable power in an entrepreneur's hands, and it is imperative that it be used responsibly. Customers may not be comfortable with everything required to gain the depth of insight necessary for successful CRM. For example, firms often watch customers' online shopping behavior very closely, taking note of the items they look at, for how long, and in what order. Some even analyze what customers say through social media, including comments left on blogs, frustrations expressed via Twitter, and more private Facebook reflections. And this is just the start. The number of database-building options available to firms is great and growing.

There is no question that well-designed CRM systems provide value to customers (such as getting notices on sales that are both timely and relevant) and companies (such as predicting and planning for what customers will want next and generating higher response rates to email offers), but there is also great potential for abuse. To address privacy concerns, the process must be honest and transparent, the company must

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comply with applicable information-use laws, and permission to use personal data must be requested whenever appropriate.

Because it can be very profitable to sell customer data to other companies or to purchase data from third parties to fill gaps in any database being built, it can be quite tempting to misuse the information. But the trust of the customer is at stake, as well as the reputation of the company, and these must be protected. The long-term success of a CRM program depends on it.

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Privacy concerns have grown tremendously with the rapidly expanding reach of computer applications and the mind-boggling growth of e-commerce, which make data collection easy and nearly cost-free. A study by the Pew Research Center reveals just how worried Americans are becoming about businesses and how they handle customers' sensitive information:[25]

> The majority of Americans are not confident about the way companies will behave when it comes to using and protecting their personal data. Roughly seven-in-ten or more say they are not too or not at all confident that companies will admit mistakes and take responsibility when they misuse or compromise data (79%), will be held accountable by government if they misuse data (75%), or will use customers' data in ways that people would feel comfortable with (69%).

Because of the sharp escalation in data collection and use, online and offline privacy practices are coming under increasing scrutiny. Though U.S. companies have, for the most part, been able to get away with self-policing, regulatory attention has been growing. According to the United Nations Conference on Trade and Development, 66 percent of the nations around the world have enacted legislation designed to safeguard the handling of customer data, while another 10 percent are in the process of drafting such laws.[26] Those firms that do business in the European Union or trade with a European company, for example, must comply with strict laws regulating these practices. Many countries are modeling their own systems after the European standard, so the burden of privacy protection is sure to rise.

14-4 Customers as Decision Makers

14-4 Explain how consumers are decision makers and why this is important in understanding customer relationships.

The second primary building block supporting a successful CRM program involves knowledge of customer behavior (refer back to Exhibit 14.2). The three interrelated "materials" that combine to form that particular building block include the decision-making process, psychological influences, and sociological influences. Offering an expanded view, Exhibit 14.6 illustrates how consumer decision making flows through four stages:

Stage 1. Need recognition

Stage 2. Information search and evaluation

Stage 3. Purchase decision

Stage 4. Post-purchase evaluation

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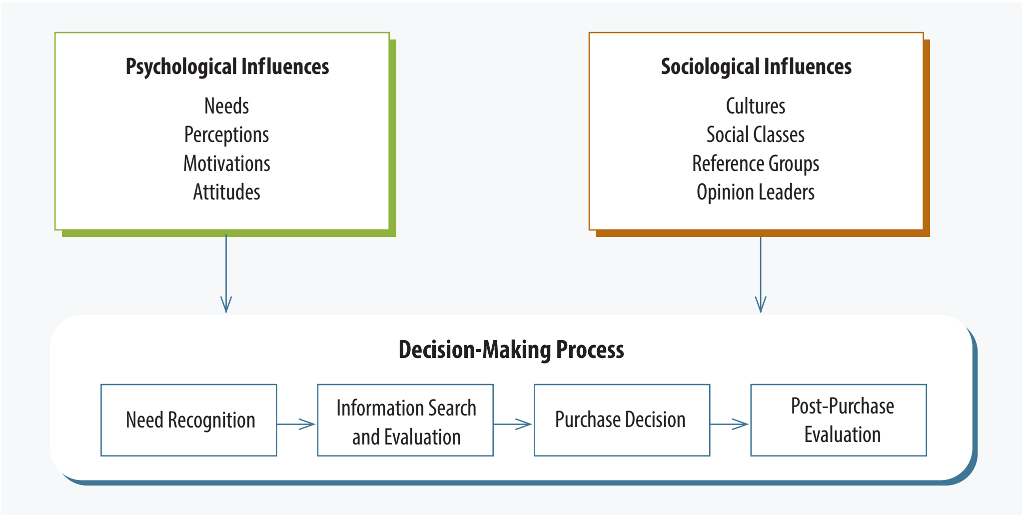
Exhibit 14.6 Simplified Model of Consumer Behavior



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We'll use this widely accepted model to examine decision making among small business customers.

14-4a Need Recognition

Need recognition (the first stage of consumer decision making) occurs when a consumer realizes that their current situation differs significantly from some ideal state. Many needs are routine conditions of depletion, such as a lack of food when lunchtime arrives. Other needs arise less frequently and may evolve slowly. Recognition of the need to replace the family dining table, for example, may take years to develop.

Because a consumer must recognize a need before purchase behavior can begin, the need-recognition stage cannot be overlooked. Many factors influence consumers' recognition of a need, either by changing the actual situation or by affecting the desired state. Here are a few examples:

- A change in financial status (job promotion with a salary increase).
- A change in household characteristics (birth of a baby).
- Normal depletion (using up the last tube of toothpaste).
- Product or service performance (breakdown of a laptop).
- Past decisions (poor repair service on a car).
- The availability of products (introduction of a new product).

Entrepreneurs must understand the need-recognition stage in order to decide on the appropriate marketing strategy to use. In some situations, a small business owner will have to *influence* need recognition. In other situations, they may simply be able to *react* to needs that consumers have identified on their own.

14-4b Information Search and Evaluation

The second stage in consumer decision making involves the collection and evaluation of appropriate information. Internal sources of insight (usually from previous experiences with a product or brand) typically are considered first. However, prospective buyers

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Living the Dream

Thriving during a Pandemic, Naturally

Consumers must first recognize that they have a need before they will be motivated to take steps to do something about it. But once that need is recognized, a company can greatly improve its odds of success by coming up with the products or services that these potential buyers are then primed to buy. For small businesses, these opportunities often involve narrow market segments, or niches, with specific needs.

Small firms tend to struggle during economic downturns. Because of this, entrepreneurs often are drawn to businesses that are recession-proof on the premise that they will still do well even if the economy takes a turn for the worse. The COVID-19 pandemic that started in 2020, however, put this to the test. The burden on small businesses was especially great, and countless ventures were forced to close their doors for good. But some were able to do far better than simply survive: They actually found ways to thrive and expand! One of these was Herb'N Eden.

Based in Atlanta, Georgia, Herb'N Eden is an all-natural bath and body products company that was founded in 2015 by Terran and Quinton Lewis. The couple had interned at Urban Sprout Farms, which introduced them to a lifestyle of healthy and sustainable practices. Working on the farm had made them aware of many different plants and their numerous benefits.

Looking to build on all that she was learning, Terran determined that it was time to master something new and concluded that soapmaking was the way to go. After taking time to explore the craft, the couple found that they really enjoyed making soap and were especially drawn to the idea of adding herbs and plant oils to their purely organic creations. This inspired them to take an even deeper dive into the world of soapmaking and skincare to see what might come of it. Out of their tireless experimentation, the concept for Herb'N Eden was born.

Herb'N Eden sells a wide range of natural products, including bar soaps, body wash and scrubs, deodorants, lotions, and bath salts. The company's products are all made with botanical ingredients that help maintain skin health. The couple refuse to use any artificial fragrances or toxic ingredients in their products. Instead, they turn to therapeutic-grade essential oils for their aromatherapeutic benefits. These products give consumers natural alternatives to the commercial offerings of big-brand competitors.

So, how did the Lewises manage to grow their business during such a difficult time? They spotted an underserved market need and moved to fill it. Natural Black hair and body products have been growing in popularity in recent years, but the major brands have largely ignored the needs of this segment of the market. As a result, several Black-owned hair and body care companies—such as Curls Dynasty, Kinky Tresses, and BLK + GRN—have stepped up to fill the void. And like Herb'N Eden, many of these companies have grown over the last decade and into 2021.

Responding to rising demand for its products, a trend that accelerated during the pandemic, the Herb'N Eden founders decided to purchase a new warehouse and to hire 35 additional employees in 2020 to support their expanding operations. At the close of 2019, the Lewises estimated that Herb'N Eden would make $600,000 in sales the following year—but the business exceeded that goal by 450 percent!

By understanding how the consumer decision-making process works, Herb'N Eden was well positioned to meet the fast-rising demand from Black Americans for healthier bath and body products. The unplanned boost from changes in consumer buying patterns during the pandemic was simply icing on the cake.

Sources: "The Inspiration," https://www.herbneden.com/pages/about-us, accessed May 28, 2021; "Terran and Quinton Lewis, Founders of Herb'N Eden," January 19, 2021, https://www.thestartupstory.co/episodes/terran-and-quinton-lewis-founders-of-herb-n-eden, accessed May 28, 2021; Derek Major, "Black Owners of Natural Skin Hair Brand, Open New Warehouse, Hire 35 Employees," *Black Enterprise*, February 22, 2021, https://www.blackenterprise.com/black-owners-of-natural-skin-care-brand-open-new-warehouse-hires-35-employees, accessed May 28, 2021; and Erin Parker and Tanisha Pina, "37 Black-Owned Beauty Brands to Shop Now and Always," *Glamour*, February 1, 2021, https://www.glamour.com/gallery/black-owned-beauty-brands, accessed May 28, 2021.

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usually turn to external sources (for example, input from friends and family, product-rating data from *Consumer Reports*, or feature descriptions from advertisements or salespeople) when their own past experience or knowledge is limited and the cost of gathering outside information is low.

To illustrate, suppose you are in the market for a big-screen television. If you work in the consumer electronics industry or have personal experience with some of the brands and models available (two *internal* sources of information), you probably know enough already to make a purchase decision. However, if you are like most people, you will need to gather information through *external* sources. You might ask for input from trusted friends, check out CNET's online reviews of big-screen models, and/or discuss model features with a salesperson at an electronics retailer. You'll need this information in order to make a sound decision when it's time to buy.

The search for information should help to clarify the purchase need and allow the consumer to establish **evaluative criteria** that will guide the decision process as it continues to unfold. That is, they will decide on the features or characteristics of the product or service that are to be used for comparison.

Small business owners should try to understand which evaluative criteria most consumers adopt, because these will be used to formulate their evoked set. An **evoked set** is a group of brands that a consumer is both aware of and willing to consider as a solution to a purchase need. Thus, the initial challenge for a new company is to gain *market awareness* for its product or service. Only then will the brand have the opportunity to become part of consumers' evoked sets.

14-4c Purchase Decision

Once consumers have evaluated brands in their evoked set and made their choice, they must still decide how and where to make the purchase (stage 3). A substantial volume of retail sales now comes from non-store settings, such as the Internet and TV shopping channels. These outlets have created a complex and challenging environment in which to develop a marketing strategy. And consumers attribute many different advantages and disadvantages to various shopping outlets, making it difficult for a small firm to devise a single correct strategy. Sometimes, however, simple recognition of these factors can be helpful.

Of course, not every purchase decision is planned prior to entering a store or looking at a mail-order catalog. Many purchases from traditional retail outlets are not planned or intended prior to the customers' entering the store. This fact underscores the tremendous influence of such features as store layout, sales personnel, and point-of-purchase displays. New technologies that can be used to help identify the limitations created by these features are continually being introduced.

evaluative criteria
The features or characteristics of a product or service that customers use for comparison.

evoked set
A group of brands that a consumer is both aware of and willing to consider as a solution to a purchase need.

post-purchase dissonance
The psychological tension or anxiety that occurs when a customer has second thoughts immediately following a purchase.

14-4d Post-Purchase Evaluation

The consumer decision-making process does not end with a purchase. Small businesses desire repeat sales from customers and thus need to understand the final stage of the process, post-purchase behavior. When this leads to post-purchase dissonance, sales staff need to handle the situation wisely to preserve the company's relationship with the customer.

Post-purchase dissonance is the psychological tension or anxiety that occurs immediately following a decision to buy when consumers have second thoughts as to the wisdom of their purchase. This dissonance can influence how a consumer evaluates a product or service and the buying experience overall. As illustrated in Exhibit 14.7,

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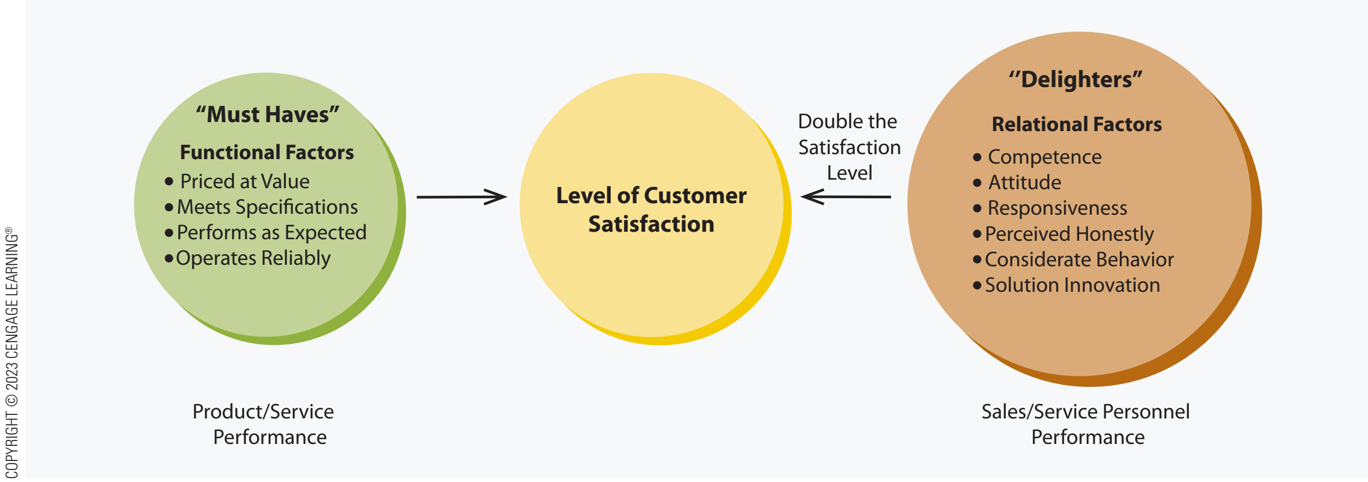
Exhibit 14.7 Determinants of Post-Purchase Satisfaction of Customers



Source: Adapted from Thomas N. Ingram, Raymond W. LaForge, Ramon A. Avila, Charles H. Schwepker, and Michael R. Williams, *Sell* (Boston: Cengage, 2020), pp. 64–65.

their level of satisfaction ultimately will be influenced largely by two major determinants:

1. *Functional factors ("Must Haves"):* Did the product or service itself meet or exceed the customer's expectations with regard to its pricing, performance, reliability, and other features?
2. *Relational factors ("Delighters"):* Was the customer pleased with the competence, attitude, responsiveness, perceived honesty, and other aspects of all experiences with sales/service personnel involved in the transaction and post-purchase dealings?

Since your products or services may be at least similar to those of competitors, it stands to reason that focusing on the "Delighters" features of the exchange can offer the most promising path toward setting your company apart from the rest of the pack. In fact, collective evidence from numerous studies has established that a customer's evaluation of relational factors can have up to two times more influence on their satisfaction and loyalty than functional factors.[27]

A consumer who is unhappy with the purchase process or the product during and after use may complain to the company, post a negative review on Yelp or another online forum, or respond in some other unfavorable way. Despite the frustration or concern a complaint may cause, it creates an important opportunity for a business to make things right. A well-handled complaint can often prevent the loss of a valuable customer. The outcome of the post-purchase process is a final level of customer satisfaction that affects customer loyalty and the likelihood of repeat purchases and product usage. If mishandled, it can also lead to brand switching and discontinued use of the product.

The best way to preserve customer satisfaction is to deal with issues and complaints as soon as possible and in the most effective way possible. This calls for a well-trained, informed, and cooperative workforce. At the Angus Barn restaurant, owner Van Eure encourages employees to use the "20-Foot Rule"—that is, any employee within 20 feet of a problem should get involved in addressing it to make sure that all customers leave completely satisfied. For example, waiters might provide dessert to a diner free of charge or accommodate a customer's needs by altering the seating chart. Because they are so central to the success of the operation, Eure takes very good care of those who work for her, as

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reflected by a very low turnover rate. Her approach to resolving customer concerns may underlie the high satisfaction quotient of both her customers and her employees.[28]

14-5 Identify certain psychological influences on consumer behavior.

14-5 Understanding Psychological Influences on Customer Behavior

Another major component of the consumer behavior model, as presented in Exhibit 14.6, is psychological influences. The four psychological influences that have the greatest relevance to small businesses are needs, perceptions, motivations, and attitudes.

14-5a Needs

Needs are often described as the starting point for all behavior. Without needs, there would be no behavior. Although consumer needs are innumerable, they can be identified as falling into four categories—physiological, social, psychological, and spiritual.

Consumers' needs are never completely satisfied, thereby ensuring the continued existence of business. One of the more complex characteristics of needs is the way in which they function together in shaping behavior. In other words, various needs operate simultaneously, making it difficult to determine which need is being satisfied by a specific product or service. Careful assessment of the needs-behavior connection can nonetheless be very helpful in developing a marketing strategy.

You should also keep in mind that purchases of the same product can satisfy different needs. For example, consumers purchase food products in supermarkets to satisfy physiological needs, but they also purchase food in status restaurants to satisfy their social and/or psychological needs. And certain foods are demanded by specific market segments to satisfy religious or spiritual needs. A needs-based strategy would result in a different marketing approach in each of these situations.

needs
The starting point for all behavior.

perceptions
The individual processes that give meaning to the stimuli confronting consumers.

perceptual categorization
The process of grouping things that are perceived as being similar.

14-5b Perceptions

A second psychological factor, **perceptions**, encompasses those individual processes that ultimately give meaning to the stimuli consumers encounter. When this meaning is severely distorted or entirely blocked, consumer perceptions can cloud a small company's marketing effort and make it ineffective. For example, a retailer may mark its fashion clothing "on sale" to communicate a price reduction from usual levels, but customers' perceptions may be that the items are out of style.

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Perceptions depend on the characteristics of both the stimulus and the perceiver. Consumers attempt to manage huge quantities of incoming stimuli through **perceptual categorization**, a process by which things that are similar are perceived as belonging together. Therefore, if a small business wishes

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to position its product as being comparable to an existing brand, the marketing mix should reflect an awareness of perceptual categorization. For example, comparable quality can be communicated through similar prices or by advertising in the same media. These techniques will help a consumer fit the new product into the desired product category.

Small businesses that attach an existing brand name to a new product are relying on perceptual categorization to pre-sell the new product. If, on the other hand, the new product is physically different or is of a different quality, a new brand name should be selected to create a distinctive perceptual categorization in the consumer's mind.

If a consumer has strong brand loyalty to a product, it will be difficult for other brands to penetrate their perceptual barriers. That individual is likely to have distorted images of competing brands because of a pre-existing perception. Consumer perceptions thus present a unique communication challenge.

14-5c Motivations

Everyone is familiar with hunger pangs, which are manifestations of the tension created by an unsatisfied physiological need. What directs a person to obtain food to try to get some relief? The answer is motivation. **Motivations** are goal-directed forces that organize and give direction to the tension caused by unsatisfied needs. Marketers cannot create needs, but they can offer unique motivations to consumers. If an acceptable reason for purchasing a product or service is provided, it will probably be internalized by the consumer as a motivating force. The key for the marketer is to determine which motivations the consumer will perceive as acceptable in a given situation. The answer is found through an analysis of other consumer behavior variables.

Like physiological needs, the other three classes of needs—social, psychological, and spiritual—can be connected to behavior through motivations. For example, a campus clothing store might promote styles that communicate that the college student wearing those clothes has obtained membership in a social group, such as a fraternity or sorority.

Understanding motivations is not easy. Several motivations may be present in any situation, and they are often subconscious. However, they must be investigated if the marketing effort is to succeed.

14-5d Attitudes

Like the other psychological variables, attitudes cannot be observed, but everyone has them. Do attitudes imply knowledge? Do they imply feelings of good or bad, favorable or unfavorable? Does an attitude have a direct impact on behavior? The answer to each of these questions is a resounding "Yes." An **attitude** is an enduring opinion, based on a combination of knowledge, feelings, and behavioral tendencies.

An attitude may act as an obstacle or a driver in bringing a customer to a product. For example, consumers with the belief that a local, family-run grocery store has higher prices than a national supermarket chain may avoid the local store. Armed with an understanding of the structure of a particular attitude, a marketer can approach the consumer more intelligently.

motivations
Goal-directed forces that organize and give direction to the tension caused by unsatisfied needs.

attitude
An enduring opinion, based on a combination of knowledge, feelings, and behavioral tendencies.

14-6 Understanding Sociological Influences on Customer Behavior

14-6 Recognize certain sociological influences on consumer behavior.

Sociological influences are the last component of the consumer behavior model. Among these influences are cultures, social classes, reference groups, and opinion leaders. Note that these influences represent different degrees of group

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aggregation: Cultures involve large masses of people, social classes and reference groups represent smaller groups of people, and opinion leaders are individuals who exert influence.

14-6a Cultures

In marketing, **culture** refers to the behavioral patterns and values that characterize a group of customers in a target market. These patterns and beliefs have a tremendous impact on the purchase and use of products. Marketing managers often overlook the cultural variable because its influences are so subtly embedded within a society. International marketers who have experienced more than one culture, however, can readily attest to the impact of cultural influence.

The prescriptive nature of cultures should concern the entrepreneur. Cultural norms create a range of product-related acceptable behaviors that influence what consumers buy. However, because a culture changes by adapting slowly to new situations, what works well as a marketing strategy today may not work a few years from now.

An investigation of a culture within a narrower boundary—defined by factors such as age, religious preference, ethnic background, or geographical location—is called *subcultural analysis*. Here, too, unique patterns of behavior and social relationships must concern the marketing manager. For example, the needs and motivations of the youth subculture are far different from those of the subculture that influences most older adults. Small business managers who familiarize themselves with cultures and subcultures are able to create better marketing mixes.

14-6b Social Classes

Another sociological factor affecting consumer behavior is social class. **Social classes** are divisions within a society having different levels of social prestige. Occupation is probably the single most important determinant of social class. Other determinants include possessions, sources of income, and education.

The social class system has important implications for marketing. People tend to ascribe greater social prestige to some lifestyles than to others, for example, and certain products naturally become symbols of those lifestyles. Products like grocery staples will probably not be very useful when analyzing social class. However, for products like home furnishings, such analysis may help to explain variations in shopping and communication patterns.

14-6c Reference Groups

Technically, social class could be considered a reference group. However, marketers are generally more concerned with smaller groups such as families, work groups, neighborhood groups, and recreational groups. **Reference groups** are those small groups that an individual allows to influence their behavior.

The existence of group influence is well established. The challenge to the marketer is to understand why this influence occurs and how it can be used to promote the sale of a product or service. Individuals tend to accept group influence because of the benefits they perceive as resulting from it, and these perceived benefits give influencers various kinds of power. Five widely recognized forms of power—all of which are available to the marketer—are reward, coercive, referent, expert, and legitimate power.

culture
Behavioral patterns and values that characterize a group of consumers in a target market.

social classes
Divisions within a society having different levels of social prestige.

reference groups
Small groups that an individual allows to influence their behavior.

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Reward power and *coercive power* relate to a group's ability to give and to withhold rewards. Rewards may be material or psychological; recognition and praise are typical psychological rewards. A Pampered Chef in-home party is a good example of a marketing technique that takes advantage of reward power and coercive power. The ever-present possibility of pleasing or displeasing the hostess-friend encourages guests to buy.

Referent power and *expert power* involve neither rewards nor punishments. They exist because an individual attaches great importance to being part of a group or perceives the group as being knowledgeable. Referent power (based on one's admiration or respect for the power holder) influences consumers to conform to a group's behavior and to choose products selected by group members. Children are often affected by referent power, so marketers can create a desire for products by using cleverly designed advertisements or packages that appeal to this inclination. And a person perceived as an expert can be an effective spokesperson for a host of products because consumers trust an expert's judgment.

Legitimate power involves authority and the approval of what an individual ought to do. We are most familiar with legitimate power at the societal level, but it can also be used in smaller groups. Social marketing efforts are an attempt to encourage a certain behavior as the right thing to do (for example, wear your seat belt, don't drink and drive).

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14-6d Opinion Leaders

According to widely accepted communication principles, consumers receive a significant amount of information through individuals called **opinion leaders**, group members who play a key communications role.

Generally speaking, opinion leaders are knowledgeable, visible, and have exposure in the mass media. A small business can enhance its own image by identifying with such leaders. For example, a farm-supply dealer may promote its products in an agricultural community by holding demonstrations of these products on the farms of highly successful local farmers, who are typically the community's opinion leaders.

Government regulators have been cracking down on undisclosed support relationships between sponsoring companies and those opinion leaders who offer their influence in return for benefits in the form of cash, goods, or services. This kind of abuse is greatest among social media stars who use their clout with adoring fans to subtly push a company's goods online, but it is easy for any celebrity to cross the line into what the Federal Trade Commission has declared to be deceptive marketing practices. Regardless of the setting or the nature of the business, such relationships must be made public.[29]

When Phil Knight established Nike, Inc., in the early 1970s, he used a marketing strategy that followed what he called the Five Cool Guys Principle. The idea was that if he could get five of the best and most popular athletes on a high school campus to wear his shoes, then others would want to buy the shoes for themselves. The "cool guys" would set the trend. Of course, the strategy can be applied at higher and more visible levels, which is why Nike has paid so much money over the years to get world-class athletes to don the company's products. Nike's tremendously successful marketing efforts are an illustration of the influence of opinion leaders.

opinion leader
A group member who plays a key communications role.

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In the modern era of social media, this effect can be magnified many times over to the benefit of small businesses. One mention of your company in a celebrity's "tweet" or even the briefest exposure of your product on a viral YouTube video can push customer interest through the roof. In fact, some small businesses find that such occurrences can increase demand so much that they have a very difficult time coming up with enough product to satisfy it. This is a great problem to have, but it can be very challenging to deal with.

Customer relationship management will be at the heart of any business that is destined for success. A satisfied customer is likely to be a repeat customer who will tell others about your company. But establishing an effective CRM program is hard work—it requires a thorough knowledge of the major components of customer satisfaction, the development of a suitable customer database, wise handling of complaints, and an understanding of the customer decision-making process. Of course, it all starts with maintaining a helpful and positive attitude toward customers, but the more small business owners know about their customers, the better they will be able to meet those customers' needs.

14-1. Explain the term *customer relationship management* (CRM) and its importance to a small business.

- Customer relationship management (CRM) is a company-wide business strategy designed to optimize profitability, revenue, and customer satisfaction by focusing on specific customer groups.
- The central message of every CRM program is to cultivate customers for more than a one-time sale.
- A CRM program recognizes the importance of keeping current customers satisfied to ensure their loyalty, given the high costs associated with attracting new customers.
- Two vital building blocks of any CRM program are outstanding relationships with customers and knowledge of consumer behavior.

14-2. Discuss the significance of providing extraordinary customer service.

- To be successful in the long run, small firms must build positive transactional relationships in order to develop and maintain loyal customers.
- Satisfied customers are loyal, which translates to increased revenue.
- Personal attention is the "gold standard" against which the quality of customer service is judged, and this can be strengthened by doing business on a first-name basis, keeping in touch with customers, findings ways to help them, customizing services offered, and addressing problems promptly.

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- Being able to respond quickly to customer service issues is one of the greatest advantages of small firms.
- Customer experience management (CX or CXM) recognizes that relationships with customers can be strengthened or weakened depending on the quality of the experience they have with a company.
- The Business of Experience (BX) approach addresses customers' concerns with certain social issues.
- Providing exceptional customer service before and after a sale can give small firms a competitive edge, regardless of the nature of the business.
- Establishing an effective customer service program begins with determining how well the firm is currently serving its customers, or its *customer service quotient*.
- More sophisticated assessment tools are available to evaluate customer experiences, including those that compute the Customer Satisfaction Score (CSAT), the Net Promoter Score (NPS), and the Customer Effort Score (CES).
- Although many types of customer service cost very little to offer, there are definite costs associated with superior levels of customer service.

14-3. Understand how technology can be used to improve customer relationships and the techniques helpful in creating a customer database.

- It is best to start thinking about a small company's need for CRM technologies—from basic spreadsheets to sophisticated software packages—from the start.
- CRM software programs allow companies to gather all customer contact information into a single data management program.
- Options for interacting with and providing personal attention to customers are built into the software.
- CRM emphasizes such sales activities as filling orders promptly and accurately, managing follow-up contacts to ensure customer satisfaction, and providing user-friendly call centers to handle all inquiries, including complaints.
- Concern about having ample support resources for CRM information technology has led some entrepreneurs to outsource certain applications.
- Alternative CRM systems are sometimes called customer information management systems.
- Blogs, wikis, social media sites, and other online communities offer ways of gathering customer feedback and ideas for product development.
- Being excellent at CRM is becoming more challenging as customer expectations continue to rise, both speed and quality of service are now more important to achieving results, and the shift toward digital service channels has picked up pace.
- Customer databases are essential to a successful CRM program, as they include such customer data as personal information, demographics, lifestyle and psychographic data, online habits, transaction data, past responses, and complaint history.
- CRM data can be collected at any touch point (places where customer contact occurs) and used to guide customer segmentation strategies.
- According to the 80/20 principle, most of a company's sales will come from a relatively small number of its best customers, and a recency-frequency-monetary analysis using the database can help to identify them.
- It is very important to think beyond any single transaction in order to focus on the customer lifetime value, representing all future expected sales from a customer.
- If a small company chooses to set up a customer database, then it is essential that all collected data be used ethically and responsibly to protect customer privacy.

14-4. Explain how consumers are decision makers and why this is important in understanding customer relationships.

- The four stages of consumer decision making are closely tied to ultimate customer satisfaction.
- Need recognition (stage 1) occurs when a consumer realizes that their current situation differs significantly from some ideal state.
- Stage 2 in consumer decision making involves consumers' collection and evaluation of appropriate information from both internal and external sources.
- Once consumers have evaluated brands in their evoked set and made their choice, they must still decide how and where to make the purchase (stage 3).
- Post-purchase evaluation (stage 4) may lead to psychological tension or anxiety, which can negatively influence customer satisfaction with the product or service and the business that provides it.
- The level of post-purchase buyer satisfaction will be influenced most by two major determinants: functional factors ("Must Haves," which relate to the product or service itself) and relational factors ("Delighters," which have more to do with the customer's experience with the transaction and post-purchase dealings).
- The best way to preserve customer satisfaction is to deal with issues and complaints as soon as they come up.

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14-5. Identify certain psychological influences on consumer behavior.

- The four psychological influences that have the greatest relevance to small businesses are needs, perceptions, motivations, and attitudes.
- Needs are often described as the starting point for all behavior.
- Perceptions are those individual processes that ultimately give meaning to the stimuli confronting consumers.
- Motivations are goal-directed forces that organize and give direction to the tension caused by unsatisfied needs.
- An attitude is an enduring opinion, based on a combination of knowledge, feelings, and behavioral tendencies.

14-6. Recognize certain sociological influences on consumer behavior.

- Among the sociological influences are cultures, social classes, reference groups, and opinion leaders.
- In marketing, the term *culture* refers to the behavioral patterns and values that characterize a group of customers in a target market.
- Social classes are divisions within a society having different levels of social prestige.
- Reference groups are those small groups that an individual allows to influence their behavior.
- Consumers receive a significant amount of information through opinion leaders, group members who play a key communications role.

Key Terms

80/20 principle p. 368
attitude p. 375
culture p. 376
customer database p. 366
customer experience management (CX or CXM) p. 358
customer lifetime value (CLV) p. 368
customer relationship management (CRM) p. 354
customer segmentation strategy p. 367
evaluative criteria p. 372
evoked set p. 372
motivations p. 375
needs p. 374
opinion leader p. 377
perceptions p. 374
perceptual categorization p. 374
post-purchase dissonance p. 372
recency-frequency-monetary analysis p. 368
reference groups p. 376
social classes p. 376
touch point p. 366
transactional relationship p. 356

Discussion Questions

1. Define *customer relationship management*. What is the central message of every CRM program?
2. Does CRM put more emphasis on current or potential customers? Why?
3. What are the two essential building blocks of a successful CRM program? What "materials" are used to construct these building blocks?
4. Why is a small business potentially in a better position to achieve customer satisfaction than a large firm?
5. What types of information should be part of a customer database?
6. How can a customer database be used to guide the marketing strategies of a small business?
7. In what ways can a small business use technology to support its customer relationship management efforts?
8. Briefly describe the four stages of the consumer decision-making process. Why is the first stage so vital to consumer behavior?
9. List the four psychological influences on consumers that were discussed in this chapter. What is their relevance to consumer behavior?
10. List the four sociological influences on consumers that were discussed in this chapter. What is their relevance to consumer behavior?

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You Make the Call

Situation 1

Jeremy Argyle launched his own clothing label in 2009 with the goal of selling great-fitting shirts and sweaters through his own stores and on the Internet. To further boost the success his company has had so far, he realizes that it is crucial to keep customers coming back for more. So, like entrepreneurs everywhere, Argyle wants to employ customer retention techniques that will establish a strong foundation for repeat business. You will find his venture's website at jeremyargyle.com, which has software capabilities to support customer interactions.

Source: https://jeremyargyle.com/pages/our-story, accessed June 8, 2021.

Question 1 What customer loyalty techniques would you recommend to Argyle?

Question 2 What information would be appropriate to collect information about customers in a database?

Question 3 What specific computer-based communication program could be used to achieve Argyle's goal?

Situation 2

Sometimes, a creative twist on standard marketing research methods can improve their effectiveness. This was certainly true for Jason Belkin, co-owner of Hampton Coffee Company, with two coffeehouse locations in New York, a mobile espresso van, and a catering business. In order to assess customer experiences, Belkin has used interesting alternatives (like a mystery shopper service that hires individuals to pose as real customers to evaluate a company's true service performance), but he also learned that comment cards can be an excellent way to get the information he wants. He has been known to offer a free cup of coffee to customers who fill out a card. The comment card asks a number of questions, which you will find at hamptoncoffeecompany.com/assets/uploads/CommentCard-front.pdf.

Source: https://hamptoncoffeecompany.com/about-us/story, accessed June 8, 2021.

Question 1 What are the advantages and disadvantages of the two approaches mentioned in this story—a mystery shopper service and comment cards—that Belkin has used to assess customer experiences at his coffee shops? Which one would you recommend?

Question 2 Do you see any problems with offering a free cup of coffee as an incentive for filling out a comment card? Would you suggest any other options for encouraging customers to provide feedback?

Question 3 Take a look at the comment card that Belkin has posted online. What are the best features of the card? How might it be improved?

Situation 3

Randall Solano owns a Pittsburgh-based decorative frame company, Creative Framing Services. In his mind, customer service today is more important than ever. "Being polite and courteous toward customers as they come into the shop is not enough," Solano observes. He goes out of his way to hire great employees and trains them to handle even the most challenging questions and service requests. Then he goes a step or two further by making the following claims on his company's promotional materials:

- *We only hire framing consultants who have a passion for art and depth of experience in the industry.*
- *We offer frame mouldings that are sourced from around the world and that you won't find in any of our competitors' shops.*
- *We are very serious about our business. We take the time to understand our customers' needs and pay careful attention to all important details so that what we deliver in the end is of the highest quality and exceeds all expectations.*
- *Because of the wide range of inventory that we have to offer and the artistic sensibilities of our staff, we deliver excellent results—and at a reasonable price.*

To ensure that all goes as planned, Solano keeps extensive documentation on every job. If complaints arise, he can figure out what happened and deal with the problem quickly. Taking this approach, he can tell if a customer's dissatisfaction stems from, say, an employee's carelessness, inadequate equipment, or some other problem. If the cause is an employee's poor workmanship, Solano will provide coaching to help improve that associate's performance. After that, if the problem still is not solved, the employee is fired. As Solano sees it, "There is no way for our small company to stay in business if we can't give customers what they want and at a price that they believe is reasonable. Therefore, we need skilled, attentive, and conscientious staff. And we focus like a laser on customer service because that is the best weapon we have to defend ourselves against our big competitors who would love to take business away from us. That's just the reality of a competitive marketplace."

Question 1 As a long-run strategy, will Solano's approach to superior customer service quality be successful?

Question 2 Would you want to work for a company with such policies? What would be the pros and cons of working there?

Question 3 What suggestions would you have for Solano? Can you see any ways to improve his system?

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Experiential Exercises

1. For several days, make notes on your own shopping experiences. Create a composite profile of what you consider to be the best customer service you have received.
2. Interview a local entrepreneur about their company's customer service efforts. Summarize your findings.
3. Ask a local entrepreneur about the types of customer complaints their business receives. Also ask how the entrepreneur deals with different complaints. Report your findings to the class.
4. Think about your most recent meaningful purchase. Compare the decision-making process you used to the four stages of decision making presented in this chapter. Report your conclusions.

Chapter 14 Case

Please see Appendix A for the Chapter 14 Case Study.

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Chapter 15

Product Development and Supply Chain Management

Looking Ahead

Learning Objectives

The purpose of the Product Development and Supply Chain Management chapter is to provide an overview of and to offer insights into how to manage product development and the supply chain in order to support growth and progress in a small business. By studying this chapter, you should be able to . . .

15-1 Recognize the challenges associated with the growth of a small business.

15-2 Explain the role of innovation in a company's growth.

15-3 Identify stages in the product life cycle and the new product development process.

15-4 Describe the building of a firm's total product.

15-5 Understand product strategy and the alternatives available to small businesses.

15-6 Discuss how the legal environment affects product decisions.

15-7 Explain the importance of supply chain management and the major considerations in structuring a distribution channel.

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Spotlight on Small Business

Chillhouse

https://chillhouse.com

With a menu featuring tasty delights like "Give Me Life Latte," "The Chill Avocado Toast 9," and "Ube-Bay Chill Serve," Chillhouse throws off a vibe that is not exactly ordinary. Opened in the Soho neighborhood of New York City in 2017, this new age spa-café was created by founder and CEO Cyndi Ramirez-Fulton. Her ambition was to offer a one-of-a-kind experience to her guests. It seems that she has hit the mark.

Ramirez-Fulton targets stressed-out millennials for her business, and it appears there is no shortage of interested patrons. She manages to pull them her way by offering reasonably priced, high-quality spa services in a facility that captures a pleasing aesthetic. Specializing in modern self-care, Chillhouse gives its guests the pampered attention they long for, a focus that is clearly reflected in the company's mission statement:

> We aim to create PRODUCTS & MOMENTS for a Chiller You.… At Chillhouse, we're cheerleaders for your ME-TIME. We want to make self-care FUN, ACCESSIBLE and EASY, something you remember to do on a daily and momentary basis.

The in-salon offerings at Chillhouse include a wide spectrum of face, nail, and body services, as well as a private infrared sauna and a café that serves up proprietary and healthy recipes. Ramirez-Fulton also maintains an interesting and informative blog called "The Chill Times" and operates an online store that sells merchandise ranging from clothing to skin care accessories, press-on nails, candles, and face and body oils. All of these features have been designed around witty, clever messaging and a unique, modern color scheme that has come to be associated with the Chillhouse brand.

The company's distinct image and specialized offerings have been a great hit with customers. And because of her success, it was no surprise that other spas were taking careful note of what Ramirez-Fulton had created. However, in 2020, one of her Instagram followers tipped her off to another New York City–based spa, called Chillology, that was borrowing far more than a little from Chillhouse's social media accounts.

After taking some time to investigate, Ramirez-Fulton discovered that Chillology was copying certain posts and captions from her spa's social media posts. She also noticed significant overlap with the copycat's products, services, and packaging. As evidence that the new competitor was drawing more-than-innocent inspiration from her efforts, Ramirez-Fulton recognized that Chillology copied the marketing efforts for a special Chillhouse event almost exactly, changing only the name and overall ad quality.

Imitation may be the sincerest form of flattery, but this had gone too far—and in a way that could cut into the brand image Ramirez-Fulton had so carefully crafted. "It wasn't just that they were taking our brand that we've put time, energy, and creative juices into," she reflected, "but it was that they were making it look worse, and kind of dragging it through the mud." Something had to be done.

Consistent with the company's millennial-leaning approach in business, Ramirez-Fulton decided to take the matter to social media. But this would have to be done wisely. She chose her next steps very carefully. After weighing the options, she decided that it would be too risky to draw attention to the issue on Chillhouse's Instagram account where all of the company's more than 100,000 followers could see it. Instead, she leveraged her own personal account and its 50,000 followers to expose the imitator. She posted several stories telling her followers all about the situation, providing evidence in the form of side-by-side pictures of copied posts and online representations. Chillhouse fans were not at all happy; many were very vocal in their defense of the company.

The strategy worked like a charm! Dacia Thompson, founder of Chillology, didn't waste any time offering an apology—and an explanation. She maintained that an employee in charge of Chillology's design and marketing efforts had acted independently and was let go once their actions had come to light.

Ramirez-Fulton was able to resolve her problem. But this will not be the last case of copycat behavior to arise. When an entrepreneur comes up with an innovative product or service and launches a successful business around it, you can bet that others will take notice—and some will try to replicate it. That's why it is important to have legal protections in place to guard against theft of intellectual property, or at least have a strategy to discourage it.

Developing a great product or service is fundamental to success in business. But figuring out how to

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hold on to that business after it takes off can be just as important.

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Economists and business leaders often talk about *supply* and *demand*, and with good reason—these fundamental forces of the marketplace determine how high the prices of products and services are likely to be. *Supply* refers to the willingness of businesses to put a certain product or service up for sale, while *demand* represents the interest and ability of buyers to purchase it. If a product is in short supply, its price will almost always rise as demand takes over and motivated buyers scramble to purchase the limited goods available at that time.

Supply and demand also affect the operation of a small business, though in a slightly different way. A company cannot survive for long if there is no demand for its product, interest that is typically generated through sales and marketing efforts. However, a successful business formula also assumes a healthy supply for the products that are to be sold. That is, the venture must also work out processes involving manufacturing, warehousing, and distribution—features that are central to what is commonly called the *supply chain*. This simplifies the recipe for success, but it clearly lays out the need for balance in these key areas of the company's operations.

In Chapter 14, you learned about customer decision-making (demand) and the need for an entrepreneur to make a strong commitment to customer relationship management (CRM) to ensure that new customers are drawn to the company and connections to current customers are preserved. You also learned that marketing programs must reflect consumer behavior concepts if CRM efforts are to sustain the firm's competitive advantage.

In this chapter, we discuss the demand side of the equation further, explaining how product innovation can lead to business growth by boosting market appeal. As illustrated in the Spotlight on Small Business at the start of this chapter, Cyndi Ramirez-Fulton was able to make the most of innovation to fuel customer interest with Chillhouse, the creative new age spa-café that she started in New York City. Of course, she also had to defend her brand from inappropriate duplication by others. There is a downside to popularity.

Beyond considerations of demand, the chapter will also deliver a healthy dose of supply-side thinking. That is, we address product and supply chain management decisions, which together have a significant impact on the total bundle of satisfaction targeted to customers. Business growth can be a wonderful thing, but supply-demand balance is critical to enterprise success.

15-1 Recognize the challenges associated with the growth of a small business.

15-1 To Grow or Not to Grow

Once a new venture has been launched, the newly created firm settles into day-to-day operations. These undertakings should be guided by the company's marketing plan, which reflects current goals as well as any expansion or growth that will impact marketing activities.

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Entrepreneurs differ in their desire for growth. Some want to grow rapidly, while others prefer a modest expansion rate. Many find that maintaining the status quo is challenge enough, and this becomes the driving force behind their marketing decisions. However, growth sometimes happens unexpectedly, and the entrepreneur is forced to concentrate all efforts on meeting demand.

Consider the experience of an entrepreneur when he showed a new line of flannel nightgowns to a large chain-store buyer, who immediately ordered 500 of them—and with delivery expected in five days! The entrepreneur accepted the order, even though he had material on hand for only 50 gowns. He emptied his bank account to purchase the necessary material and frantically begged friends to join him in cutting and sewing the gowns. After several sleepless nights, he filled the order.[1]

As you can see, growing quickly can be a stressful proposition if you are not prepared. Many paths can lead a small business owner to similar situations. For example, a new entrepreneur may price a product too low, prompting some buyers to exploit the opportunity by placing large orders. This can be especially hard on a start-up, because the final costs of production can exceed total revenue from sales. Also, if a small business is unable to deliver on time or with the level of quality promised, or if it must turn down an order because it can't handle the volume, its reputation can be damaged significantly.

Successful growth seldom happens on its own; it occurs only when a number of factors are carefully considered and well managed. When a business experiences rapid growth in sales volume, its income statements will generally reflect growing profits. However, rapid growth in sales and profits may be hazardous to the company's cash flows. A *growth trap* can occur because growth tends to demand additional cash faster than it can be generated in the form of increased profits.

Inventory, for example, must be expanded as sales volume increases. Additional dollars must be spent on merchandise or raw materials to accommodate the higher level of sales. Similarly, accounts receivable must be expanded proportionately to meet the increased sales volume. A profitable business can quickly find itself in a financial bind, growing while its bank accounts dwindle. (For more on forecasting financial requirements, including those related to raw materials and inventory, refer to Chapter 11. You can also look ahead to Chapter 22 to learn about effective methods for managing assets, such as accounts receivable, cash flows, and inventory.)

The growth problem can be particularly acute for small companies. Increasing sales by 100 percent is easier for a small venture than for a Fortune 500 firm, but doubling sales volume makes an enterprise a much different business. Combined with difficulty in obtaining external funding, this may have unfavorable effects if cash is not managed carefully. In short, a high-growth firm's need for additional financing may exceed its available resources, even though the venture is profitable. Without additional resources, the company's cash balances may decline sharply, leaving it in an uncertain financial position.

Growth also places huge demands on a small company's personnel and the management style of its owners. When orders escalate rapidly—sometimes doubling, tripling, or more in one year's time—managerial and sales staff can become overwhelmed. At that point, major adjustments may be required immediately. But too many owners fear that their "start-up baby" may be quickly morphing into a venture they no longer recognize or understand—and they may not be ready for the change or the new responsibilities. If they fail to adjust, they are likely to find that the increased demand will stretch their staff too thin, resulting in burnout, apathy, and poor overall performance.

Despite these and other challenges, the entrepreneurial spirit continues to carry small companies forward in pursuit of growth. Business expansion can occur in many ways. One common path to growth is paved by innovation.

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15-2 Explain the role of innovation in a company's growth.

15-2 Innovation: A Path to Growth

Small entrepreneurial firms are extremely productive when it comes to innovation. As evidence of this, government reports reveal that that these businesses produce 16 times more patents per employee than large firms.[2] It could be said that innovation provides the soil in which a start-up's competitive advantage can take root and grow, taking on a life of its own. Some widely recognized examples of small firm innovations are soft contact lenses, the zipper, overnight delivery services, the personal computer, and photo-bookmarking services like Pinterest.

There is a certain glamour associated with innovation, but creating and then perfecting new products or services can be difficult to achieve. The probability that a new innovation will go on to become a success is extremely low. The vast majority of all such entrepreneurial initiatives have to pivot or make adjustments in order to better align with the requirements of the innovation and the tastes and expectations of the market.

Still, only a few of those new products and services succeed. Despite some entrepreneurs' tortured attempts to massage life into their new product or service, 80 to 85 percent of innovations ultimately will end up failing.[3] Nobody said it would be easy.

15-2a Gaining a Competitive Advantage

From a menu of growth options, entrepreneurs generally choose the one they think will lead to the most favorable outcomes, such as superior profitability, increased market share, and improved customer satisfaction. These are some of the "fruits" of competitive advantage, and they all contribute to the value of the venture. However, when innovation is the goal, failure is always a risk. With that in mind, we offer a few "rules of thumb" that may help to reduce the risk in gaining a competitive advantage through innovation:

- *Base innovative efforts on your experience*. Innovative efforts are more likely to succeed when you know something about the product or service technology.
- *Focus on products or services that have been largely overlooked*. You are more likely to strike "pay dirt" in a vein that has not already been fully mined and in which competitors are few.
- *Validate the market before jumping in with both feet*. A new product or service will invariably fail if the pool of potential customers is too shallow to generate sufficient sales to recover the cost of innovation, along with a reasonable profit. This is consistent with the lean start-up approach outlined in Chapter 6.
- *Pursue innovation that customers will perceive as adding value to their lives*. It is not enough to create a product or service that *you* believe in. People become customers when *they* believe your product or service will provide value they cannot find elsewhere.
- *Focus on new ideas that will lead to more than one product or service*. Success with an initial product or service is critical, of course, but investment in innovation packs even more of a punch when it also leads to other innovative products or services.
- *Raise sufficient capital to launch the new product or service*. Many formal investors will take on *market* risks, but they will not accept *product* risks. They want to see at least a working prototype, and preferably a developed product, before they invest in a new venture. To get to that point, the entrepreneur will most likely need to rely on more informal sources of capital, such as personal savings and support from family and friends. This requires significant forward planning.

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Small companies that are "one-hit wonders" may find that the ride comes to an abrupt and unpleasant ending. While one innovation can provide a launch pad for a new and interesting business, continued innovation is critical to sustaining competitive advantage in the years to follow. Many founders find it necessary to transform their businesses so much that what they end up with is completely different from what started out as their original venture concept.

15-2b Achieving Sustainability

The importance of a company's competitive advantage was underscored in Chapter 3, but this strength needs to be long-lasting to have great impact. A company can sustain its competitive advantage through the use of various strategies. For example, some entrepreneurs with sophisticated technologies obtain patents to protect them. Because obtaining a patent requires the disclosure of intellectual property to the public, they may choose instead to guard it by maintaining trade secrets (that is, taking steps to keep private a formula, a process, collected data, and more that give the company a competitive advantage).

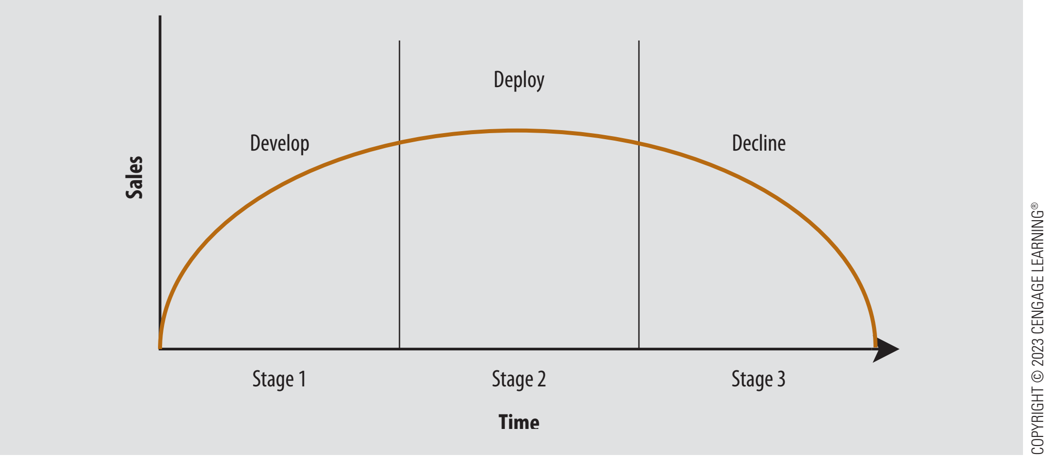
Others will try to operate "below the radar screen" of competitors, but unfortunately the effort to avoid attracting attention limits the growth potential of the enterprise. In some cases, businesses find protection through long-term contracts or alliances with larger and more powerful partners, which can lead to exclusive and secure deals as a distributor, vendor, or user of an important technology. But regardless of the strategy selected, the goal is to develop the competitive muscle of the enterprise while establishing protective features as a safeguard against being swept aside by resource-rich rivals.

A business can take steps to block threats from competitors, but no competitive advantage lasts forever. Research has emphasized the importance of a **sustainable competitive advantage**, a value-creating position that is likely to endure over time. To incorporate sustainability into strategy, an entrepreneur should use the firm's unique capabilities in a way that competitors will find difficult to imitate. However, since rivals will discover a way to copy any value-creating strategy sooner or later, it is important to plan for its transformation over the long run.

sustainable competitive advantage
A value-creating position that is likely to endure over time.

Exhibit 15.1 illustrates the competitive advantage life cycle, which has three typical stages: develop, deploy, and decline. Simply put, a firm must invest resources to *develop* a competitive advantage, which it can later *deploy* to boost its performance. But that

Exhibit 15.1 The Competitive Advantage Life Cycle



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position will eventually *decline* as rival firms build these advantages into their own strategies, new and better technologies emerge, customer preferences change, or other factors come into play.

To understand how this works, consider the Blue Buffalo Company, a maker of holistic pet food products. The company is small but growing, and it is unique in that only Blue Buffalo products contain LifeSource Bits, which provide "a precise blend of vitamins, minerals, and antioxidants carefully selected by veterinarians and animal nutritionists."[4] But how long will the sales growth continue, given that the company's competitive advantage seems to be based mostly on its proprietary blends? When competitors come up with similar ingredients, Blue Buffalo's competitive advantage and the sales growth it generates may very well stabilize and eventually fall into decline. That's when it pays to be very forward-thinking.

In order to maintain performance over time, companies must continue to reinvent themselves—and it is very important that they do this *before* the business stalls. Research has shown that firms that wait until they hit a slump before making adjustments run a serious risk of failing to realize a complete recovery. In one study, only 7 percent were able to return to healthy levels of growth.[5]

So how can a small business maintain its successful performance? A firm is more likely to avoid a slump if it keeps a close eye on "hidden curves" related to its competition, its internal capabilities, and its people—and takes corrective measures before these hidden trends become apparent in the company's financial results. Specifically, high performers have a way of doing three things well:[6]

1. Spotting changes in customer needs early and adjusting to them ahead of their rivals.
2. Upgrading capabilities to maintain marketplace advantages.
3. Developing and retaining people with "both the capabilities and the will to drive new business growth."

By taking these steps, a firm can extend its competitive advantage *before* the current strategy has run its course.

Small business owners can maintain their venture's performance and stay one step ahead of competitors if they keep an eye on the future and continuously improve their product and/or service offerings to meet the rising expectations of customers, all while developing the capabilities and the people who make this possible. Businesses that continuously plan for the future and take smart risks to beat all challengers to the competitive punch are much more likely to hold onto their marketplace advantage.

Benjamin Gilad and Mark Chussil, two business consultants who have helped hundreds of brands successfully navigate their way to sustainable performance, emphasize the value of addressing competitive obstacles by viewing them from new perspectives. "When you face a challenge," they insist, "it's solved by thinking differently." They go on to explain that "thinking differently" includes "asking what can go wrong and developing robust strategies to enable resilience." But they emphasize the importance of doing this "brain-work" while things are still going *right*. That's the time to run simulations of the nightmare scenarios.[7]

Make no mistake, staying ahead of competitors may require small business owners to make some very gutsy decisions. Such was the case with Austin, Texas-based food-delivery service Favor. When it became clear that the economics of the business for its in-state deliveries were really good but terrible in every other state, the very difficult decision was made to close all markets outside of Texas and redouble efforts at home. The concern was that such a move would cut into the start-up's growth potential, but the result was exactly the opposite. In fact, the venture grew by more than 160 percent

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Living the Dream

Business for Dummies

Mannequin Madness is a one-of-a-kind enterprise that has used innovation to stay on top of its competitive game. The Oakland, California-based company got its start in 2001 when Judi Townsend seized an off-chance opportunity to purchase 50 mannequins from a window dresser who was leaving the state.

To make ends meet in the early days, Townsend kept her job and rented out the mannequins as a side hustle. She also created a website that made it possible to market her business beyond the immediate area.

Townsend hit her first new-venture speed bump only a few months after deciding to give Mannequin Madness a go. That's when her employer declared bankruptcy. But rather than bemoan the loss of her job, she instead took it as a sign that she needed to focus on her start-up full-time. By leveraging the venture's existing online presence, she was able to expand the reach of her company. She reports that 80 percent of all of her new business now comes from outside the geographic area where Mannequin Madness is located.

Townsend learned by accident that retailers who use mannequins typically throw them away when they decide to close or remodel a store. This is harmful to the environment, as mannequins are made from materials that do not biodegrade. So, Townsend came up with a creative idea: What if she offered these stores a free mannequin-recycling alternative? The retailers would surely be happy since it would save on waste disposal fees (which ran $800 per dumpster), while also offering bragging rights for being kind to the environment. At the same time, this would expand the inventory of mannequins that her company could resell or rent.

This idea was a huge hit! Within the first year, the company had recycled over 100,000 pounds of mannequins. The U.S. Environmental Protection Agency was so impressed that it publicly recognized the start-up with a Special Achievement Award. Not satisfied with the progress she had made to that point, Townsend reached out to create an affiliation with used mannequin vendors in other cities to promote recycling as a national movement, not just a regional effort. This initiative expanded the client base of Mannequin Madness, quickly tripling the number of mannequins rescued from landfills. It was a brilliant move!

Mannequin Madness grew so much over the next few years that Townsend had to hire employees rather than relying completely on independent contractors. These new workers brought with them many new ideas and skills, which led Townsend to become active in what is called the maker/crafter movement, using mannequins and mannequin parts to create art. It was also during this period that headdress classes were launched. Area businesses got into the idea, signing up for private workshops as birthday parties and corporate team-building events. The classes became so popular that Townsend had to carve out a new division, called the Headdress Workshop, to handle the demand.

But then came the COVID-19 pandemic in 2020. Like so many small businesses, Mannequin Madness struggled to survive. But that just inspired Townsend to innovate even more, this time by expanding into a completely different line of business: pet photography. The company had a photo studio that was used for headdress workshops, so Townsend figured she might be able to rent it out to people who wanted to take photos of their pets. Though it doesn't seem to line up very well with a mannequin business, the pet-photography venture has done very well.

So, note the inventive evolution of Mannequin Madness. First, it was selling and renting mannequins. That led to an environmentally conscious venture that recycled stores' cast-offs, a move that helped to grow the company's inventory. Townsend then became even more creative and figured out how to make money offering headdress workshops to individuals and corporations. And finally, she was able to diversify her business even further by offering pet-photography services, which were much safer to operate during a pandemic. It has been quite a journey.

Townsend has shown, step by step, how an entrepreneur can grow a thriving enterprise through innovation. It just takes a cool head for business, and it seems that she has plenty of those just lying around the shop.

Source: "Founder of Largest Black-Owned Supplier of Mannequins Making Millions," May 6, 2021, https://www.blackbusiness.com/2021/05/judi-henderson-townsend-black-woman-largest-black-owned-supplier-mannequins.html, accessed June 22, 2021; https://www.mannequin-madness.com/pages/history, accessed June 22, 2021; "Mannequin Madness," https://shopoaklandnow.org/listing/mannequin-madness, accessed June 22, 2021; "Mannequin Madness," https://smallbusiness.yahoo.com/advisor/resource-center/mannequin-madness, accessed June 22, 2021; and Shanique Yates, "Judi Henderson-Townsend Turned a Side Hustle into a Million-Dollar Business, Now She's the Mannequin Queen," *AfroTech*, May 7, 2021; https://afrotech.com/mannequin-queen, accessed June 22, 2021.

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over a few short years after the decision was made to refocus the business.[8] The prize often goes to the courageous.

15-3 Identify stages in the product life cycle and the new product development process.

15-3 The Product Life Cycle and New Product Development

While innovation helps establish a competitive advantage for a new venture, an understanding of the product life cycle provides a strong foundation for product strategy. We will examine the product life cycle concept next, followed by an explanation of a four-stage approach to new product development.

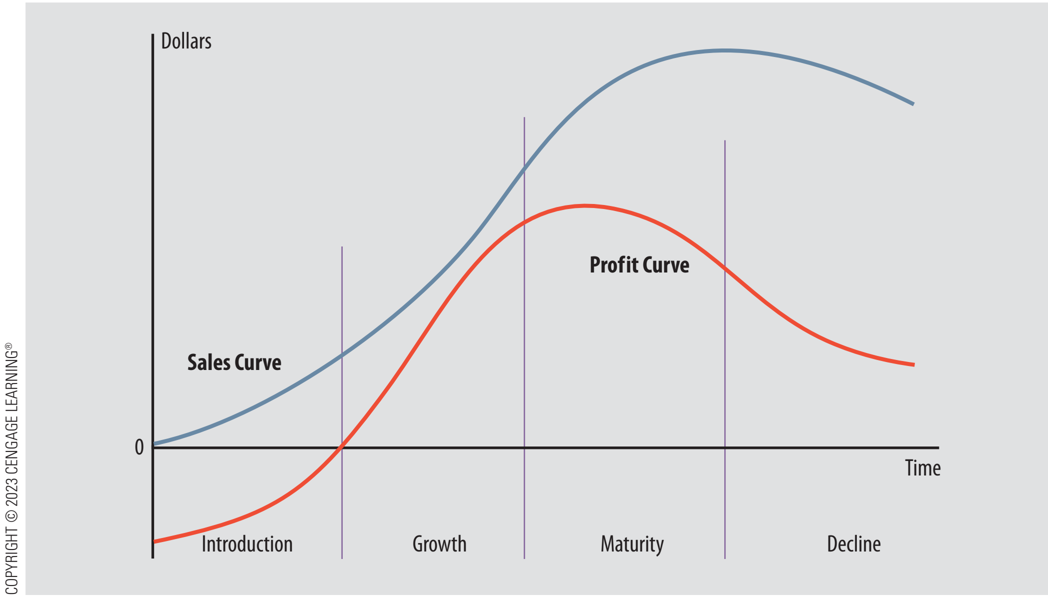
15-3a The Product Life Cycle

An important concept underlying sound product strategy is the product life cycle, which allows us to visualize the sales and profits of a product from the time it is introduced until it is no longer on the market. The **product life cycle** provides a detailed picture of what happens to the sales and profits of an *individual* product or service over time. (Although its shape is similar to that of the competitive advantage life cycle, shown in Exhibit 15.1, the two models are very different. The product life cycle reflects the sales and profit trend for a specific product or service, whereas the competitive advantage life cycle is based on the competitive edge of the company overall and can influence the sales of multiple products or services.)

product life cycle
A detailed picture of what happens to a specific product's sales and profits over time.

The product life cycle sales curve, shown in Exhibit 15.2, depicts a slow and, ideally, upward movement in the initial stages. The stay at the top is exciting but relatively brief. Then, suddenly, the decline begins, and the downward movement can be rapid. Also note the shape of the typical profit curve. The introductory stage is dominated by losses, with profits peaking late in the growth stage—that is, the point around which new firms, having been lured into the market because of its evident potential, begin to compete and drive per-unit prices, and thus total profits, down.

Exhibit 15.2 The Product Life Cycle



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The product life cycle concept is important to a small business for three reasons:

1. It points out that promotion, pricing, and distribution policies should all be adjusted to reflect a product's position on the curve.
2. It highlights the importance of revitalizing product lines, whenever possible, to extend their commercial potential.
3. It is a continuing reminder that the natural life cycle for most products rises and then falls; therefore, innovation is necessary for a firm's survival.

Good business practice calls for forward-thinking product planning, which should begin before the curve of the existing life cycle peaks. This parallels the point made earlier about the need to extend the firm's competitive advantage *before* the current strategy has run its course.

Keep in mind that products and/or services and competitive advantages that are on the verge of decline can be reinvigorated using any number of different strategies, including the following:

- *Modifying a product or service by adding new features*, such as fitting smartphones with high-quality superzoom cameras to increase the range of possible uses.
- *Proposing alternative uses*, for example, by suggesting that baking soda placed in refrigerators can kill odors.
- *Refreshing a competitive advantage through an ongoing program of research and development that yields proprietary technology,* as in the case of a small biomedical start-up that has numerous patents or patents pending.
- *Expanding into complementary products*, such as Oreck Corporation's addition of lightweight steam mops to its vacuum offerings.
- *Redefining the business*, as The Walt Disney Company did by shifting from animation to a broader identity as an entertainment services provider.

The point is that the downward-trending sections of the life cycles presented in Exhibits 15.1 and 15.2 can be extended or reversed using these strategies, among many others.

15-3b The New Product Development Process

It is usually up to the small business owner to find, evaluate, and introduce the new products that the company needs. This responsibility requires setting up a process for new product development. As in large firms, where committees or entire departments are created for that purpose, new product development in small businesses is best handled through a structured process, as long as enough flexibility is maintained to allow for adjustments when unforeseen circumstances arise.

Entrepreneurs tend to view new product development as a monumental task—and it can be in some cases. But many find that the best way to tackle new product development is to follow a common four-stage, structured approach:

Stage 1: Idea accumulation

Stage 2: Business analysis

Stage 3: Development of the physical product

Stage 4: Product testing

(Some of these stages may seem similar to those related to the launch of a new venture, as outlined in Chapter 3, but the focus here shifts to expanding an *existing* business through new product development.)

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Idea Accumulation

The first stage of the new product development process—idea accumulation—involves increasing the pool of ideas under consideration. New products start with ideas, and these ideas have varied origins. The many possible sources include the following:

- Sales staff, engineering personnel, or other employees within the firm.
- Government-owned patents, which are generally available on a royalty-free basis.
- Privately owned patents listed by the U.S. Patent and Trademark Office.
- Other small companies that may be available for acquisition or merger.
- Competitors' products and their promotional campaigns.
- Requests and suggestions from customers (increasingly gathered through online channels such as blogs, online surveys, and similar tools).
- Marketing research (primary and secondary).

In an *Inc*. magazine survey, 500 CEOs reported that the most promising ideas for new products or services came from customers (38 percent), followed by the CEOs themselves (24 percent), and then employees (20 percent).[9] But determining which ideas are the *most* promising is often the greatest challenge. Small firms can feel the strain of the weight of too many ideas, and it is the job of the entrepreneur to figure out which ones to eliminate and which to pursue.

Business Analysis

Business analysis, the second stage in new product development, requires that every new product idea be carefully studied in relation to several financial considerations. Costs and revenues are estimated and analyzed with techniques such as break-even analysis (a concept that is described in greater detail in Chapter 16). Any idea failing to show that it can be profitable needs to be discarded. The following four key factors should be considered in conducting a business analysis:

1. *The product's relationship to the existing product line*. Some firms intentionally add very different products to their product mix. In most cases, however, an added product item or line should be somehow related to the existing product mix. For example, a new product may be designed to fill a gap in a firm's product line or in the range of prices of the products it currently sells. If the product is completely new, it should have at least a family relationship to existing products to save on costs of manufacturing, distribution, promotion, and/or sales strategy.
2. *Cost of development and introduction*. Considerable capital outlays may be necessary when adding a new product. These include expenditures for design and development, marketing research to establish sales potential, advertising and sales promotion, patents, and additional equipment. One to three years may pass before profits are realized on the sale of a new product.
3. *Available personnel and facilities*. Obviously, having adequate skilled personnel and sufficient production capabilities is preferable to having to add employees and buy equipment. Thus, introducing new products is typically more appealing if the personnel and the required equipment are already available.
4. *Competition and market acceptance*. The potential competitive response to a proposed product in its target market must not be too extreme. The ideal solution, of course, is to offer a product that is sufficiently different from existing products or that is in a price bracket where it avoids direct competition.

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Development of the Physical Product

The next stage of new product development entails sketching out the plan for branding, packaging, and other supporting efforts, such as pricing and promotion. But before getting to that point, an actual prototype (usually a functioning model of the proposed new product) may be needed. After these components have been evaluated, the new product idea may be judged a misfit and discarded, or it may be moved to the next stage for further consideration.

Many small business owners are intimidated by the thought of having to develop a prototype, but new approaches and rapidly emerging technologies are changing that. This was certainly true for Celestina Pugliese of Melville, New York, who came up with a new product idea when she was dining at a restaurant with a friend. After dropping off the check, their server returned repeatedly to ask, "Are you ready to pay the check?" Somewhat annoyed, Pugliese mused out loud about an idea for a check presenter with a light that would signal servers when diners were ready to pay the check. This experience led to the creation of her Ready Check Glo Illuminating Check Presenter.[10]

To move forward with her idea, however, Pugliese had to find ways to make the most of the limited funds she had for the new venture. And she did, bringing her product to market in only seven months and for a mere $11,800 in *total* costs, not just those related specifically to product development.

The power and reach of the Internet were key to her results. It allowed Pugliese to find the talent she needed for a fraction of the normal price. For example, rather than spending $100,000 to have an engineer build the product, Pugliese used guru.com to hire a freelance engineer in Ohio, who designed her product for just $500. She also used the site to contract with an attorney, who filed a provisional patent application for her for a very affordable $500 charge. A legitimate online inventors' network led her to deals with capable and reliable manufacturers, who handled production at a reasonable cost.[11] It took some ingenuity, but using such strategies clearly saved Pugliese a significant amount of money.

However, the options for physical product development certainly do not end there. Today, there are countless new tools and services that can support and radically reduce costs for entrepreneurs who want to bring a new product or service to market. Suppose that you've come up with an idea for a product. Here are just a few of the countless resources that are available to help you develop the idea further:[12]

- You could use one of the free or relatively low-cost versions of Wings 3D (wings3d.com) to create or revise your model.
- Once you've perfected a digital model, you could use a 3D-printing marketplace like Shapeways (shapeways.com) to build your creation using a variety of materials, including plastic (in various colors and grades of transparency), metal (steel, stainless steel, and aluminum), and sandstone.
- As an alternative, you could buy a professional-quality, rapid-prototyping 3D printer for as little as $2,500 from MakerBot (makerbot.com) and produce your own creations. Much less expensive options (less than $500) are also available.
- Does your product need to be interactive? With the Arduino open-source electronics-prototyping platform (arduino.cc), it has never been easier to embed an electronic controller in a product. This very inexpensive and easy-to-use control board allows your product to link to a variety of sensors to gauge its environment and then respond by controlling lights, motors, and other actuators.
- If you think that you might need more help, hundreds of *makerspaces* (which have been described as "community centers with tools") give entrepreneurs

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and do-it-yourselfers access to equipment, instruction, and a community of like-minded individuals. Check out the Makerspace Directory for possibilities that are conveniently located for you at makerspaces.make.co.

- If you need more information to protect your intellectual property as you are getting started, LegalZoom (legalzoom.com) may provide the answers.
- If you like the sound of all this but think you need a little more direction to solve the complications that are sure to come up, check out the seemingly unlimited free tools and resources at NoCode (nocode.tech).

The whole point is that small businesses can turn to many sources of assistance as they move through the new product development process.

Product Testing

The last step in the product development process, product testing, should determine whether the physical product is acceptable (safe, effective, durable, etc.). While the product can be evaluated in a laboratory setting, a limited test of market reaction should also be conducted.

Although using a structured process to handle new product development can be very helpful, a new venture is much more likely to succeed if it is outwardly focused on customers. Inwardly focused firms—those that are in it only to please themselves or to beat rivals—are apt to fall short of the mark. High-performing companies research what, precisely, customers want. They also test and validate customer preferences periodically during the development process to be sure initial expectations hold up. Taking such steps provides the only reliable path to creating value for customers, which, in turn, can boost the company's performance.

15-4 Describe the building of a firm's total product.

15-4 Building the Total Product

A major responsibility of marketing is to transform a *basic* product concept into a *total* product. Suppose, for example, you have come up with an idea for an innovative new hoverboard that is designed to better navigate walkways with heavy pedestrian traffic. Even when that hoverboard has been developed into physical reality (the basic product), it is still not ready for the marketplace. The total product offering involves more than the materials used to manufacture the new hoverboard. To be marketable, the basic product must be named, perhaps have a package, come with a warranty, and be supported by other product features. Let's examine a few of the components of a total product offering: branding, packaging, labeling, and warranties.

15-4a Branding

An essential element of a total product offering is a **brand**, which is a means of identifying the product—verbally and/or symbolically. The most effective branding efforts are carefully designed and executed.

The brand identity of most small businesses will have the three components identified in Exhibit 15.3. The first of these features, the intangible **brand image** component—that is, people's overall perception of a brand—may be even more important to acceptance of a firm's total product offering than the tangible brandmark and brand name elements. Consumers tend to resist heavy-handed marketing appeals. They are far more likely to respond positively to businesses that craft and communicate interesting and consumer-relevant images that promote a sense of emotional attachment to the company.

brand
A verbal and/or symbolic means of identifying a product.

brand image
The intangible overall perception of a brand.

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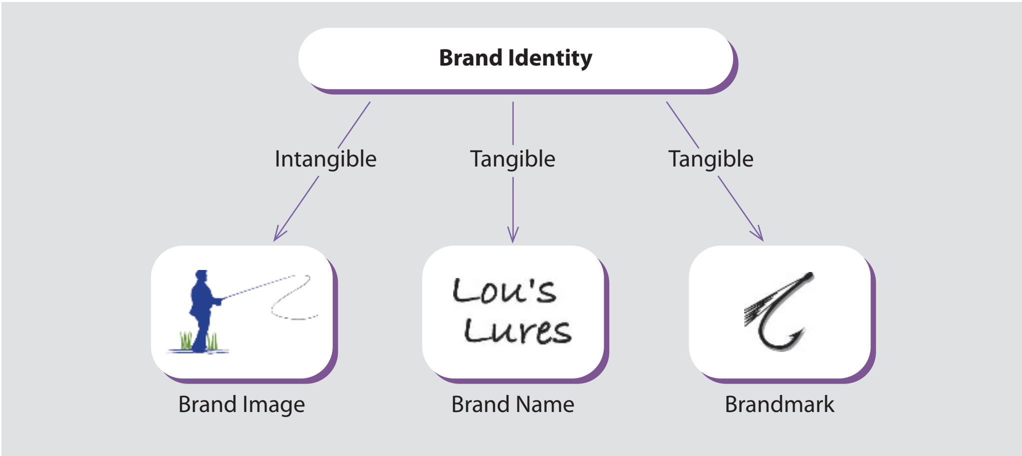
Exhibit 15.3 Components of a Brand Identity



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The most effective U.S. brands generate trust in the minds of buyers by conveying to them a sense of personal connection (Amazon), happiness (Coca-Cola), dependability (FedEx), and/or consistency (Ford). Being seen as cool (Apple), focused on the customer (Nordstrom), or even a little quirky (Southwest Airlines) can also be powerful. Regardless of the type of appeal, branding is increasingly important because most consumers will give their business to a company based more on the way they feel about it than on the facts and figures of the firm's selling proposition or its hard-hitting marketing campaigns.

The tangible components of brand identity are brand names and brandmarks. A **brand name** is a brand that can be spoken—like the name Dell. Since a product's brand name is so important to the image of the business and its products, careful attention should be given to its selection. In general, six rules apply in naming a product:

1. *Select a name that is easy to pronounce and remember.* You want customers to remember your product. Help them do so with a name that can be spoken easily—for example, Two Men and a Truck (a moving service). Before choosing to use your own family name to identify a product, evaluate it carefully to ensure its acceptability.
2. *Choose a descriptive name.* A name that is suggestive of the major benefit of the product can be extremely helpful. As a name for a sign shop, Sign Language correctly suggests a desirable benefit. But Sam and Ella's might not be the best name for a pizza and subs restaurant.
3. *Use a name that is eligible for legal protection.* Be careful to select a name that can be defended successfully. Do not risk litigation by copying or adapting someone else's brand name. For example, a new retailer named Wally-Mart would certainly be challenged by industry giant Walmart—even if the new store was actually started by someone named Wally.
4. *Select a name with promotional possibilities.* Long names are not compatible with good copy design on signs and billboards, where space is at a premium. A competitor of the McDonald's hamburger chain called Bob's has a name that will easily fit on any sign or billboard.
5. *Select a name that can be used on several product lines of a similar nature.* Customer understanding can be lost when a name doesn't fit a new line. The name Just Brakes is excellent for an auto service shop that repairs brakes, but the company had to help the car-owning public see past its

brand name
A brand that can be spoken.

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name when it decided to expand its range of offerings to include other factory-scheduled maintenance services.

6. *In cases where online presence is crucial, consider the cost of domain name acquisition.* Common domain names like Diamonds.com and VacationRentals.com can cost millions of dollars to secure. Selecting a quirky name like Kaggle and Zazzle (which are now in use) may be the only way to avoid the high costs.

If you haven't already chosen a strong brand name, you might consider licensing one, especially if you have a product for which an appropriate name is available. Winston Wolfe, founder of Olympic Optical, a maker of industrial safety sunglasses for the shooting sports industry, harnessed the power of this approach for his business. By licensing the names Remington, Smith & Wesson, and Zebco, he was able to boost sales of his high-end sporting glasses dramatically by riding the wave of popular enthusiasm for these established brands. As he puts it, "Licensing the right name can be magic. It can separate you from the crowd and give you a great sales advantage. It can also allow you greater profit margins, since most consumers are willing to pay more for a brand name they know."[13]

A **brandmark** is the other tangible component of brand identity. It is a brand that *cannot* be verbalized—like the golden arches of McDonald's. A brandmark also has tremendous value. Apple's "bitten apple" and the Chevy badge are marks widely associated with their owners. A small company's special "signature," or logo, should symbolize positive images of the firm and its products. Because of the impact a brandmark can have, it's important to get it right.

Developing an effective logo can be an expensive undertaking. The following tips may help you to design a logo without breaking the bank:

- *Be simple*. The best logos are often the least complicated. Think of Target, whose red circle with a red dot in the center conveys the essence of affordable, hip practicality. H&R Block uses a green square in association with its name. Simple things are easy to remember and slower to appear dated.
- *Design for visibility*. Nike paid Carolyn Davidson, a graphic design student, $35 to design the bold red swoosh that has been the firm's brandmark since its unveiling at the U.S. Track & Field Olympic Trials in 1972. One of its most positive qualities is that you simply cannot miss it wherever it is displayed.
- *Leave it open to interpretation*. The logo should not explain, at a glance, the complete nature of your company. One of the reasons the Starbucks "Siren" logo is so effective is that it stands as an "empty vessel." The two-tailed mermaid depicted is unique and highly recognizable, but it has no obvious meaning. This allows Starbucks to build any image around it that serves the firm's purposes, and the design will be associated only with its products.
- *Be relentlessly consistent*. Companies with strong graphic identities have built that recognition through years of use. Pick a typeface. Pick a color. Use them over and over again *on everything*. Eventually, you will be able to establish an identifiable look and feel.
- *Recognize the importance of logo design*. Logos, colors, and other design factors are often considered "cosmetic," unimportant features of doing business.

brandmark
A brand that cannot be spoken; a company logo.

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But most design-driven companies got to be that way through the efforts of highly placed and influential advocates who understood the power of logos to shape brand impressions and the behavior to which they can lead. Their results speak for themselves.

- *Get good advice.* You can go pretty far with common sense. But sooner or later, you'll need the services of a professional graphic designer. The website of the largest professional organization for graphic designers (aiga.org) offers useful information about how to find and work with experienced professionals.
- *Don't expect miracles.* Your company's image is the sum total of many factors. Make sure that your company looks, sounds, and feels smart in every way, every time it goes out in public.

Trademark and **service mark** are legal terms indicating the exclusive right to use a brand to represent products and services, respectively. Once an entrepreneur has found a name or symbol that is unique, easy to remember, and related to the product or service, it is time to run a name or symbol search and then to register the brand name or symbol. The protection of trademarks and service marks is discussed later in this chapter.

15-4b Packaging

In addition to protecting the basic product, packaging is a significant tool for increasing the value of the total product. Consider some of the products you purchase. How many do you buy mainly because of a preference for package design and/or color? The truth is that innovative packaging is often the deciding factor for consumers. If two products are otherwise similar, packaging may create the distinctive impression that makes the sale.

Peter Rahal and Jared Smith are co-founders of RXBAR, a protein bar maker that obsesses over the simplicity of the core ingredients in its product, as well as the taste, quality, and the nutrition of all that it sells. The essence of the business is clearly explained on the company's website: "Like eating 3 egg whites, 2 dates, and 6 almonds. It's how we've always described our bars. What's inside. What isn't. We think it's everything you need to know."[14] That pretty much says it all. But the packaging for RXBAR (which can be seen at rxbar.com) adds a visual exclamation point that makes what the product stands for even harder to miss.

RXBAR packaging was not always as it is today. When the company was started in 2013, Rahal and Smith followed the usual path of protein bar makers—that is, using the wrapper to declare what is (or is not) in the product, highlight the protein content, and tie the product to one fad diet or another. But after two years in business, the founders figured it was time to reassess their approach. "We took one step back and had a humbling moment," recalls Rahal. "We realized our baby was ugly."[15]

As part of a radical packaging overhaul, the start-up duo decided to make the ingredients the "star" of the redesigned wrapping—so much so, in fact, that some industry experts felt it was a mistake because this feature made a much bigger visual splash than the company's logo. This, along with other important tweaks, including a stark but simple reminder of the company's honest commitment to product quality, made a huge difference in market reaction.

Within months of changing the packaging, RXBAR products found their way onto the shelves of big retailers like Kroger, Target, Trader Joe's, and Whole Foods, and the company's sales shot up dramatically. Nothing changed about the products themselves, but the look and design of the packaging and presentation increased consumer interest. This shows just how important these features can be to a small business and its total product offering.[16]

trademark
A legal term indicating that a firm has exclusive rights to use a brand to represent a product.

service mark
A legal term indicating that a company has the exclusive right to use a brand to represent a service.

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Financial constraints often prevent small businesses from pursuing creative packaging strategies that would boost sales. Entrepreneurs who can't afford the expensive equipment required for such packaging innovations can often work with "contract packagers," who can handle such orders at a low per-unit cost. It certainly pays to consider what goes on the outside of your product, and not just what's in it.

15-4c Labeling

A label is an important informative tool for consumers. It often includes information on product use and care and may even provide instructions on how to dispose of the product.

Labeling also serves several important purposes for manufacturers, which apply most labels. One purpose is to display the brand, particularly when branding the basic product would be undesirable. For example, a furniture brand is typically shown on a label and not on the basic product. On some products, brand visibility is highly desirable; Louis Vuitton handbags would surely not sell as well if the name label were only inside the purse.

Laws concerning labeling requirements should be reviewed carefully. A number of government agencies issue regulations that must be followed to remain within the law. These include the Food and Drug Administration (fda.gov), the Federal Trade Commission (ftc.gov), and the U.S. Department of Agriculture (usda.gov). To read up on any requirements, including any recent changes, enter "labeling requirements" in the website search window. Small businesses are exempt from many of these requirements, but it is wise to consider including information that goes beyond the specified minimum legal requirements if doing so would give an advantage to your company and the way your products are positioned in the marketplace.

15-4d Warranties

A **warranty** is simply a promise, written or unwritten, that a product will perform at a certain level or meet certain standards. All sellers make an implied warranty that the seller's title to the product is good. A merchant seller, who deals in goods of a particular kind, makes the additional implied warranty that those goods are fit for the ordinary purposes for which they are sold. A written warranty on a product is not always necessary. In fact, many firms operate without written warranties, believing that offering one would likely confuse customers or make them suspicious.

warranty
A promise, written or unwritten, that a product will perform at a certain level or meet certain standards.

Warranties are important for products that are innovative, comparatively expensive, purchased infrequently, relatively complex to repair, or positioned as high-quality goods. When assessing the merits of a proposed warranty policy, a firm should consider important factors, such as cost, service capability, competitive practices, customer perceptions, and legal implications.

15-5 Understand product strategy and the alternatives available to small businesses.

15-5 Product Strategy

Product strategy includes decisions about branding and other elements of the core component of the bundle of satisfaction, whether a product or service. To be more

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specific, a **product strategy** describes the manner in which the product component of the marketing mix is used to achieve the objectives of a firm. This involves several supporting features:

- A **product item** is the lowest common denominator in a company's product mix. It refers to an individual item, such as one brand of bar soap.
- A **product line** is the sum of the related individual product items, but the relationship is usually defined generically. So, two brands of bar soap are two product items in one product line.
- A **product mix** is the collection of all product lines within a firm's ownership and control. A firm's product mix might consist of a line of bar soaps and a line of household cleansers.
- **Product mix consistency** refers to the closeness, or similarity, of the product lines. The more product items in a product line, the greater its depth; the more product lines in a product mix, the greater its breadth.

To illustrate how these features can come together, Exhibit 15.4 shows the product lines and product mix of the firm 180s LLC, which makes innovative performance apparel and accessories in various styles for men and women.

15-5a Product Marketing versus Service Marketing

Traditionally, marketers have used the word *product* as a generic term to describe both goods and services. However, certain characteristics—tangibility, amount of time separating production and consumption, standardization, and perishability—lead to a number of differences between the strategies for marketing goods and those for marketing services (refer to Exhibit 15.5). Based on these characteristics, for example, the marketing of sunglasses fits the pure goods end of the scale and the marketing of haircuts fits the pure services end.

Although marketing services obviously presents unique challenges that are not faced when marketing goods, space constraints prevent us from describing it separately. Therefore, from this point on in the chapter, a **product** will be considered to include the total bundle of satisfaction offered to customers in an exchange transaction, whether this involves goods, a service, or a combination of the two.

In addition to the physical product or core service, a product also includes complementary components, such as its packaging or a warranty. The physical product or core service is usually the most important element in the total bundle of

product strategy
The way in which the product component of the marketing mix is used to achieve a firm's objectives.

product item
The lowest common denominator in the product mix—the individual item.

product line
The sum of related individual product items.

product mix
The collection of a firm's total product lines.

product mix consistency
The similarity of product lines in a product mix.

product
A total bundle of satisfaction—whether a service, goods, or both—offered to consumers in an exchange transaction.

Exhibit 15.4 Product Lines and Product Mix for 180s LLC

Depth of Product Lines	Breadth of Product Mix					
	Ear Warmers	Gloves	Neck Warmers	Headbands	Hats	Scarves
Casual Wear	21 Men's 26 Women's	3 Men's 9 Women's			2 Men's 2 Women's	
Formal Wear	3 Men's 6 Women's	3 Men's 3 Women's	3 Women's	4 Women's		4 Women's
Camo Wear	3 Men's					
Bluetooth and MP3 Gear	3 Men's 3 Women's					

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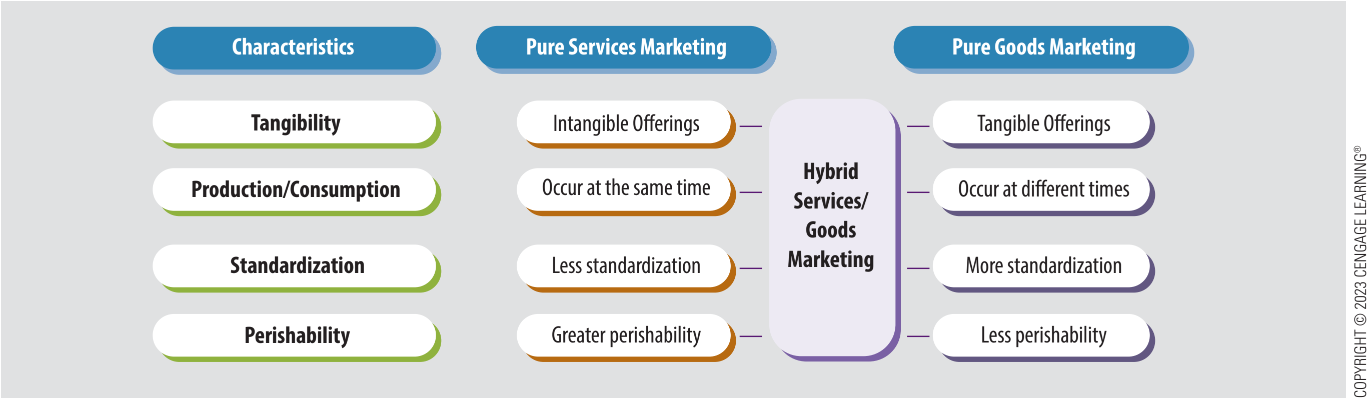
Exhibit 15.5 Services Marketing versus Goods Marketing



satisfaction, but that main feature is sometimes perceived by customers to be similar for a variety of products. In that case, complementary components become the most important features of the product. For example, a particular brand of cake mix may be preferred by consumers not because it is a better mix, but because of the unique website mentioned on the package that offers creative baking suggestions. Or a certain dry cleaner may be chosen over others because it treats customers with great care, not because it cleans clothes exceptionally well.

15-5b Product Strategy Options

Failure to clearly understand product strategy options will lead to ineffectiveness and conflict in the marketing effort. The major product strategy alternatives of a small business can be condensed into six categories, based on the nature of the firm's product offering and the number of target markets:

1. One product/one market
2. One product/multiple markets
3. Modified product/one market
4. Modified product/multiple markets
5. Multiple products/one market
6. Multiple products/multiple markets

Each alternative represents a distinct strategy, although two or more of these strategies can be attempted at the same time. However, a small company will usually pursue the alternatives in the order listed. Also, keep in mind that once a product strategy has been implemented, sales can be increased through certain additional growth tactics. For example, within any market, a small firm can try to increase sales of an existing product by doing one or more of the following:

- Convincing non-users in the targeted market to become customers.
- Persuading current customers to use more of the product.
- Alerting current customers to new uses for the product.

When small businesses add products to their product mix, they generally select related products. There are also strategies that involve unrelated products, but these can be much more difficult to pull off—even for larger firms. For example, at one time iconic motorcycle maker Harley-Davidson tried to launch its own line of fragrances

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called "Hot Road." But Harley owners apparently didn't take to the "woodsy aromas with hints of tobacco," so sales suffered and the company decided to back out of the venture.[17] Nonetheless, small businesses occasionally can make unrelated product strategies work, especially when the new product fits existing sales and distribution systems or requires similar marketing knowledge.

Adding an unrelated product to the mix to target a *new* market can be even more challenging to manage, as a business would then be attempting to sell an unfamiliar product in an unfamiliar market. However, if well planned, this approach can offer significant advantages. For example, a company that sells both snow skis and surfboards expects that demand will be high in one market or the other at all times, smoothing the sales curve and maintaining a steady cash flow throughout the year. It is tempting to take on new product opportunities—sometimes to the point of becoming overextended—but staying manageably focused is critical.

15-6 The Legal Environment

15-6 Discuss how the legal environment affects product decisions.

Strategic decisions about growth, innovation, product development, and the total product offering are always made within the guidelines and constraints of the legal environment of the marketplace. Let's examine a few of the laws by which the government protects both the rights of consumers and the marketing assets of companies.

15-6a Consumer Protection

Federal regulations on such subjects as product safety and labeling have important implications for product strategy. For example, to protect the public against unreasonable risk of injury or death, the federal government enacted the Consumer Product Safety Act of 1972. This act created the Consumer Product Safety Commission to set safety standards for toys and other consumer products and to ban and recall goods that are exceptionally hazardous, which ultimately increase the costs of doing business. This law was extended by the Consumer Product Safety Improvement Act of 2008, but its focus remains the same.[18] You can learn more about compliance requirements by consulting the webpage of the U.S. Consumer Product Safety Commission created specifically for small businesses, which can be found at cpsc.gov/Business--Manufacturing/Small-Business-Resources.

The Nutrition Labeling and Education Act of 1990 requires every food product covered by the law to have a standard nutrition label, listing the amounts of calories, fat, salt, and nutrients in the product. The law also addresses the accuracy of advertising claims such as "low salt" and "fiber prevents cancer." Even more demanding requirements specific to small businesses went into effect on January 1, 2021. (To review a side-by-side comparison of the original and revised nutrition labels, go to medallionlabs.com/blog/fda-nutrition-label-changes.) These legal requirements may seem to be a minor burden, but nutritional testing alone, which is needed to confirm labeling information, can run well over $1,300 per sample.[19]

As indicated earlier in this chapter, you can access a wealth of applicable information on the Food and Drug Administration website (fda.gov) by entering the words "labeling requirements" in the search window. Similarly, you can search for "small business exemptions" to learn more about your specific obligations under the law. These guidelines should be carefully followed to avoid problems.

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15-6b Protection of Intellectual Property

Safeguarding a company's intellectual property is critical to success. Four primary means are used by firms to protect certain proprietary assets:

1. Trademarks/Service marks
2. Patents
3. Copyrights
4. Trade dress

Trademarks

Trademark or service mark protection is important, because it safeguards a company's distinctive use of a name, word, phrase, slogan, symbol, design, logo, picture, or any combination of these. In some cases, even features such as a sound, color, motion, or scent (submitted for registration application in the form of a detailed written description) can be part of a trademark or service mark, but these *nontraditional marks* can be difficult to defend in court.[20] In essence, trademarks or service marks represent the way people identify your business.

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Because names that refer to products or services are often registered, potential names should be investigated carefully to ensure that they are not already in use. Entrepreneurs can conduct their own searches online at uspto.gov or by using any of the more than 80 United States Patent and Trademark Resource Centers that can be found in nearly every U.S. state.[21]

Small business owners often seek the advice of an attorney for assistance with trademark search and registration, which may be necessary, especially if complications arise (for example, if the desired trademark is similar to one that is already registered). Applications for registration now must be submitted online using the USPTO's Trademark Electronic Application System (uspto.gov/trademarks/apply). A schedule of filing, search, examination, and other charges can be found by entering the word "fees" in the website's search window.[22]

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Common law recognizes a property right in the ownership of trademarks. However, reliance on common-law rights is not always adequate. For example, Microsoft Corporation claimed that it had common-law rights to the trademark *Windows* because of the enormous industry recognition of the product. Nevertheless, the U.S. Patent and Trademark Office rejected Microsoft's trademark application, claiming the word was a generic term and, therefore, in the public domain.

Registration of trademarks is permitted under the federal Lanham (Trademark) Act, making protection easier if infringement is encountered. The act was amended in 1989 and now allows trademark rights to begin with merely a "bona fide intent to use" the mark, along with the filing of an application and payment of fees. Prior to this revision, a firm had to have already used the mark on goods shipped or sold.[23]

A company's federally registered trademark rights can last indefinitely, as long as the owner uses the mark continuously on or in connection with the goods and/or services to which it applies. However, it also is necessary to renew the registration with the USPTO in accordance with the mandatory schedule (filing a required form between years 5 and 6, and then a different form between years 9 and 10 and every 10 years thereafter).[24] But keep in mind that the trademark also must be enforced. Failing to take reasonable steps to prevent the illegitimate use of a mark by others, even if that means taking the infringers to court, can lead to loss of the legitimate holder's right to use it.[25]

According to the law, a business must use a trademark in order to protect it, but it is also important to *use it properly*. Inform the public that your trademark is exactly that by labeling it with the symbol ™ (℠ for a service mark). If that trademark or service mark is registered, the symbol ® should be used.

Patents

A **patent** is the registered, exclusive right of an inventor to make, use, or sell an invention. The two primary types of patents are utility patents and design patents. A **utility patent** covers the discovery or improvement of a new and useful process, machine, manufactured product, or "composition of matter." A **design patent** covers the appearance of a product and everything that is an inseparable part of the product. Utility patents are granted for a period of 20 years, while design patents are effective for 14 years (15 years if issued after May 13, 2015). Patent law also provides for **plant patents**, which cover the invention or discovery and reproduction of any distinct, new variety of living plant.[26]

To get answers to most of your patent-related questions, we suggest that you first visit the Patent and Trademark Office's "Patent FAQs" webpage (uspto.gov/help/patent-help). But because the process can be so complicated, it is advisable to use a patent attorney to prepare a patent application. Even when a patent is secured, however, the protection it provides will not be perfect. If patent infringement can be proved, the court can require monetary damages and hand down injunctions to prevent further misuse. However, just fighting these challenges can burn through cash that could be better used to fuel enterprise growth. Unfortunately, the cost of even getting to that point is often more than a small company can afford.

All patent applications are prioritized according to the "first-to-file" rule that replaced the long-standing "first-to-invent" specification in 2013. This revised standard may allow big corporations with deep pockets and more familiarity with the process to "patent early and challenge often," potentially separating resource-strapped and less-connected small companies and garage tinkerers from the inventions that they created. So, inventors need to be very careful about discussing their ideas with others, including potential investors, who might be in a position to file quickly and secure patents on those inventions first.

patent
The registered, exclusive right of an inventor to make, use, or sell an invention.

utility patent
Registered protection for a new or improved process, machine, manufactured product, or "composition of matter."

design patent
Registered protection for the appearance of a product and its inseparable parts.

plant patent
Registered protection for any distinct, new variety of living plant.

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Under the Copyright Act of 1976, copyrightable works are automatically protected from the moment of their creation. However, any work distributed to the public should contain a copyright notice. This notice consists of three elements (all of which can be found on the copyright page in the front of this textbook):[28]

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- The year the work was first published.
- The copyright owner's name.

The law provides that copyrighted work may not be reproduced by another person without authorization. Even photocopying such work is prohibited, although an individual may copy a limited amount of material for such purposes as research, criticism, comment, and scholarship. A copyright holder can sue a violator for damages.

copyright
The exclusive right of a creator to reproduce, publish, perform, display, or sell their own works.

trade dress
Elements of a firm's distinctive image not protected by a trademark, patent, or copyright.

supply chain management
A system of management through which a company integrates and coordinates the flows of materials and information needed to produce a product or service and deliver it to customers.

Trade Dress

The valuable intangible asset called **trade dress** describes those elements of a firm's distinctive operating image not specifically protected under a trademark, patent, or copyright. Trade dress is the "look" that a firm creates to establish its marketing advantage. For example, if the employees of a small pizza chain dress as prison guards and inmates, a "jailhouse" image could become uniquely associated with this business and, over time, become its trade dress.

Trade dress can be protected under trademark law if it can be shown that the design or appearance of one product is so similar to that of another that the typical consumer would be likely to confuse the two.[29] This is only one small part of the intellectual property rights picture, however. A small business needs to take measures to protect its legitimate claims to all such entitlements—that is, trademarks, service marks, patents, copyrights, and trade dress.

15-7 Explain the importance of supply chain management and the major considerations in structuring a distribution channel.

15-7 Supply Chain Management

The focus of this chapter so far has been on product development and total product strategy. However, a company's offerings are of use only to the extent that consumers have access to them. **Supply chain management** is a system of management through which a company integrates and coordinates the flows of materials and information needed to produce a product or service and deliver it to customers. It also coordinates the flow of payments between entities in the chain of transactions.

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Recent attention directed toward supply chain management has motivated firms of all sizes to create a more competitive, customer-driven supply system. Effective supply chain management can potentially lower the costs of inventory, transportation, warehousing, and packaging, while increasing customer satisfaction. This has never been more true than it is today as the Internet, with its simple, universally accepted communication standards, brings suppliers and customers together in a way never before thought possible.

In this section, we look briefly at some of the important features of supply chain management.[30] This includes the functions of intermediaries, the various distribution channels that can be folded into supply chain operations, and the basics of logistics.

15-7a Intermediaries

Intermediaries can often perform marketing functions better than the producer of a product can. A producer can handle its own distribution operations—including delivery—if the geographic area of the market is small, customers' needs are specialized, and risk levels are low. This might be the case for, say, a donut maker. However, intermediaries generally provide more efficient means of distribution if customers are widely dispersed or if special packaging and storage are needed.

Some intermediaries, called **merchant wholesalers**, take ownership of the goods they distribute, thereby helping a company to share or shift business risk. Other intermediaries, such as **agents** and **brokers**, do not take title to goods and, therefore, assume less market risk than do merchant wholesalers.

15-7b Channels of Distribution

An effective distribution system is just as important as a unique package, a clever name, or a creative promotional campaign. In the context of supply chain operations, **distribution** encompasses both the physical transfer of products and the establishment of relationships with intermediaries to achieve product movement. This system of linked connections created to guide the movement of a product is called the **channel of distribution**, and the activities involved in physically moving a product through the channel of distribution are called **physical distribution (logistics)**.

Distribution is essential for both goods (tangible products) and services (intangible products). However, since distribution activities are more visible for goods, our comments here will focus primarily on tangible products. Most services are delivered straight to the user—for example, an income tax preparer and a hairdresser serve their clients directly. Nonetheless, even the distribution of labor can involve channel intermediaries, such as when an employment agency provides a firm with temporary personnel.

A channel of distribution can be either direct or indirect. In a **direct channel**, there are no intermediaries—the product goes directly from producer to user. An **indirect channel** of distribution has one or more intermediaries between producer and user.

Exhibit 15.6 depicts the various options available for structuring a channel of distribution. E-commerce (online merchandising) and mail-order marketing are examples of direct channel systems for distributing consumer goods. As an especially cost-conscious airline, Southwest Airlines is typical of those companies that use a direct channel to customers. Whereas most of its rivals lean toward selling tickets through travel agents and online travel service distributors, Southwest has always emphasized direct booking through its own website and in-airport ticket counters and self-service kiosks. This approach reduces the firm's operating costs.

merchant wholesaler
An intermediary that takes ownership of the goods it distributes.

agents/brokers
Intermediaries that do not take ownership of the goods they distribute.

distribution
The physical movement of products and the establishment of intermediary relationships to support such movement.

channel of distribution
The system of relationships established to guide the movement of a product.

physical distribution (logistics)
The activities of distribution involved in the physical relocation of products.

direct channel
A distribution system without intermediaries.

indirect channel
A distribution system with one or more intermediaries.

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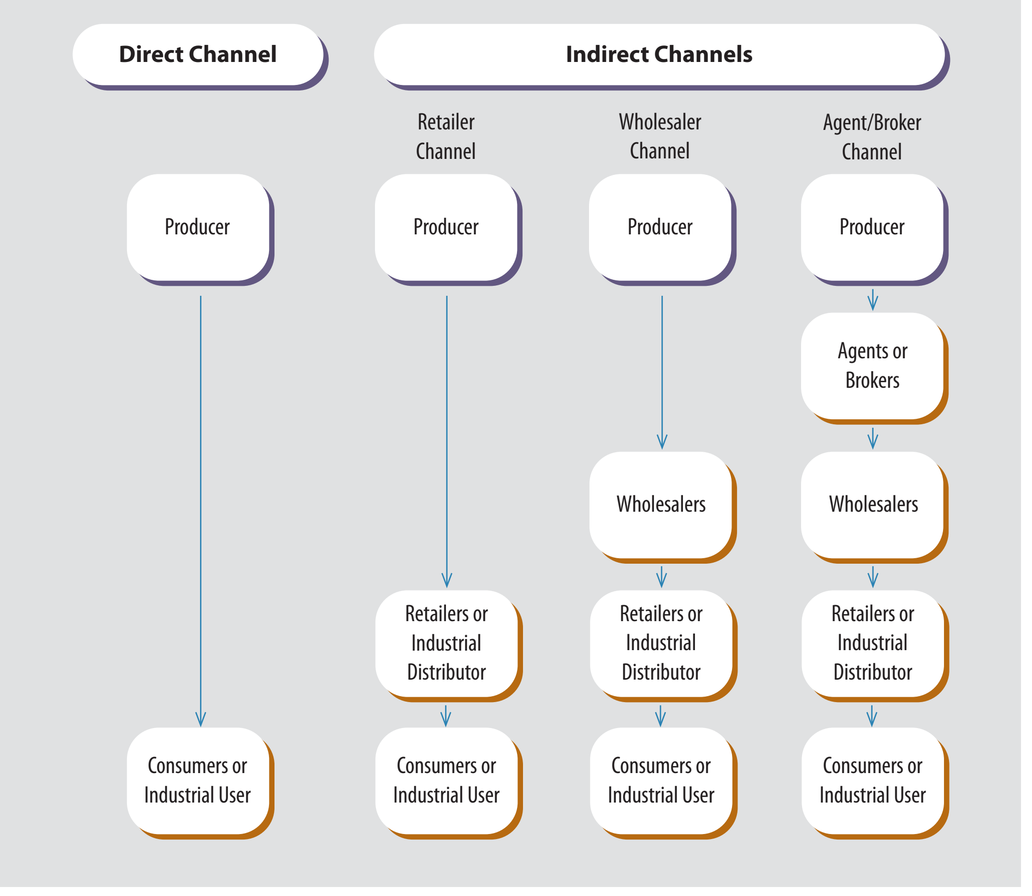
Exhibit 15.6 Channels of Distribution



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Indirect channels of distribution are shown on the right-hand side of Exhibit 15.6. Channels with two or more stages of intermediaries are typically used by companies that want to reach geographically dispersed markets. But it is also important to note that firms of any size can set up multiple channels of distribution. Those that choose this option typically work through market intermediaries to serve some of their customers while selling to others directly. This practice is called **dual distribution**.

Small businesses that successfully employ a single distribution channel may switch to dual distribution if they find that an additional channel will improve overall profitability. Alex Romanov, owner of Chagrin Shoe Leather & Luggage Repair, saw sales increase by 25 percent after the U.S. economy slowed in 2008 and Americans decided that it would be cheaper and wiser to repair their shoes than to buy new ones.

Despite the success of the business, Alex's son, Ilya, had a different but related career path in mind. Ilya didn't see himself becoming a cobbler. So, he decided instead to launch American Heelers, an online business that receives by mail about 100 pairs of shoes for repair each week. These shoes are serviced in the elder Romanov's shop and returned to their owners. Establishing this father-son partnership expanded the business by opening up two fronts for sales: a physical operation that takes orders directly from customers and an e-commerce operation that generates revenue from customers who live in other areas.[31]

dual distribution
A distribution system that involves more than one channel, most often by selling through market intermediaries and directly to other end users at the same time.

But this was not the end of the expansion generated by this shift to online sales. Customers began to mention interest in additional services that have typically been provided by local cobblers—specifically, shoe lift modifications and elevations to

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Living the Dream

"Meating" the Specific Needs of Customers

More and more small businesses are figuring out how to leverage the power of the Internet in innovative and strategic ways to compete and grow. Ricky Dollison, owner of Dollison Farms and Warrior Creek Premium Meats, has been able to transform his business in this way. His experience provides at least one model for entrepreneurs who want to add an online thrust to their ventures and sell to customers directly. But he had to overcome plenty of obstacles to get to where he is today.

Dollison Farms is a 200-acre family farm located in Poulan, Georgia. Dollison runs the business, along with his daughter, Leiandra, representing the fourth and fifth generations of the farm's ownership. The business produces several different crops, including leafy greens, peanuts, cotton, soybeans, and corn. The Dollisons also raise cattle, hogs, and chickens, all without the use of hormones, by-products, nitrates, or antibiotics. These healthy and organic meats are exactly what their customers want.

The Dollisons originally launched Warrior Creek Premium Meats as a side business. The venture produces and sells bacon, sausage, ground beef, ribeye steaks, pork tenderloins, and chicken leg quarters—all from responsibly raised livestock. Their signature product is "Whole Hog" Warrior Creek Premium Meats sausage, which they offer as links, patties, and pan sausage. These products can be found at various grocery stores throughout southwest Georgia, including Towson Meats, Snipes, Publix, and Piggly Wiggly.

With a vision to do more, the Warrior Creek team settled on the idea of expanding the reach of the business by selling their meat products online and shipping them directly to customers nationwide. But that presented a serious challenge. Figuring out how to ship perishable products in a safe way was quite different from growing and processing products.

The team had to do some quick thinking. After running through several possibilities, they eventually settled on an innovative solution. The company would use specially designed and reusable cold-shipping boxes to keep its temperature-sensitive perishables chilled and unspoiled while in transit. Once an eco-thermal box is delivered, customers simply have to transfer the meat to their freezers, reinsert all box parts for later reuse, apply the return label to the box, and have it shipped back to the company. To make sure the expensive containers are returned, the company charges its customers $120 (the cost of replacement) if they fail to send a box back within one week of delivery.

This very creative and entirely necessary solution to ship frozen food products directly to end users has been working very well. Customers who want to get meat straight from the farm now can do so when they buy the company's goods. And since they know that the meat they get has been organically grown and is free from antibiotics, it seems there is no shortage of demand. It's fair to say that the Warrior Creek team has figured out a way to "meat" customers where they are.

Sources: www.dollisonfarms.com/about, accessed February 18, 2021; "Black Farmer's Antibiotic-Free Meat Now Available in Grocery Stores and Online," *Black Business*, January 26, 2021, www.blackbusiness.com/2021/01/4th-generation-black-farmers-antibiotic-free-meat-products-available-grocery-stores.html, accessed February 18, 2021; www.warriorcreekpremiummeats.com, accessed February 18, 2021; and Shanique Yates, "Meet the Black Farmer Bringing Responsibly Raise Meat to Your Doorstep," *AfroTech*, January 28, 2021, https://afrotech.com/meet-the-black-farmer-bringing-responsibly-raised-meat-to-your-doorstep, accessed February 18, 2021.

correct for something known as leg-length discrepancy. Ilya accommodated these requests and came to realize that this would be a much better business than standard shoe repair because the margins are much greater, customers are inclined to return often for repeat business, and their satisfaction tends to run very high. So, Ilya decided it was time to add another website (orthopedicshoelift.com) to pursue more of this business. The company now serves more than 12,000 customers worldwide, generating annual sales that are reaching seven figures. More than 200 shoe-lift jobs are performed in a typical week, and Ilya has opened a warehouse from which his employees perform all the work.[32]

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A logical starting point in structuring a distribution system is to study systems used by competing businesses. Such an analysis should reveal some practical alternatives, which can then be evaluated. The three main considerations in evaluating a channel of distribution are costs, coverage, and control.

Costs

In many cases, the least-expensive channel may be indirect. For example, a firm producing handmade dolls may choose not to purchase trucks and warehouses to distribute its product directly to customers if it costs less to use established intermediaries that already own such equipment and facilities. Small companies should look at distribution costs as an investment—spending money in order to make money—and ask themselves whether the cost of using intermediaries (by selling the product to them at a reduced price) is more or less expensive than distributing the product directly to customers.

Coverage

Small businesses can often use indirect channels of distribution to increase market coverage. Suppose a small manufacturer's internal sales force can make 10 contacts a week with final users of the venture's product. Creating an indirect channel with 10 industrial distributors, each making 10 contacts a week, could expose the product to 100 final users a week.

Control

A direct channel of distribution is sometimes preferable because it provides more control. To ensure that the product is marketed with care, an entrepreneur must deliberately select intermediaries that provide the desired support.

A small business that chooses to use intermediaries to market and distribute its product must be sure that the intermediaries understand how the product is best used and why it's better than competitors' offerings. Additionally, if a wholesaler carries competing products, an entrepreneur must be sure that their product gets its fair share of marketing efforts. An intermediary's sloppy marketing support and insufficient product knowledge can undermine the success of even the best product.

15-7c The Scope of Physical Distribution

As mentioned earlier, in addition to the intermediary relationships that make up a channel of distribution, there must also be a system of *physical distribution (logistics)*, the activities that physically move a product through a channel. The main component of physical distribution is transportation. Other components include storage and materials handling, delivery terms, and inventory management. (Inventory management is discussed in Chapter 21.)

Transportation

The major decision regarding physical transportation of a product is which method to use. Available modes of transportation are traditionally classified as airplanes, railroads, trucks, pipelines, and waterways. Each mode has unique advantages and disadvantages. For example, the train operator CSX Corporation has run radio ads that boldly announce, "Nature is spectacular, and we want to keep it that way. That's why CSX trains move one ton of freight nearly 500 miles on a single gallon of fuel."[33] The purpose of the ad campaign is twofold—to let potential customers know that the

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company offers inexpensive transportation services that also minimize environmental impact. But the choice of a specific mode of transportation is usually based on several criteria: relative cost, transit time, reliability, capability, accessibility, and traceability.

Transportation intermediaries are legally classified as common carriers, contract carriers, and private carriers. **common carriers** are available for hire by the general public, without discrimination. Like common carriers, **contract carriers**, which engage in individual contracts with shippers, are subject to regulation by federal and/or state agencies; however, they have the right to choose their clients at will. Transport lines owned by shippers are called **private carriers**.

Storage and Materials Handling

Lack of space is a common problem for small businesses. But when a channel system uses merchant wholesalers, ownership of the goods is transferred, as is responsibility for the storage function. With other options, the small business must plan for its own warehousing. If a firm is too small to own a private warehouse, it can rent space in a public warehouse. When storage requirements are simple and do not involve much special handling equipment, a public warehouse can provide inexpensive storage.

Even if it is in the right place at the right time, a damaged product is worth very little. Therefore, a physical distribution system must arrange for suitable materials-handling methods and equipment. Forklifts, as well as special containers and packaging, are part of a materials-handling system.

Delivery Terms

A small but important part of a physical distribution system is the delivery terms, specifying which party is responsible for several aspects of the distribution. Delivery terms include paying the freight costs, selecting the carriers, bearing the risk of damage in transit, and selecting the modes of transport.

The simplest delivery terms—and the most advantageous to a small business as the seller—is F.O.B. (free on board) origin, freight collect. This shifts all of the responsibility for freight costs to the buyer. Ownership of the goods and risk of loss also pass to the buyer at the time the goods are shipped.

Logistics companies specialize in transportation and distribution services, providing trucking, packaging, and warehousing services for small and medium-size companies with limited in-house staff. Many small businesses are finding that using **third-party logistics firms (3PLs)** is more cost effective than carrying out the same functions on their own.

To provide a case in point, Rick Platt started Sky Zone in 2002 as a trampoline park, a venture that he passed on to his son, Jeff, four years later.[34] To maintain lofty hygiene standards in its parks, all bounce-seeking guests are required to wear "SkySocks" while jumping. But when the company entered a rapid growth spurt, it soon found that it was having to sell nearly 10 million pairs a year to keep up with demand. At the time, Sky Zone had been shipping the socks from its warehouse on the West Coast. However, that was becoming expensive, so Jeff decided to sign on with a third-party logistics operator in Ohio that would ship the product to parks in the Midwest and East Coast (a region representing more than three-fourths of the company's parks). And he is glad he did! Putting pencil to paper, Jeff figures that the company was able to save more than $120,000 a year by making this one simple change.[35]

More familiar firms offering 3PL services include household names such as FedEx and UPS. These fulfillment companies, among others, can provide customized assistance to small businesses that would prefer to focus on their primary operations and leave the transportation and distribution challenges to others.

common carriers
Transportation intermediaries available for hire to the general public.

contract carriers
Transportation intermediaries that contract with individual shippers.

private carriers
Lines of transport owned by shippers.

third-party logistics firm (3pl)
A company that provides transportation and distribution services to firms that prefer to focus their efforts on their primary operations.

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As this chapter explains, innovation and growth are critical to competitive advantage and small business success. For this reason, a company's efforts to maintain existing products and develop new ones should be wisely managed according to a carefully devised product strategy. But it doesn't stop there. Thought must also be given to all facets of the physical flow of inputs and outputs. Managing the supply chain requires planning for how and where the firm will get components for the products it produces and how it will deliver the finished products to customers. Though many channels of distribution exist, each has benefits and drawbacks and must therefore be considered carefully. In the end, if all of these vitally important tasks are not managed effectively, the performance of the company is almost certain to decline.

15-1. Recognize the challenges associated with the growth of a small business.

- Some entrepreneurs find that maintaining the status quo is challenge enough and thus choose not to grow their ventures.
- A business's reputation may be damaged if it is unable to deliver on time or with the level of quality promised, or if it must turn down an order because it can't handle the volume.
- A growth trap may occur when a firm's growth soaks up cash faster than it can be generated.
- Growing a business too quickly can be stressful for a small firm's owners and personnel.

15-2. Explain the role of innovation in a company's growth.

- As evidence of their innovative capacity, small entrepreneurial firms produce 16 times more patents per employee than large firms.
- The risk of failure increases when innovation is the goal.
- An entrepreneur can reduce the risk of innovation by basing innovative efforts on experience, targeting products or services that have been overlooked, validating a market for the product or service, emphasizing value creation for customers, pursuing new ideas that will lead to more than one product or service, and raising sufficient capital before launching a new product or service.
- Innovation is a means by which a firm can achieve and sustain a competitive advantage.
- The competitive advantage life cycle has three stages: develop, deploy, and decline.
- High-performing companies have an awareness of "hidden curves" related to their competitors, their own internal capabilities, and the capabilities and motivations of their employees.

15-3. Identify stages in the product life cycle and the new product development process.

- The product life cycle portrays the sales and profits of an individual product or service from introduction through growth and maturity to sales decline.
- The new product development process has four stages: idea accumulation, business analysis, development of the physical product, and product testing.

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- When conducting a business analysis on a new product, the following four factors should be considered: its fit with existing product lines, its development and introduction costs, the personnel and facilities available to get it started, and its competition and market-acceptance potential.
- New technologies are making the creation of a working prototype for a new product much more manageable.
- Product testing determines whether a product is safe, effective, durable, etc.
- A new product development process is much more likely to succeed if it is focused on the firm's customers.

15-4. Describe the building of a firm's total product.

- Components of a total product offering include branding, packaging, labeling, and warranties.
- The intangible brand image component is important to consumers' acceptance of a firm's total product offering.
- A brand name should be easy to pronounce and remember, descriptive, eligible for legal protection, full of promotional possibilities, and suitable for use on several product lines. It should also lead to a domain name that is relatively inexpensive to acquire.
- In order to develop an effective but inexpensive logo, be simple, design for visibility, leave room for interpretation, emphasize consistency, recognize the importance of logo design, get good design advice, and don't expect miracles.
- *Trademark* and *service mark* are legal terms referring to a company's exclusive right to use a brand to represent products and services, respectively.
- Packaging is a significant tool for increasing total product value.
- A label is an important informative tool, providing instructions on product care and use, as well as brand visibility.
- A warranty is important for products that are innovative, comparatively expensive, purchased infrequently, complex to repair, or positioned as high-quality goods.

15-5. Understand product strategy and the alternatives available to small businesses.

- Product strategy describes how a product is used to achieve a firm's goals and involves the product item, product line, product mix, and product mix consistency.
- Marketing services presents unique challenges not faced when marketing goods.
- There are six categories of major product strategy alternatives, which are based on the nature of the firm's product offering and the number of target markets.

15-6. Discuss how the legal environment affects product decisions.

- Federal legislation regarding labeling and product safety was designed to protect consumers.
- Meeting the legal requirements for labeling can cost thousands of dollars per product.
- The legal system provides protection for a firm's intellectual property through trademarks and service marks, patents, copyrights, and trade dress.
- According to the law, businesses must use a trademark or service mark in order to protect it, but they must also use it properly.
- New procedures in the patent approval process are not always kind to small businesses, and lawsuits concerning patent infringement can be costly.
- Copyrighted work may not be reproduced without authorization.
- A firm can use the law related to trade dress to protect its unique operating image.

15-7. Explain the importance of supply chain management and the major considerations in structuring a distribution channel.

- Effective supply chain management can potentially lower the costs of inventory, transportation, warehousing, and packaging, while increasing customer satisfaction.
- Intermediaries provide an efficient means of distribution if customers are widely dispersed or if special packaging and storage are needed.
- Distribution encompasses both the physical movement of products and the establishment of intermediary relationships to guide the movement of products from producer to user.
- A distribution channel can be either direct or indirect, and many small businesses successfully employ more than one channel of distribution.
- Costs, coverage, and control are the three main considerations in evaluating a channel of distribution.
- Transportation, storage and materials handling, delivery terms, and inventory management are the main components of a physical distribution system.
- Small companies with limited in-house staff sometimes find it helpful to use third-party logistics firms for their transportation and distribution needs, as these vendors provide trucking, packaging, and warehouse services.

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Key Terms

agents/brokers p. 407
brand p. 396
brand image p. 396
brandmark p. 398
brand name p. 397
channel of distribution p. 407
common carriers p. 411
contract carriers p. 411
copyright p. 406
design patent p. 405
direct channel p. 407
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dual distribution p. 408
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merchant wholesalers p. 407
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service mark p. 399
supply chain management p. 406
sustainable competitive advantage p. 389
third-party logistics firm (3PL) p. 411
trade dress p. 406
trademark p. 399
utility patent p. 405
warranty p. 400

Discussion Questions

1. What limitations on growth should a small business owner consider?
2. What can a small business do to reduce the risk associated with innovation efforts?
3. How can an understanding of the product life cycle concept help with the crafting of an effective product development strategy?
4. Identify and describe the stages that are involved in the product development process.
5. What are the primary components of a total product offering? Describe the importance of each of these components to the success of a new or existing product.
6. What are the six rules that apply generally to the selection of a good product name?
7. What is meant by each of the following terms: product line, product mix, and product consistency? How are these terms related to a small company's product strategy options?
8. In what ways can a small company manage trademarks or service marks, copyrights, patents, and trade dress to protect its brand image? To protect the business itself?
9. Why should small businesses consider indirect channels of distribution for their products? Why involve intermediaries in distribution at all?
10. What major considerations should be factored into decisions regarding the structuring of a channel of distribution?

You Make the Call

Situation 1

The world's first elliptical bike, called the ElliptiGo, was invented by mechanical engineer and Ironman athlete Brent Teal and his friend, fellow cyclist and triathlete Bryan Pate, who had so much pain from knee and hip injuries that he was forced to limit his exercise activity to low-impact options. Because Pate wanted to continue exercising but hated being locked away in a gym, he and Teal came up with the new product concept, a low-impact running device that could be ridden on the street. The ElliptiGo is a mix between an elliptical trainer and a standard bicycle, but with multiple-speed models that can make the ride as leisurely as a stroll or as aggressive as a full-out cycling workout. It has been described as having "the sleek curves of a high-end road bike, the clean lines of a Razor scooter, a pair of shiny carbon-fiber elliptical pedals, a smooth hub-and-crank stride mechanism and a steering column that collapses for easy storage." Check it out for yourself at elliptigo.com.

Sources: Based on https://www.elliptigo.com/about, accessed July 1, 2021; "On Your Left!," https://www.elliptigo.com/press/on-your-left-2, accessed July 1, 2021; and Jennifer Wang, "A Profitable Alternative to the Bicycle," http://www.entrepreneur.com/article/207532, accessed July 1, 2021.

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Question 1 Using the rules of thumb for reducing the risks related to introducing an innovative new product, how well are Teal and Pate likely to do with the ElliptiGo?

Question 2 What are the primary benefits and drawbacks of this innovation?

Question 3 What can Teal and Pate do to sustain or extend their competitive advantage with this new product?

Situation 2

Tomboy Tools provides tools for women who want to do their own home improvement and repair projects. The company's founders, friends Mary Tatum and Janet Rickstrew, were concerned that the tools they used for home repair projects were designed for men, not women. So, they decided to do something about it by starting a new venture. Tomboy Tools has taken some interesting twists and turns over the years, but its mission statement has not deviated from the original sentiment of its founders: "To build confidence and empower women through education, quality tools, and an independent business opportunity." What is most interesting about the venture is how the products are sold—exclusively through in-home workshops led by independent sales representatives. But instead of Tupperware or cosmetics, guests see basic home repair tools in action and learn simple home repair and improvement techniques. The company's founders chose the in-home approach to market their products because of its proven success with consumers, particularly women.

Source: Based on "Tomboy Tools," https://www.linkedin.com/company/tomboy-tools, accessed July 1, 2021; https://www.tomboytools.com/about-us, accessed July 1, 2021; and Women for Hire, "Tomboy Tools," http://womenforhire.com/tools-direct_sales-work_from_home/tomboy_tools, accessed July 2, 2021.

Question 1 What are the advantages and disadvantages of the in-home method of selling Tomboy Tools products?

Question 2 What other channels of distribution should Tomboy Tools consider?

Question 3 What do you think about the name "Tomboy Tools"? Does it create a positive impression for the company?

Situation 3

Chris Sugai owns Niner Bikes, a 15-year-old mountain bike company in Fort Collins, Colorado. With products that range in price from around $2,000 to more than $10,000, the models he sells are not garden-variety two-wheelers. These bikes are for the serious rider who is really into mountain biking and the buzz and conversation that goes along with being a part of the Niner community. There must be many such enthusiasts out there, because business has increased impressively in recent years.

But with growth comes new hassles, especially on the supply chain end of things. For example, Sugai had been depending on a third-party logistics provider to store and deliver his bikes. More recently, though, he started to think it would be better to bring the operation in-house. He figured the company had enough employees to handle the change, even though it would cost about $85,000 to buy the software, scanners, forklifts, and more that would be needed. Sugai might have to hire a few more employees to make the transition possible, but that should be very manageable for a company that is growing at such a rapid pace. And the up-front investment would probably pay for itself in no time. It would definitely make life more complicated, though.

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Question 1 What are the advantages that Sugai will likely gain if he decides to bring inventory storage and bike delivery in-house?

Question 2 What complications might arise if Sugai makes this change? What might he have to give up if he should choose the new approach?

Question 3 On balance, do you think that converting to an in-house operation would be the way to go? Why or why not? Put together the best case you can to support your decision.

Chapter 15 Case

Please see Appendix A for the Chapter 15 Case Study.

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ROBERT KNESCHKE/SHUTTERSTOCK.COM

Chapter 16

Pricing and Credit Decisions

Looking Ahead

Learning Objectives

The pricing decisions and the credit decisions of small firms, both of which are vital to a firm's success, are examined in the Pricing and Credit Decisions chapter. By studying this chapter, you should be able to . . .

16-1 Discuss the role of cost and demand factors in setting a price.

16-2 Apply break-even analysis and markup pricing.

16-3 Identify specific pricing strategies.

16-4 Explain the benefits of credit, factors that affect credit extension, and types of credit.

16-5 Describe the activities involved in managing credit.

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Spotlight on Small Business

The Barefoot Spirit

https://thebarefootspirit.com/

SHEILA FITZGERALD/SHUTTERSTOCK.COM

"Every day, bam, smacked in the head by a brick. You think you've got something figured out, then, bam, there's a new brick." Michael Houlihan turned problems into a rallying cry: "Have you had your brick for the day?" The message he was sending to his staff was "Keep your eyes open; there's always a surprise coming."

Those who take a course in small business management or entrepreneurship are told to learn as much as possible about the business they want to own—that is, know the product, the industry, and the customer. Michael Houlihan did none of that. Houlihan and his partner, Bonnie Harvey, found themselves somewhat accidental owners of a winery. Houlihan had done some consulting with wine companies, helping them with contracts, finding financing, and negotiating with government agencies. Harvey owned an office management company, and one of her clients supplied grapes to wineries. A customer of the grape producer was going into bankruptcy and could not pay the producer's bill. Houlihan and Harvey offered to take over the facility and produce the wine to offset the debt. In 1986, without intending to create a permanent business, they found themselves the owners of what is today Barefoot Cellars.

When Houlihan and Harvey later described their entrepreneurial venture, they stated that they never wasted a good mistake. And they made plenty as they learned about state and federal regulations, manufacturing processes, dealing with distributors, promotional strategies, and more. Cost control and product pricing proved to be challenging.

The first lesson they learned was about what customers were willing to pay. Their brand was unknown, and they were not going after the high-end market. The target customer was a housewife shopping for a $5 bottle of wine to take home to serve at dinner. That meant Houlihan and Harvey had to work backward to make sure that they could produce a bottle for less than the retail price. And they discovered that controlling costs was more than just turning grapes into wine and putting it in bottles. States have their own regulations for wine sales, which have to be met. Some retail outlets will buy directly from producers, while others choose to work only with distributors. Houlihan and Harvey found out that there was an industry practice of legally paying extra commissions, called *spiffs*, to distributor representatives in order to get special attention. And they learned about something they labeled the "velocity price point," which led to the discovery that the volume they could sell was vastly different at certain price points.

Initially, selling a bottle at $4.99 generated far more sales than did their experiments at $5.99 and $6.99. They also followed the necessary practice of giving away bottles to gain access to some stores. That, in turn, led them to give away bottles at charity events, which helped them build brand image. But the sales revenue had to cover the costs of the giveaways.

The team built a successful business over time, leading the company to become attractive to others in the industry. In 2005, Barefoot was acquired by E. & J. Gallo Winery. Houlihan and Harvey have become champions for entrepreneurship through their company, The Barefoot Spirit. They published a book about their experiences and are now on the talk circuit, sharing the insights they gained as entrepreneurs.

Sources: Bonnie Harvey, Michael Houlihan, and Rick Kushman, *The Barefoot Spirit: How Hardship, Hustle, and Heart Built America's #1 Wine Brand* (Ashland, OH: Evolve Publishing, 2013); http://thebarefootspirit.com/about, accessed July 14, 2021; Robert Reiss, "The Incredible Story of Starting the World's Largest Wine Brand," http://www.forbes.com/sites/robertreiss/2014/12/09/the-incredible-story-of-starting-the-worldslargest-wine-brand-barefoot-wines, accessed July 14, 2021; and "Barefoot with Us," https://www.barefootwine.com/, accessed July 14, 2021.

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Houlihan and Harvey had enough experience from their consulting and property management companies to know that pricing and credit decisions are vital to the success of a company. They are more than just collecting sales and paying bills. These decisions influence the relationship between a business and its customers. If you start with prices too low to cover your costs, you can expect that your customers won't be happy with price increases or restrictive credit policies.

Very few business owners have any formal training in how to set the prices for the products and services they sell. Many times, their prices are based on what competitors are charging, on some percentage above their costs, or on what their suppliers suggest. All too often, new business owners think that their path to success is to undercut competitors' prices. Later in this chapter, we will explain why that can be dangerous. Don't be fooled by the Barefoot Wine example. Houlihan and Harvey were not trying to beat their competitors' prices. They made a strategic pricing decision based on the market segment they identified.

Keep one thing in mind: *Value should always be at the heart of a pricing strategy.* Think of **value** as representing "the most important components of your offering, how you relieve pain and create gains for your customers."[1] The **price** of a product or service specifies what the seller requires in exchange for giving up ownership or use of that product or service. Often, the seller must extend credit to the buyer in order to make the exchange happen. **Credit** is an agreement between a buyer and a seller specifying that payment for a product or service will be received at some later date.

16-1 Setting a Price

16-1 Discuss the role of cost and demand factors in setting a price.

In setting a price, a business owner decides on the most appropriate value for the product or service being offered for sale. There is no magic formula for calculating the precise match of price and value, but that does not mean you should ignore the numbers. The first pricing lesson is to remember that total sales revenue depends on just two components—sales volume and price—and even a small change in price can drastically influence revenue. Consider the following situations for products being sold, assuming no change in demand:

Situation A

Quantity sold	×	Price per unit	=	Gross revenue
250,000	×	\$3.00	=	\$750,000

Situation B

Quantity sold	×	Price per unit	=	Gross revenue
250,000	×	\$2.80	=	\$700,000

The price per unit is only \$0.20 lower in Situation B than in Situation A. However, the total difference in revenue is \$50,000! A small business can lose significant revenue if a price is set too low.

Pricing is also important because it indirectly affects sales quantity. Setting a price too high for the value being offered may result in lower quantities sold, reducing total revenue. In the example just provided, quantity sold was assumed to be independent of price—and it very well may be for such a small price difference. However, a larger price increase or decrease might substantially affect the quantity sold. It makes no sense to lower a price if you wind up selling the same number of products. On the other hand,

value
The most important components of your offering, how you relieve pain and create gains for your customers.

price
A specification of what a seller requires in exchange for transferring ownership or use of a product or service.

credit
An agreement between a buyer and a seller that allows for delayed payment for a product or service.

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it makes no sense to raise your price if the result is a big cut in sales. Pricing, therefore, has a dual influence on total sales revenue. It is important directly as part of the gross revenue equation and indirectly through its impact on demand.

16-1a Know the Costs When Setting Your Prices

One of the first lessons learned by Michael Houlihan and Bonnie Harvey when they started selling wine (refer to the Spotlight feature) was that they had to figure out right away what their target customer was willing to pay. For a business to survive in the long run, however, its prices must cover the costs of providing products or services, plus provide a profit margin that sustains the company and moves it forward.

Costs often vary as the quantity produced and sold increases or decreases. Recall from Chapter 10 that *the cost of goods sold increases as the quantity of products sold increases*. Material costs and sales commissions are typical variable costs incurred as a product is made and sold. For instance, material costs may be $10 per unit. If the company sells 1,000 units, the total cost of goods sold would be $10,000, but that figure would change if the number of units increases or decreases.

Operating expenses remain relatively constant at different levels of quantity sold (fixed costs). Marketing expenses, factory equipment costs, and salaries of office personnel are typically operating expenses. Service organizations handle operating expenses in ways similar to those of product companies. Their cost of sales, however, is often harder to define than the cost of goods sold. One frequently used metric for services is to calculate a figure for the time spent providing a service to the customer. Some owners combine hourly personnel costs with a percentage of the operating expenses.[2]

An understanding of the nature of different kinds of costs can help a seller minimize pricing mistakes. Although the cost of goods sold and the cost of sales and operating expenses do not behave in the same way, small businesses often treat them identically. An approach called **average pricing** exemplifies this practice. With average pricing, the total cost (cost of goods sold plus operating expenses) over a previous period is divided by the quantity sold in that period to arrive at an average cost, which is then used to set the current price. For example, consider the cost structure of a firm selling 25,000 units of a product in 2022 at a sales price of $8 each (refer to Exhibit 16.1). The average unit cost would be $5 [$125,000 ($50,000 + $75,000) in total costs ÷ 25,000 units sold]. The $3 markup provides a profit at this sales volume $\left(25{,}000 \text{ units sold} \times \$3 \text{ markup} = \$75{,}000\right)$.

Note, though, that Exhibit 16.2 shows a negative impact on profits if sales in 2023 reach only 10,000 units and the selling price has been set at the same $3 markup, based

Exhibit 16.1 **Cost Structure of a Hypothetical Firm, 2022**

Sales revenue (25,000 units @ $8)	$200,000
Cost of goods sold ($2 per unit)	(50,000)
Gross profits	$150,000
Operating expenses	(75,000)
Net profits (before interest and taxes)	$ 75,000

$$\text{Average cost} = \frac{(50{,}000 + 75{,}000)}{25{,}000} = \$5$$

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average pricing
An approach in which the total cost for a given period is divided by the quantity sold in that period in order to set a price.

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Exhibit 16.2 Cost Structure of a Hypothetical Firm, 2023

Sales revenue (10,000 units @ $8)	$ 80,000
Cost of goods sold ($2 per unit)	(20,000)
Gross profits	$ 60,000
Operating expenses	(75,000)
Net profits (before interest and taxes)	$ (15,000)

$$\text{Average cost} = \frac{(20{,}000 + 75{,}000)}{10{,}000} = \$9.50$$

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on the average cost. At the lower sales volume (10,000 units sold), the average unit cost increases to $9.50 ($95,000 ÷ 10,000). This increase is, of course, attributable to the need to spread operating expenses over fewer units. *Average pricing overlooks the reality of higher average costs at lower sales levels*. Be cautious about taking this approach.

On rare occasions, pricing at less than total cost can be used as a special short-term strategy. Operating expenses tend to be ongoing, regardless of how much production or provision of services is occurring. When sales revenue is down, pricing should cover all marginal or incremental costs—that is, those costs incurred specifically to get additional business. Keep in mind the old business saying, "If you price below cost, you can't make it up in volume!" For example, you might bid on a contract that appears to offer a high price only to discover that you have to add personnel, equipment, or materials whose costs are more than that attractive price. Sometimes, business owners offer *loss leaders*, merchandise they intentionally sell below the direct product cost with the expectation that customers will buy more of other products and services that the business has available. It can be unpleasant to discover that the loss leader was the only thing customers bought—no profit there. In the long run, all costs must be covered.

Some businesses use a **freemium** (a combination of the words "free" and "premium") **strategy**, with the idea that customers will accept basic features at no cost and then seek advanced products or services at a subscription price. As with loss leaders, it is critical that enough customers upgrade—in this case, to offset what the company is giving away.[3] Many new businesses try this strategy when the owners feel that customers are not willing to take a chance by paying for the new products or services being offered.

freemium strategy
A strategy that offers customers basic features at no cost based on the idea that they will upgrade to advanced products or services at subscription prices.

16-1b Pricing Starting with Customers

Cost analysis can identify a level below which a price should not be set under normal circumstances. However, it does not show by how much the final price might exceed that minimum figure and still be acceptable to customers. In Chapter 7, we stressed how critical it is to identify the customer segment for which you can offer a value proposition. Factors in demand by customers must be considered before making the price determination.

Elasticity of Demand

Customer demand for a product or service is often sensitive to the price level. Elasticity is the term used to describe this sensitivity, and the effect of a change in price on the quantity demanded is called **elasticity of demand**. A product or service is said to have **elastic demand** if an increase in its price lowers demand for the product or service or a decrease in its price raises demand. A product or service is said to have

elasticity of demand
The degree to which a change in price affects the quantity demanded.

elastic demand
Demand that changes significantly when there is a change in the price of a product or service.

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Living the Dream

You Can Have My Business Plan!

Ernst Gemassmer and Martin Zwilling both enjoyed professional and financial success with various high-tech companies. They each reached a point where they decided it was time to give back and started sharing what they had learned with new venture founders. Sharing included providing information about making investments, serving on boards, coaching, and more.

Their work opened Gemassmer and Zwilling's eyes to a consistent problem that entrepreneurs were encountering. High-tech ventures often had growth potential but were getting turned down as they attempted to obtain the capital they needed to fund the growth. In fact, Gemassmer and Zwilling found that business owners seeking financing from angel investor groups and venture capitalist firms were unsuccessful more than nine out of ten times when they asked for money. Often, the failure rate was more a function of an inexperienced management team or lack of preparation than of the company's product or service. That observation led them to create Startup Professionals, a firm providing services to new venture founders, designed to "help you make your business dreams a reality, without breaking your budget!"

Zwilling used a blogging strategy to introduce Startup Professionals to prospective customers and clients. His blogs gave readers practical advice, frequently providing succinct, point-by-point summaries from publications of other experts. A number of publishers found his blogs to be appealing to their readers. Zwilling's write-ups were regularly reprinted in *Entrepreneur, Forbes, Fortune, Huffington Post, Inc.* magazine, and others. Those reprints attracted budding entrepreneurs to the Startup Professionals website.

When a prospect hits the website, they are immediately exposed to *freemiums,* products that Zwilling and Gemassmer make available at no charge. By using the free products, entrepreneurs are able to determine if Startup Professionals' other products might be worth paying for. Freemiums include examples of nondisclosure agreements, financial plans, business plans, and more.

The freemiums also serve as screening devices for Zwilling and Gemassmer. An entrepreneur who tries the free products and wants more shows potential as a paying client seeking professional advice for obtaining venture funding. For $100, an entrepreneur can purchase an Early Stage Startup Starter Kit. The kit consists of software and templates for preparing financial and business plans, a tutorial on preparing a pitch for investors, and a copy of one of Zwilling's books. (Zwilling compiled three books based on his blogs: *StartupPro: How to Set Up and Grow a Tech Business, Do YOU Have What It TAKES to Be an Entrepreneur?,* and *Attracting an Angel: How to Get Money from Business Angels and Why Most Entrepreneurs Don't.*)

For very serious entrepreneurs, the next product level is the preparation of an investment-grade financial plan for $2,000. Prices increase for additional products, up to $5,000 for an investment-grade business plan. Buyers can expect up to 100 hours of time from the professional advisers for assistance on such a plan.

There is no secret to the strategy for Startup Professionals. Their path to success hinges on their ability to help others succeed.

Sources: "Welcome to Startup Professionals," https://startupprofessionals.com/index.html, accessed July 24, 2021; Martin Zwilling, "How to Stretch Your Comfort Zone For Business Success," https://www.forbes.com/sites/martinzwilling/?sh=475ecf4a2e59, accessed July 24, 2021; and Martin Zwilling, "Startup Professionals Musings," https://www.inc.com/author/martin-zwilling, accessed July 24, 2021.

inelastic demand if demand does not change significantly when there is a change in the price of the product or service.

inelastic demand
Demand that does not change significantly when there is a change in the price of a product or service.

In some markets, the demand for products or services is very elastic. With a lower price, the amount purchased increases sharply, thus providing higher revenue. For example, with many electronic products, a decrease in price will frequently produce a more than proportionate increase in quantity sold, resulting in higher total revenue. For products such as milk, however, demand is highly inelastic. Regardless of price, the quantity purchased will not change significantly, because consumers use a fixed amount of milk.

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The concept of elasticity of demand is important because the degree of elasticity sets limits on or provides opportunities for higher pricing. A small firm should seek to distinguish its product or service in such a way that small price increases will incur little resistance from customers and thereby yield increasing total revenue. Keep in mind the word we introduced at the beginning of this chapter: *value*. Customers are ready to pay higher prices when they perceive that a product or service offers greater value than other choices.

Some business owners experiment beyond small price increases or decreases. One tactic that is gaining more and more attention is surge, or dynamic, pricing. Movie theaters that offer low prices during the day and then boost them at night when more people are in attendance provide an example of surge pricing. A company receiving a lot of attention for its surge pricing policy is Uber, a firm that represents the gig economy to many people. Uber connects riders and drivers via its app. Passengers are accustomed to seeing meters in taxis that calculate charges, often regulated by a municipality. Uber, on the other hand, raises the price dramatically during periods of high demand.[4]

Pricing and a Firm's Competitive Advantage

Several factors affect the attractiveness of a product or service to customers. One factor is the firm's competitive advantage—a concept discussed in Chapter 3. Consumers are likely to demand more of a product or service if they perceive it as an important solution in meeting their unsatisfied needs.

Companies want prospective buyers to see their products as special. But even if two products are physically similar, other factors typically differ. Speed of service, credit terms offered, delivery arrangements, personal attention from a salesperson, and warranties are a few of the factors that can be used to distinguish one product from another. A unique and attractive combination of products and services may well justify a higher price. A pricing tactic that often reflects a competitive advantage is **prestige pricing**, or setting a high price to convey an image of high quality or uniqueness.

A strong brand image is typically associated with prestige pricing. Some business owners think that a clever name is sufficient to establish the brand in people's minds. Do not underestimate the time and expense necessary to create a positive brand image. The influence of prestige pricing varies from market to market, from product to product, and from service to service.

16-2 Applying a Pricing System

16-2 Apply break-even analysis and markup pricing.

In order to properly evaluate a pricing system, a small business owner must understand potential costs, revenue, and product demand. A key to that understanding is the ability to determine when enough products and services have been sold to cover the operating expenses of running the business—or, more simply, the ability to recognize the break-even point.

prestige pricing
An approach based on setting a high price to convey an image of high quality or uniqueness.

16-2a Break-Even Analysis

Break-even analysis has two phases: (1) examining cost-revenue relationships, and (2) incorporating sales forecasts into the analysis. It allows the entrepreneur to compare alternative cost and revenue estimates in order to determine the acceptability of each price. Break-even analyses are usually represented by formulas and graphs, which help owners visualize how their businesses are functioning.

break-even analysis
Analysis that requires the examination of cost-revenue relationships and the incorporation of sales forecasts.

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Examining Cost-Revenue Relationships

The objective of the first phase of break-even analysis is to determine the sales volume level at which the product, at an assumed price, will generate enough revenue to start earning a profit. Exhibit 16.3(a) presents a simple break-even chart reflecting this comparison. Fixed costs, or operating expenses, as represented by a horizontal line in the bottom half of the graph, are \$300,000. The section for the variable costs of making and selling the products, or cost of goods sold, is a triangle that slants upward, depicting the direct relationship of variable costs and expenses to output. In this example, variable costs are \$5 per unit. The entire area below the upward-slanting total cost line represents the combination of fixed and variable costs and expenses. The distance between the sales and total cost lines reveals the profit or loss position of the company at any level of sales. The point of intersection of these two lines is called the **break-even point**, because total sales revenue equals total costs and expenses at this sales volume. As shown in Exhibit 16.3(a), the break-even point in units is approximately 43,000 units sold, which means that the break-even point in dollar revenue is roughly \$514,000.

Exhibit 16.3(a) shows how you can visualize the break-even concept. Another way to think of it is as a simple math equation:

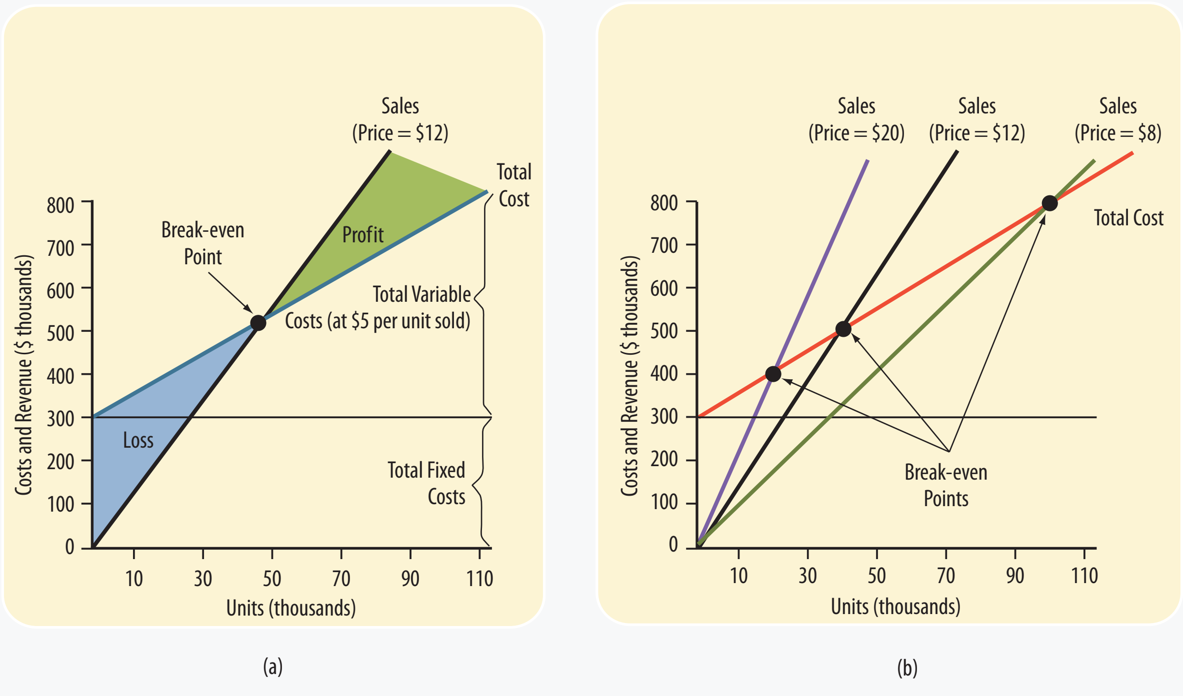
$$\text{Break-even point} = \frac{\text{Total fixed operating costs and expenses}}{\text{Unit selling price} - \text{Unit variable costs and expenses}}$$

$$\text{Break-even point} = \frac{\$300{,}000}{\$12 - \$5} = 42{,}857 \text{ units}$$

break-even point
Sales volume at which total sales revenue equals total costs and expenses.

We can now see that the exact break-even point in units sold is 42,857. And given the \$12 sales price, the dollar break-even point is \$514,284 (\$12 sales price per unit × 42,857 break-even units sold).

Exhibit 16.3 Break-Even Graphs for Pricing



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This example shows that the break-even point is a function of (1) the firm's total fixed operating costs and expenses (numerator) and (2) the unit selling price less the unit variable costs and expenses (denominator). The higher the total fixed costs, the more units the firm must sell to break even. The greater the difference between the unit selling price and the unit variable costs and expenses, the fewer the units the firm must sell to break even. The difference between the unit selling price and the unit variable costs and expenses is the **contribution margin**; that is, for each unit sold, a contribution is made toward covering the company's fixed costs.

To evaluate other break-even points, the entrepreneur can plot additional sales lines for other prices on the chart. Don't be intimidated about drawing a graph or crunching the numbers to get a break-even point. The key issue is that calculating the break-even point helps you to determine whether you have a chance to make a profit by selling your product or service at a certain price.

Every business owner must determine a way to represent these critical numbers so that they can understand them and run the business successfully. On the flexible break-even chart shown in Exhibit 16.3(b), the higher price of $20 yields a much more steeply sloped sales line, resulting in a break-even point of 20,000 units and a sales dollar break-even point of $400,000. Similarly, the lower price of $8 produces a flatter revenue line, delaying the break-even point until 100,000 units are sold and the firm has $800,000 in sales. Additional sales lines could be plotted to evaluate other proposed prices.

Because it shows the profit area growing larger and larger to the right, the break-even chart implies that quantity sold can increase continually. Obviously, this assumption is unrealistic. Growth can require new expenses, such as computers, vehicles, buildings, employees, and more. These should be factored in by modifying the break-even analysis with information about the way in which demand is expected to change at different price levels.

Incorporating Sales Forecasts

The indirect impact of price on the quantity that can be sold complicates pricing decisions. Demand for a product typically decreases as price increases. However, in certain cases, price may influence demand in the opposite direction, resulting in increased demand for a product when it is priced higher. Therefore, estimated demand for a product at various prices, as determined through marketing research (even if it is only an informed guess), should be incorporated into the break-even analysis. An adjusted break-even chart that incorporates estimated demand can be developed by using the initial break-even data from Exhibit 16.3(b) and adding a demand curve, as done in Exhibit 16.4. This graph allows a more realistic profit area to be identified.

We see that the break-even point in Exhibit 16.4 for a unit price of $20 corresponds to a quantity sold that appears impossible to reach at the assumed price (the break-even point does not fall within the demand curve). No customers are willing to pay $20 for any quantity—the demand curve line is always below the $20 sales line. In contrast, at the low price of $8, the company would never break even—the more the company sells, the greater its loss would be. Only at $12 does the revenue from the demand curve rise above the total cost line. The potential for profit at this price is indicated by the shaded area in the graph.

16-2b Markup Pricing

In the retail industry, where businesses often carry many different products, **markup pricing** has emerged as a manageable pricing system. This cost-plus approach

contribution margin
The difference between the unit selling price and the unit variable costs and expenses.

markup pricing
An approach based on applying a percentage to a product's cost to obtain its selling price.

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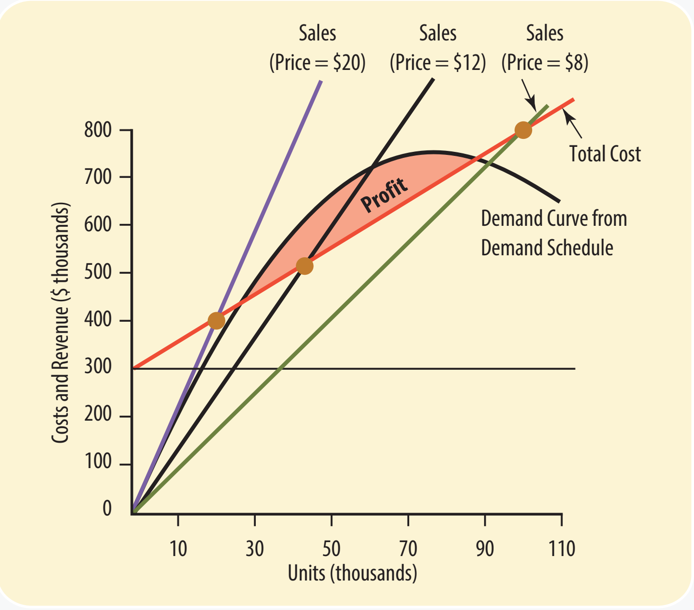
Exhibit 16.4 A Break-Even Graph Adjusted for Estimated Demand



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to pricing is used both in traditional brick-and-mortar stores and by online product vendors. Using this pricing system, retailers are able to price hundreds of products much more quickly than they could by using individual break-even analyses.

Manufacturers will often recommend a retail price for their products that retailers and wholesalers can use as guidelines. In calculating the selling price for a particular item, a retailer adds a markup percentage (sometimes referred to as a *markup rate*) to cover (1) operating expenses, (2) subsequent price reductions—for example, markdowns and employee discounts, and (3) the desired profit. It is important to have a clear understanding of markup pricing computations.

Margins may be expressed as a percentage of either the selling price or the cost. For example, if an item costs $6 and sells for $10, the markup of $4 represents a 40 percent markup of the selling price [($4 markup ÷ $10 selling price) × 100] or a 66⅔ percent markup of the cost [($4 markup ÷ $6 cost) × 100]. Two simple formulas are commonly used for markup calculations:

$$\frac{\text{Markup}}{\text{Selling price}} \times 100 = \text{Margin expressed as a percentage of selling price}$$

or

$$\frac{\text{Markup}}{\text{Cost}} \times 100 = \text{Margin expressed as a percentage of cost}$$

16-3 Identify specific pricing strategies.

16-3 Selecting a Pricing Strategy

Break-even analysis and similar techniques give owners an idea of how much they need to sell to cover their costs. But their seemingly precise nature can be very misleading. Such analyses should not by themselves determine the final price. Price determination

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must also consider characteristics of targeted customers and the firm's total marketing strategy. Pricing strategies that reflect these additional considerations include prestige or premium pricing (which we discussed earlier), penetration pricing, price skimming, follow-the-leader pricing, variable pricing, price lining, and optional product and service pricing.[5]

16-3a Penetration Pricing

A firm that uses a **penetration pricing strategy** prices a product or service at less than its normal, long-range market price in order to gain more rapid market acceptance or to increase existing market share. This strategy can sometimes discourage new competitors from entering a market niche if they view the penetration price as potentially a long-range price. Obviously, a firm that uses this strategy sacrifices some profit margin to achieve market penetration.

16-3b Price Skimming

A **price skimming strategy** sets prices for products or services at high levels for a limited time period before reducing them to more competitive levels. This strategy assumes that certain customers will pay a higher price because they view a product or service as a prestige item. Use of a skimming price is most practical when there is little threat of short-term competition or when start-up costs must be recovered rapidly. Another reason for using this strategy is the high cost of introducing a new product. The company may not have achieved economies of scale in production, so higher prices might be charged to customers who could be labeled early adopters. Some buyers (especially tech buyers) like to be the first to own or use new products or services, so they are willing to pay a premium price. To reach a larger market, however, the price usually needs to be reduced.

penetration pricing strategy
A technique that sets lower than normal prices to hasten market acceptance of a product or service or to increase market share.

price skimming strategy
A technique that sets very high prices for a limited period before reducing them to more competitive levels.

follow-the-leader pricing strategy
A technique that uses a particular competitor as a model in setting prices.

16-3c Follow-the-Leader Pricing

A **follow-the-leader pricing strategy** uses a particular competitor as a model in setting a price for a product or service. The probable reaction of competitors is a critical factor in determining whether to cut prices below a prevailing level. A small business in competition with larger firms is seldom in a position to consider itself the price leader. Different brands may have different characteristics, but customers often do not perceive sufficient differences to pay premium prices. Thus, small businesses selling commodities (products purchased primarily based on price) tend to be better off holding down costs so that they can price their merchandise in the same range as their larger competitors.

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16-3d Variable Pricing

Some businesses use a **variable pricing strategy** to offer price concessions to certain customers, even though they may advertise a uniform price. Lower prices are offered for various reasons, including a customer's knowledge and bargaining strength. In some fields of business, therefore, firms make two-part pricing decisions. They set a standard list price but offer a range of price concessions to particular buyers—for example, those who purchase large quantities of their product.

16-3e Price Lining

A **price lining strategy** establishes distinct price categories at which similar items of retail merchandise are offered for sale. For example, men's suits (of differing quality) might be sold at $250, $450, and $800. The amount of inventory stocked at different quality levels would depend on the income levels and buying desires of a store's customers. A price lining strategy has the advantage of simplifying the selection process for the customer and reducing the necessary minimum inventory.

16-3f Optional Product and Service Pricing

Companies often seek to increase the amount that customers spend by offering optional products or services that increase the total price paid by the customer. An office management company, for example, may rent office space by the square foot but provide receptionist services, access to printers and copiers, delivery services, and more at additional cost.

Local, state, and federal laws must be considered in setting prices. For example, the Sherman Antitrust Act generally prohibits price fixing. Direct competitors cannot agree on the prices they will charge customers. Fixing prices can lead to prison sentences and fines or civil lawsuits, resulting in significant legal expenses and possibly damage payments.[6] On the other hand, a Supreme Court decision gave manufacturers the authority to impose minimum prices at which retailers must sell their products. Large discount retailers objected, claiming that such policies are anticompetitive. However, the Court concluded that smaller businesses might give better service to customers through the information they provide about products, only to see those customers then buy from a discounter that provides less service.[7] Resale price maintenance is assumed to encourage stores to offer a better shopping experience.

When a small business markets a line of products, some of which may compete with each other, pricing decisions must take into account the effects of a single product price on the rest of the line. This often results in **product line pricing**, placing different prices on a range of products or services to reflect the benefits to the customer of parts of the range.[8]

Continually adjusting a price to meet changing marketing conditions can be both costly to the seller and confusing to buyers. Thanks to the Internet, companies can monitor product sales in real time and determine immediately if dropping a price might lead to more sales or if raising it might make sense for a product in high demand. Discounting can also be designed to meet a variety of needs. For example, a seller may offer a trade discount to a buyer (such as a wholesaler) that performs a certain marketing function for the seller (such as distribution). The stated, or list, price is unchanged, but the seller offers a lower actual price by means of a discount.

Small firms should not treat bad pricing decisions as uncorrectable mistakes. Remember, pricing is not an exact science. If the initial price appears to be off target, make any necessary adjustments and keep on selling!

variable pricing strategy
A technique that sets more than one price for a product or service in order to offer price concessions to certain customers.

price lining strategy
A technique that sets a range of several distinct merchandise price levels.

product line pricing
A technique that places different prices on a range of products or services to reflect the benefits to the customer of parts of the range.

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Living the Dream

Pricing to Grow

After majoring in operations research at MIT, Payal Kadakia Pujji began her professional life as a consultant with Bain & Company, later moving on to the Warner Music Group to work on digital strategy. Pujji's love had always been dancing, however. She started training in Indian classical and folk styles of dancing and considers herself a "dancetrepreneur." That attitude led her to create an Indian dance company while still with Warner, the Sa Dance Company. Another venture idea was sparked when Pujji was traveling and wanted to attend a dance class for some relaxation. She had trouble finding one, then felt her time was wasted at the one that had room for her. This experience led her to co-found ClassPass.

ClassPass is an app that began by providing customers with access to fitness classes. The company formed relationships with gyms, universities, studios, and other venues that offered classes, allowing app users to immediately sign up for whatever might be scheduled. Initially, ClassPass offered a 30-day free trial and was immediately swamped with potential new clients. Its success led to an expansion of services. Before long, customers could register for dance, yoga, boxing, cycling, strength training, meditation, and more. The company also quickly expanded access to more cities, including international locations.

As the company grew, the 30-day free trial was reduced to 14 days. During that period, customers now get 10 credits entitling them to three reservations. Those who want to continue beyond their free trial pay by subscription. ClassPass has five subscription levels, ranging from $15 per month for six credits good for two classes to $159 a month for 80 credits, permitting customers to book up to 30 classes.

The company has added services as it has grown. Subscribers can buy more credits without changing their monthly plan. At-home fitness classes are available, as well as classes at studios and other locations. Customers are not locked into contracts, and they can roll over their credits if they don't use the full month's allocation.

The company is headquartered in New York, but Pujji is concentrating on global expansion and spends much of her time traveling to new locations. She is proud of the business she is able to channel to studio owners and others that use her firm's services. Pujji regards them as entrepreneurs, too, and wants to help them prosper by investing in some and using advanced analytics to help them calculate the popularity of their classes.

Sources: https://www.sadancecompany.com/about, accessed July 21, 2021; Allison Brunner, "How ClassPass Founder Payal Kadakia Built a $150M Business from Her Love of Dance," https://csq.com/2019/12/payal-kadakia-classpass-founder-success-story/#.YPbwJj2SnIU, accessed July 21, 2021; Jordan Crook, "ClassPass Is in Session with $40 Million in Series B," https://techcrunch.com/2015/01/15/classpass-is-in-session-with-40-million-in-series-b/, accessed July 21, 2021; "Start Your Free Trial," https://classpass.com/pricing/united-states, accessed July 21, 2021; and "The ClassPass Business Model—How Does ClassPass Work & Make Money?" https://productmint.com/the-classpass-business-model-how-does-classpass-work-make-money/, accessed July 21, 2021.

16-4 Offering Credit

16-4 Explain the benefits of credit, factors that affect credit extension, and types of credit.

In a credit sale, the seller provides products or services to the buyer in return for the buyer's promise to pay later. The major reason for granting credit is to make sales. Credit encourages decisions to buy by providing an incentive for customers who can buy now but would prefer to pay later. However, businesses want to make sure their customers will fully pay for what they are buying. An added bonus to the seller is that credit provides records containing customer information that can be used for sales promotions, such as direct-mail appeals to customers.

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16-4a Benefits of Credit

If credit buying and selling did not benefit both parties in a transaction, their use would cease. Buyers obviously enjoy the availability of credit, and small firms, in particular, benefit from being able to buy on credit from their suppliers. Being able to delay paying a bill is the equivalent of obtaining an interest-free loan until the time the bill is due. Benefits of credit to buyers include the following:

1. Access to working capital, often allowing for continuity of operations.
2. The ability to satisfy immediate needs and pay for them later.
3. Better records of purchases on credit billing statements.
4. Better service and greater convenience when exchanging purchased items.
5. The ability to establish a credit history.

Suppliers, on the other hand, extend credit to customers with the expectation that the increased revenue from interest on unpaid balances will more than offset the costs of extending credit, so that profits will increase. Benefits of credit to sellers are:

1. Facilitation of increased sales volume.
2. The ability to earn money on unpaid balances.
3. A closer association with customers because of implied trust.
4. Easier selling through phone- and mail-order systems and over the Internet.
5. Smoother sales peaks and valleys, since purchasing power is always available to the buyer.
6. Easy access to a tool with which to stay competitive.

16-4b Factors That Affect Selling on Credit

A business owner must decide whether to sell on credit or for cash only. In many cases, credit selling cannot be avoided, as it is standard trade practice in many types of businesses. It is important to note that in today's marketplace, credit-selling competitors will almost always outsell a cash-only firm.

Although a seller always hopes to increase profits by allowing credit sales, it is not a risk-free practice. Small firms frequently shift or at least share credit risk by accepting credit cards carried by customers rather than by offering their own credit. For example, the franchisee of a DoubleTree Hotel, part of the Hilton chain, may accept Hilton credit cards and other major credit cards, thereby avoiding the hassles of credit management. The business will pay a fee to the credit card company, but that cost may be less than the expense of managing its own independent credit system, especially when losses from bad debts are factored in. A retailer following this strategy must obtain merchant status with individual credit card companies. This is not an automatic process and can be problematic, particularly for home-based businesses.

Unfortunately, the cost of accepting major credit cards for payment online has increased. To deal with Internet fraud, small online retailers have turned to third-party firms (like PayPal, Charge.com, and TSYS) that specialize in handling Internet credit card payments. For example, PayPal offers a variety of plans with transaction fees of 3.49 percent plus $.49 or less, depending on monthly sales volume.[9] Also, if a small firm makes credit sales online, it is subject to "chargebacks" whenever buyers dispute a transaction. Some credit card companies assess fines and threaten account termination if the number of chargebacks is excessive.

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For a variety of reasons, a small business may or may not decide to sell on credit. The following five factors are related to an entrepreneur's decision to extend credit:

1. *Type of business.* Retailers of durable products typically grant more credit than do sellers of perishables and small service firms with primarily local customers. Most consumers find it necessary to buy big-ticket items on an installment basis, and the life span of such a product makes installment selling feasible.
2. *Credit policies of competitors.* Most firms in an industry offer comparable credit terms unless they have a competitive advantage that causes customers to be willing to pay cash. Wholesale hardware companies and retail furniture stores are examples of businesses that face stiff competition from credit sellers.
3. *Age and income levels of customers.* Customers' ages and income levels are significant factors in determining credit policy. For example, a drugstore adjacent to a high school might not extend credit to high school students, who are typically undesirable credit customers because of their lack of both maturity and steady income.
4. *Availability of working capital.* Credit sales increase the amount of working capital needed by the business doing the selling. Open charge and installment accounts (described in the next section) tie up money that may be needed to pay business expenses.
5. *Economic conditions.* Business cycles are real. Owners sometimes have short memories when sales are good, and they receive and extend credit without concern for an economic downturn. The pandemic of 2020 led to a recession that caused bankruptcy for many who were overextended or who could not outlast the lockdowns. But free enterprise systems are also characterized by recoveries and prosperity. Good credit management is critical to long-term success.

16-4c Types of Credit

There are two broad classes of credit: consumer credit and trade credit. **Consumer credit** is granted by retailers to final consumers who purchase for personal or family use. A small business owner sometimes uses their personal consumer credit to purchase supplies and equipment for the business. **Trade credit** is extended by nonfinancial firms, such as manufacturers and wholesalers, to business firms that are customers. Consumer credit and trade credit differ with respect to the types of credit instruments, the paperwork required, sources for financing receivables, and the terms of sale.

Consumer Credit

The three major kinds of consumer credit accounts are open charge accounts, installment accounts, and revolving charge accounts. Many variations of these credit accounts are also used. Credit cards (a type of revolving charge account) are discussed separately because of their widespread use.

- *Open Charge Accounts.* When using an **open charge account**, a customer takes possession of products (or services) at the time of purchase, with payment due when billed. Customers typically have a month to pay their bills from the time their statements are sent. There is no finance charge for this kind of credit if the balance on the account is paid in full at the end of the billing period. Customers are not generally required to make a down payment or to pledge collateral. Small accounts at department stores are good examples of open charge accounts.

consumer credit
Financing granted by retailers to individuals who purchase for personal or family use.

trade credit
Financing provided by suppliers to client companies.

open charge account
A line of credit that allows the customer to obtain a product or service at the time of purchase, with payment due when billed.

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- *Installment Accounts.* An **installment account** is a vehicle for long-term consumer credit, useful for large purchases, such as a car, home appliance, or home renovation. A down payment is normally required, and annual finance charges can be a significant percentage of the purchase price. Payment periods are commonly from 12 to 36 months, although automobile dealers often offer an extended payment period of 60 months or even longer.
- *Revolving Charge Accounts.* A **revolving charge account** is a variation of the installment account. A seller grants a customer a line of credit, and charged purchases may not exceed the credit limit. A specified percentage of the outstanding balance must be paid monthly, forcing the customer to budget and limiting the amount of debt that can be carried. Finance charges are computed on the unpaid balance at the end of the month.

Credit Cards

A **credit card** provides assurance to a seller that a buyer has a satisfactory credit rating and that the seller will receive payment from the financial institution that issued the card. Credit cards are usually based on a revolving charge account system. Depending on the issuer, we can distinguish two basic types of credit cards: bank credit cards and retailer credit cards.

- *Bank Credit Cards.* The best-known credit cards issued by banks or other financial institutions are MasterCard and Visa. Bank credit cards are widely accepted by retailers that want to offer credit but don't provide their own credit cards. Most small business retailers fit into this category. In return for a set fee (typically from 1.3 to 3.5 percent of the purchase price) paid by the retailer, the bank takes the responsibility for making collections. Some banks charge annual membership fees to their cardholders. Also, cardholders are frequently able to obtain cash up to the credit limit of their card.
- *Retailer Credit Cards.* Many companies—for example, department stores and oil companies—issue their own credit cards specifically for use in their outlets or for purchasing their products or services from other outlets. Customers are usually not charged annual fees or finance charges if the balance is paid each month.

Trade Credit

Firms selling to other businesses may specify terms of sale, such as 2/10, net 30. This means that the seller is offering a 2 percent discount if the buyer pays within 10 days of the invoice date. Failure to take this discount makes the full amount of the invoice due in 30 days. For example, with these terms, a buyer paying for a $100,000 purchase within 10 days of the invoice date would save 2 percent, or $2,000.

Sales terms for trade credit depend on the product sold, as well as the buyer's and the seller's circumstances. The credit period often varies directly with the length of the buyer's inventory turnover period, which depends on the type of product sold. The larger the order and the higher the credit rating of the buyer, the better the sales terms will be, assuming that individual terms are fixed for each buyer. The greater the financial strength and the more adequate and liquid the working capital of the seller, the more generous the seller's sales terms can be. Of course, no business can afford to allow competitors to outdo it in reasonable generosity of sales terms. In many types of businesses, terms are so firmly set by tradition that a unique policy is difficult, if not impossible, for a small firm to implement.

installment account
A line of credit that requires a down payment, with the balance paid over a specified period of time.

revolving charge account
A line of credit on which the customer may charge purchases at any time, up to a pre-established limit, and must pay a percentage of the balance monthly.

credit card
An alternative to cash whose use provides assurance to a seller that a buyer has a satisfactory credit rating and that payment will be received from the issuing financial institution.

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16-5 Managing the Credit Process

16-5 Describe the activities involved in managing credit.

A small clothing store or online craft shop that accepts Visa or MasterCard is transferring much of the credit risk to another party. In effect, the fee that the business pays the credit card company covers the credit management process. Banks and their business customers are often in conflict over the fees charged. In 2013, small businesses sued Wells Fargo's Merchant Business Services, accusing it of overcharging on the processing of credit card transactions.[10] Many small business owners find that the fees cut their profits significantly. Small firms that want to offer their own line of credit to customers need to understand the credit function. Let's take a look at some of the major considerations in developing and operating a comprehensive credit management program for a small business.

16-5a Evaluation of Credit Applicants

In most retail stores, the first step in credit investigation is having the customer complete an application form. The information obtained on this form is used as the basis for examining an applicant's creditworthiness. Since the most important factor in determining a customer's credit limit is their ability to pay the obligation when it becomes due, it is crucial to evaluate the customer's financial resources, debt position, and income or revenue level.

The amount of credit requested also requires careful consideration. Drugstore customers usually need only small amounts of credit. On the other hand, business customers of wholesalers and manufacturers typically expect large credit lines. In the special case of installment selling, the amount of credit should not exceed the repossession value of the goods sold. Automobile dealers follow this rule as a general practice.

The Four Credit Questions

In evaluating the credit status of applicants, a seller must answer the following four questions:

1. Can the buyer pay as promised?
2. Will the buyer pay?
3. If so, when will the buyer pay?
4. If not, can the buyer be forced to pay?

The answers to these questions have to be based in part on the seller's estimate of the buyer's ability and willingness to pay. Such an estimate constitutes a judgment of the buyer's creditworthiness. For credit to be approved, the answers to questions 1, 2, and 4 should be "yes," and the answer to question 3 should be "on schedule."

Every applicant is creditworthy to some degree. A decision to grant credit merely recognizes the buyer's credit standing. However, the seller must consider the possibility that the buyer will be unable or unwilling to pay. When evaluating an applicant's credit status, therefore, the seller must decide how much risk of nonpayment to assume.

The Traditional Five Cs of Credit

As explained in Chapter 12, the ability to repay a loan is frequently evaluated in terms of the five Cs of credit: character, capacity, capital, collateral, and conditions. These factors are also indicators of a firm's ability to repay trade credit:

- *Character* is the fundamental integrity and honesty that should underlie all human and business relationships. For business customers, character is

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embodied in the business policies and ethical practices of the firm, generally measured by its credit history.

- *Capacity* refers to the customer's ability to conserve assets, and to faithfully and efficiently follow a financial plan. A business customer should have sufficient cash flows to pay bills.
- *Capital* can be defined as net worth but really consists of the cash and other liquid assets owned by the customer. A prospective business customer should have sufficient capital to underwrite planned operations, including an appropriate amount invested by the owner.
- *Collateral* represents enough assets to secure the debt. It is a secondary source for loan repayment in case the borrower's cash flows are insufficient for repaying a loan.
- *Conditions* refer to both the industry in which the firm competes and to the larger economy. Economic factors include business cycles and changes in price levels, which may be either favorable or unfavorable to the payment of debts. Adverse factors that might limit a business customer's ability to pay include strong new competition, labor problems, and fires and other natural disasters.

16-5b Sources of Credit Information

One of the most important, and most frequently neglected, sources of credit information is a customer's previous credit history. Properly analyzed, credit records show whether a business customer regularly takes cash discounts and, if not, whether the customer's account is typically slow.

Manufacturers and wholesalers can frequently use a firm's financial statements as an additional source of information. Obtaining maximum value from financial statements requires a careful ratio analysis, which will reveal a firm's working capital position, profit-making potential, and general financial health (as discussed in Chapter 10).

Although financial data and credit histories should be collected directly from customers who apply for credit, pertinent data should also be obtained from outsiders. For example, arrangements may be made with other sellers to exchange credit data. Such credit information exchanges are quite useful for learning about the sales and payment experiences that others have had with the seller's own customers or credit applicants.

Another source of credit information for the small firm, particularly about commercial accounts, is the customer's banker. Some bankers willingly supply credit information about their depositors, considering this to be a service that helps those firms or individuals obtain credit in amounts they can successfully handle. Other bankers believe that credit information is confidential and should not be disclosed.

trade-credit agencies Privately owned organizations that collect credit information on businesses.

credit bureaus Privately owned organizations that summarize different firms' credit experiences with individual consumers.

Organizations that may be consulted regarding credit standing are **trade-credit agencies** and credit bureaus. Trade-credit agencies are privately owned organizations that collect credit information on businesses only, not individual consumers. After analyzing and evaluating the data, trade-credit agencies make credit ratings available to client companies for a fee. Dun & Bradstreet, Inc. (dnb.com), a nationwide trade-credit agency, offers a wide array of credit reports, such as the Small Business Risk Insight Origination Scores.[11]

Credit bureaus are the most common type of consumer reporting agency. These private companies maintain credit histories on individuals, based on reports from

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banks, mortgage companies, department stores, and other creditors. These companies make possible the exchange of credit information on persons with previous credit activity. Some credit bureaus do not require a business firm to be a member in order to get a credit report. The fee charged to nonmembers, however, is considerably higher than that charged to members. The three primary online credit bureaus are Experian, Equifax, and TransUnion.[12]

16-5c Aging of Accounts Receivable

Many small businesses can benefit from an **aging schedule**, which categorizes accounts receivable based on the length of time they have been outstanding. Typically, some accounts are current, and others are past due. Regular use of an aging schedule allows troublesome collection trends to be spotted so that appropriate actions can be taken.

Exhibit 16.5 presents a hypothetical aging schedule for accounts receivable. According to the schedule, four customers have overdue credit, totaling $200,000. Only customer 005 is current. Customer 003 has the largest amount overdue ($80,000). In fact, the schedule shows that customer 003 is overdue on all charges and has a past record of slow payment (indicated by a credit rating of C). Immediate attention must be given to collecting from this customer. Customer 002 should also be contacted, because, among overdue accounts, this customer has the second largest amount ($110,000) in the "Not due" classification. Customer 005, however, could quickly have the largest amount overdue and should be watched closely.

Customers 001 and 004 require a special kind of analysis. Customer 001 has $10,000 more overdue than customer 004. However, customer 004's overdue credit of $40,000, which is 60 days past due, may well have a serious impact on the $100,000 not yet due ($10,000 in the beyond-discount period plus $90,000 still in the discount period). On the other hand, even though customer 001 has $50,000 of overdue credit, this customer's payment is overdue by only 15 days. Also, customer 001 has only $50,000 not yet due ($30,000 in the beyond-discount period plus $20,000 still in the discount period), compared to the $100,000 not yet due from customer 004. Both customers have

aging schedule
A categorization of accounts receivable based on the length of time they have been outstanding.

Exhibit 16.5 Hypothetical Aging Schedule for Accounts Receivable

	Customer Account Number					
Account Status (Days past due)	**001**	**002**	**003**	**004**	**005**	**Total**
120 days	—	—	$50,000	—	—	$ 50,000
90 days	—	$ 10,000	—	—	—	10,000
60 days	—	—	—	$40,000	—	40,000
30 days	—	20,000	20,000	—	—	40,000
15 days	$50,000	—	10,000	—	—	60,000
Total overdue	$50,000	$ 30,000	$80,000	$40,000	$ 0	$200,000
Not due (beyond discount period)	$30,000	$ 10,000	$ 0	$10,000	$130,000	$180,000
Not due (still in discount period)	$20,000	$100,000	$ 0	$90,000	$220,000	$430,000
Credit rating	A	B	C	A	A	—

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Sources: http://www.consumer.ftc.gov/articles/0155-free-credit-reports, accessed July 17, 2021; City National Bank, "7 Tips to Improve Your Accounts Receivable Collection," https://fitsmallbusiness.com/business-credit-report/, accessed July 17, 2021; and "The Accounts Receivable Aging Definition," https://www.accountingtools.com/articles/what-is-accounts-receivable-aging.html?rq=accounts%20receivable%20aging, accessed July 17, 2021.

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an A credit rating. In conclusion, customer 001 is a better potential source of cash. The aging schedule helps us see that collection efforts should be focused on customer 004 rather than on customer 001, who may simply need a reminder of the overdue amount of $50,000.

16-5d Billing and Collection Procedures

Timely notification to customers regarding the status of their accounts is essential for keeping credit accounts current. Most credit customers pay their bills on time if the creditor provides them with information verifying their credit balance. Failure on the seller's part to send invoices delays payments.

Overdue credit accounts tie up a seller's working capital, prevent further sales to the slow-paying customer, and lead to losses from bad debts. Even if a slow-paying customer is not lost, relations with this customer are strained for a time at least.

A firm that is extending credit must have adequate billing records and collection procedures if it expects prompt payments. Also, a personal relationship between seller and customer must not be allowed to tempt the seller into being less than businesslike in extending further credit and collecting overdue amounts. Given the seriousness of the problem, a small firm must decide whether to collect past-due accounts directly or turn the task over to an attorney or a collection agency.

Perhaps the most effective weapon in collecting past-due accounts is reminding the debtors that their credit standing may be in jeopardy. A lower credit rating is certain to happen if the account is turned over to a collection agency. Delinquent customers will typically attempt to avoid damage to their credit standing, particularly when it would be known to the business community. This concern underlies and strengthens the various collection efforts of the seller.

A small firm should deal compassionately with delinquent customers. Some will intentionally abuse a relationship and drag out or even refuse to make a payment. However, a collection technique that is too threatening not only may fail to work but also could cause the firm to lose a customer worth keeping or to become subject to legal action. During the COVID-19 crisis, credit card losses more than tripled from previous periods. Retailers were not the only companies that had to reinvent their customer service practices; the pandemic also affected telecommunication companies, universities, hospitals, utilities, banks, and more.[13]

Effective collection practices usually consist of a series of steps, each somewhat more forceful than the preceding one. Historically, the process has started with a gentle written reminder; subsequent steps may include additional letters, phone calls, registered letters, personal contacts, and referral to a collection agency or attorney. The timing of these steps should be carefully standardized so that each one automatically follows the preceding one in a specified number of days. More recently, some businesses have started to send text messages and emails as reminders, especially when they have a significant percentage of younger customers.

Various ratios can be used to monitor expenses associated with credit sales. The best known and most widely used expense ratio is the **bad-debt ratio**, which is computed by dividing the amount of bad debts by the total amount of credit sales. The bad-debt ratio reflects the efficiency of credit policies and procedures and can help you track how well you are managing the credit you have extended to customers. To compare the effectiveness of your firm's credit management with that of other firms, look for sources that provide industry financial ratios. (These are

bad-debt ratio
Expense ratio that reflects the efficiency of credit policies; bad debts divided by credit sales.

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often available in university libraries.) Two examples are Dun & Bradstreet's Key Business Ratios and the Almanac of Business and Industrial Financial Ratios. A relationship exists among the bad-debt ratio, profitability, and the size of the firm. Many times, small profitable retailers have a higher bad-debt ratio than large profitable retailers do.

PALMER KANE LLC/SHUTTERSTOCK.COM

16-5e Credit Regulation

The use of credit is regulated by a variety of federal laws, as well as state laws that vary considerably from state to state. The most significant piece of credit legislation is the federal Consumer Credit Protection Act, which includes the Truth-in-Lending Act. Its two primary purposes are to ensure that consumers are informed about the terms of a credit agreement and to require creditors to specify how finance charges are computed. The act requires that a finance charge be stated as an annual percentage rate and that creditors specify their procedures for correcting billing mistakes.

Other federal legislation related to credit management include the following:

- The *Fair Credit Billing Act* provides protection to credit customers in cases involving incorrect billing. A reasonable time period is allowed for billing errors to be corrected. The act does not cover installment credit.
- The *Fair Credit Reporting Act* gives certain rights to credit applicants regarding reports prepared by credit bureaus. Amendments such as the Fair and Accurate Credit Transactions Act (FACTA), signed into law in 2003, have strengthened privacy provisions and defined more clearly the responsibilities and liabilities of businesses that provide information to credit-reporting agencies.
- The *Equal Credit Opportunity Act* ensures that all consumers are given an equal chance to obtain credit. For example, a person is not required to reveal their sex, race, national origin, or religion to obtain credit.
- The *Fair Debt Collection Practices Act* bans the use of intimidation and deception in collection, requiring debt collectors to treat debtors fairly.

It should be apparent by now that pricing and credit decisions are of prime importance to a small firm because of their direct impact on its financial health. However, small business owners can fall into the trap of giving all their attention to costs of products, materials, and operations when setting prices. Be sure that your pricing decisions are driven by a customer focus: What is the customer willing and able to pay, and does that price enable you to make a profit? Providing value for your customers and putting them first are the ways to move your business forward.

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16-1. Discuss the role of cost and demand factors in setting a price.

- The total sales revenue of a firm is a direct reflection of two components: sales volume and price.
- The price must be sufficient to cover total cost plus a margin of profit that sustains the company and moves it forward.
- Pricing at less than total cost can be used as a special short-term strategy to increase demand.
- A firm should examine elasticity of demand—the effect of a change in price on quantity demanded—when setting a price.
- A product's competitive advantage is a demand factor in setting price.

16-2. Apply break-even analysis and markup pricing.

- Break-even analysis has two phases: (1) examining cost-revenue relationships, and (2) incorporating sales forecasts into the analysis.
- Analyzing costs and revenue under different price assumptions identifies the break-even point, the quantity sold at which total costs and expenses equal total sales revenue.
- Markup pricing is a generalized cost-plus system of pricing used for many products by retailers and wholesalers.
- Margins may be expressed as a percentage of either the selling price or the cost.

16-3. Identify specific pricing strategies.

- Penetration pricing and price skimming are short-term strategies used when new products are first introduced into the market.
- Follow-the-leader and variable pricing are special strategies that reflect, respectively, the nature of the competition's pricing and concessions to certain customers.
- A price lining strategy simplifies choices for customers by offering a range of several distinct prices.
- Offering optional product and service pricing may increase the total price paid by the customer.
- Local, state, and federal laws must be considered in setting prices, as well as any impact that a price may have on other product line items.

16-4. Explain the benefits of credit, factors that affect credit extension, and types of credit.

- Credit provides small firms with working capital. Its other benefits to buyers are the ability to immediately satisfy needs and pay later, better records of purchases, better service and convenience when exchanging purchased items, and the ability to establish a credit history.
- Benefits of credit to sellers include the facilitation of increased sales volume, the ability to earn money on unpaid balances, a closer association with customers, easier selling, smoother sales peaks and valleys, and easy access to a competitive tool.
- The type of business, credit policies of competitors, age and income levels of customers, the availability of working capital, and economic conditions affect the decision to extend credit.
- The two broad classes of credit are consumer credit and trade credit.

16-5. Describe the activities involved in managing credit.

- Evaluating the credit status of applicants begins with the completion of an application form.
- A seller must know whether the buyer can pay as promised, whether the buyer will pay, when the buyer will pay, and if the buyer can be forced to pay.
- A customer's ability to pay is often evaluated in terms of the five Cs of credit: character, capacity, capital, collateral, and conditions.
- Pertinent credit data can be obtained from several sources, including credit bureaus, financial statements, bankers, and formal trade-credit agencies such as Dun & Bradstreet.
- An accounts receivable aging schedule, which categorizes receivables based on the length of time they have been outstanding, can be used to improve the credit collection process.
- A small firm should establish a formal procedure for billing and collecting from credit customers.
- It is important that a small firm follow all relevant federal and state credit regulations.

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Key Terms

- **aging schedule** p. 435
- **average pricing** p. 420
- **bad-debt ratio** p. 436
- **break-even analysis** p. 423
- **break-even point** p. 424
- **consumer credit** p. 431
- **contribution margin** p. 425
- **credit** p. 419
- **credit bureaus** p. 434
- **credit card** p. 432
- **elastic demand** p. 421
- **elasticity of demand** p. 421
- **follow-the-leader pricing strategy** p. 427
- **freemium strategy** p. 421
- **inelastic demand** p. 422
- **installment account** p. 432
- **markup pricing** p. 425
- **open charge account** p. 431
- **penetration pricing strategy** p. 427
- **prestige pricing** p. 423
- **price** p. 419
- **price lining strategy** p. 428
- **price skimming strategy** p. 427
- **product line pricing** p. 428
- **revolving charge account** p. 432
- **trade credit** p. 431
- **trade-credit agencies** p. 434
- **value** p. 419
- **variable pricing strategy** p. 428

Discussion Questions

1. How does price relate to value in the eyes of the customer?
2. Give an example of a product for which there is elastic demand and another example for inelastic demand.
3. Think of a brand that has been successful in using prestige pricing. How is the company able to use that strategy?
4. If a firm has fixed costs of $100,000 and variable costs per unit of $1, what is the break-even point in units, assuming a selling price of $5 per unit?
5. What is the difference between a variable pricing strategy and a price lining strategy? Under what circumstances would each be used?
6. If a small business conducts a break-even analysis properly and finds the break-even point in units at a price of $10 to be 10,000 units, should it price the product at $10? Why or why not?
7. What are the major benefits of credit to buyers? What are its major benefits to sellers?
8. What does a company have to consider in establishing a credit policy?
9. What are four key questions in evaluating a credit applicant?
10. What are the five Cs of credit? Why are they important?

You Make the Call

Situation 1

Daniel Clark owns Prime Print Shop in Poughkeepsie, New York. The company provides full-service copying, plotting, scanning, and custom printing to professional, municipal, and educational communities. Prime Print Shop claims on its website to be easy to work with. Part of the effort to serve customers well is being fair in pricing. But what does "fair" mean? To Clark, it means concentrating on outlays for materials and input from customers. Clark relies on customer feedback to determine fair rates. Much of the shop's work is customized, but many of the materials can be priced in a standard way, such as black-and-white copies. Clark also buys some materials in large quantities to get discounts and then promotes special deals when he can drop prices. He has learned that customers perceive prices to be fair when the products and services they purchase meet quality standards. And he takes pride in knowing customers' names.

Sources: https://www.primeprintshop.com, accessed July 18, 2021; and Karen Maserjian Sham, "Setting Prices with Prime Print Shop, Poughkeepsie," https://www.poughkeepsiejournal.com/story/news/local/2014/12/14/small-business-settingprices/20362921, accessed July 18, 2021.

Question 1 Does a company that offers products and services, like Prime Print Shop, face elastic or inelastic demand? Explain your answer.

Question 2 Which pricing strategy fits Prime Print Shop best? Why?

Question 3 What recommendation would you make to Daniel Clark about offering credit to his customers?

Situation 2

The Internet provides new channels for artists to reach collectors. One example is eBay. Many artists have found they can auction

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their work using that platform. On eBay, artists can choose different pricing alternatives. They can use "Buy It Now" listings, charging full retail prices; choose "Buy It Now or Make Offer," allowing customers to determine they price they want to pay subject to the artist's acceptance of their offer; or set a minimum price and allow bidders to determine the final price. Some artists have discovered that collectors do not want to see the value of their artwork decline due to price cutting, and inconsistent pricing may cause buyers to lose confidence in the value of the art.

Question 1 What do you think makes selling works of art different from selling other kinds of products? What makes it the same?

Question 2 Have you bought anything on eBay? If so, did you receive good value for the price you paid? If not, ask someone who has shopped successfully on eBay for advice on how to shop on that site, and report on what that person tells you.

Question 3 How would you price a work of art? What do you think the advantages and disadvantages of using an auction site would be?

Experiential Exercises

1. Pick a local retail business that also sells products on its website. Compare the prices listed online with those in the store. Are there any differences? Ask the owner why or why not.
2. Many small companies regularly promote sales and other price changes on their websites. Track the changes that one such company makes for a week. Can you find any patterns in its actions? Why do you think the owners chose to make those changes?
3. Contact the credit manager of a company you do business with. Ask about the benefits and drawbacks of extending credit to customers.

Chapter 16 Case

Please see Appendix A for the Chapter 16 Case Study.

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Chapter 17

Promotional Planning

Learning Objectives

Looking Ahead

In the Promotional Planning chapter, we discuss the promotional budget, promotion on the Internet and social media, and the valuable traditional methods of personal selling, advertising, and sales promotion. By studying this chapter, you should be able to . . .

17-1 Describe the communication model and the factors that determine a promotional mix.

17-2 Explain methods of determining the appropriate level of promotional expenditures.

17-3 Explain how websites and social media are changing promotional practices.

17-4 Describe personal selling activities.

17-5 Identify advertising options for a small business.

17-6 Discuss the use of sales promotional tools.

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Spotlight on Small Business

The Dyrt

https://thedyrt.com/

What's new about camping? Maybe its connection with the tech industry.

Sarah Smith and Kevin Long love both camping and travel. They were frustrated, though, when they tried to find campgrounds in places they had not visited before. It hit them that the camping industry needed something like Yelp or Tripadvisor to provide campers with information about their campsite options. To fill the void, they created an app called The Dyrt.

Creating the app was one thing, but identifying campgrounds, obtaining user reviews, and generating revenues were not going to come automatically. How could they catch people's attention and attract them to the app? Their marketing approach started with gamification. According to Gamify, a software developer that helps companies design video games for promotional campaigns, gamification "is the addition of game elements to non-game activities."

The Dyrt introduced a game that campers play by posting reviews and photos of their camping experiences. Competitors move up and down the leaderboard. At the end of each month, the top ten on the leaderboard receive gift cards. The photos, reviews, and recommendations of the campers who have played the game comprise a library of information that can be accessed by the estimated 80 million people who go camping in the United States each year. Smith and Long developed games for each state, which they then licensed. The large database of camping information is attractive to brands that want to reach these millions of campers.

The initial business-to-business (B2B) strategy of licensing was the first step for Smith and Long. But the critical path to growth for their company was B2C, marketing to the ultimate consumers. They forecasted doubling their sales through campground bookings and targeted the most significant source of income as adventure travel bookings. This would be a natural outcome resulting from all the data they were collecting, categorizing, and making available from the individuals, families, and others who gather camping information and report their experiences on The Dyrt app.

On the company website, Smith, Long, and their team offer a seven-day free trial of multiple services, including planning camping trips, obtaining camping discounts, and even finding free campsites. Users can organize their trips, purchase camping gear, and find both commercial campgrounds and those in state and national parks.

The company was able to survive the 2020 lockdown and has continued to expand the amount of information its users make available. By the summer of 2021, The Dyrt had over a million and a half reviews of over 40,000 campsites. As people began taking to the roads once again, The Dyrt helped them prepare for enjoyable camping experiences in a summer of record-breaking heat.

Sources: Katherine Donnelly, "Woman in the Wild: Sarah Smith," https://www.outdoorproject.com/articles/woman-wild-sarah-smith, accessed July 29, 2021; Tim Gordon, "Portland-Based App Makes It Easier to Find Free Camping," https://www.kgw.com/article/features/portland-app-will-help-you-find-a-campground-anywhere-in-the-country/283-5a8757cf-153e-4843-8d28-8b08fde24595, accessed July 31, 2021; Alyssa Padgett, "RVE 200: Start Small, Start Now (with the Founders of The Dyrt)," https://heathandalyssa.com/thedyrt/, accessed August 2, 2021; "What Is Gamification?" https://www.gamify.com/what-is-gamification, accessed August 2, 2021; "The Dyrt," https://gust.com/companies/the-dyrt-2, accessed August 2, 2021; and "Camping Starts Here," https://thedyrt.com/, accessed July 29, 2021.

Clicking on an app to find user reviews about products or services or a company that catches your attention has become normal behavior. But imagine what life was like a generation ago, before the Internet and social media. Think about how expensive it might have been for a start-up like The Dyrt to get the word out about campgrounds and the services they offer. Getting reviews and recommendations from campers would

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have been far more difficult and time consuming. Would it have been feasible for the company to advertise on television, on billboards, and in magazines? Promotional strategies and technologies are advancing and evolving daily with a myriad of platforms like Twitter, Pinterest, and WhatsApp giving entrepreneurs countless cost-efficient alternatives for getting their message out.

A new venture can be an international player from the day it is launched. Entrepreneurs can see and communicate with foreign customers and suppliers via Zoom, Skype, Webex, Adobe Connect, and others. The online environment contains countless opportunities for small businesses to compete with large companies, as long as they promote their products and services effectively.

Promotion consists of marketing communications that inform potential consumers about a firm or its products or services with the objective of persuading those prospects to buy. A key decision in developing a promotional strategy is determining what you want to get out of it. Do you want to attract customers to your store or website? Are you asking them to buy a specific product or service? Or do you just want to plant the name of your business firmly in customers' minds so that they will think of you when they are ready to buy? This initial decision will drive what you choose to communicate to prospective customers and the means for getting your message out to them.

First, let's look at the basic communication model that characterizes promotion. An entrepreneur who understands that promotion is a special form of communication will be better able to grasp the entire process.

17-1 Promotion Is Communication

17-1 Describe the communication model and the factors that determine a promotional mix.

The basic communication model is simple—someone sends a message through a channel, and someone else receives it and understands it. Of course, in practice, communication is much more complicated. Through your promotional activities as a small business owner, you seek to have an existing or prospective customer take action as a result of the message you are sending. So, has your message reached your target customer? Did the customer understand the message? Did they take the action you desired?

An effective promotional strategy will take into account the promotional mix, the costs of promotion, the characteristics of your products and services, and what you can learn from your competitors and especially from your customers.

17-1a The Promotional Mix

The promotional efforts of a small firm can encompass nonpersonal (advertising), personal (personal selling), combined (social media), and special (sales promotional tools) forms of communication. A business organizes these promotional methods in a **promotional mix**, aimed at a target market. The particular mix of the various promotional methods—advertising, personal selling, social media, and sales promotional tools—is determined by many factors. For example, a widely dispersed market generally requires mass coverage through advertising or social media, in contrast to the more costly one-to-one personal selling. On the other hand, if the market is local or if the number of customers is relatively small, personal selling and the sales promotional tool of point-of-display promotion may be more feasible. Based on current technologies and the behaviors of consumers and businesses, social media demand the attention of the small business owner.

promotion
Marketing communications that inform and persuade consumers.

promotional mix
A blend of nonpersonal, personal, combined, and special forms of communication aimed at a target market.

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17-1b The Costs of Promotion

Small firms may not select certain forms of promotion, especially traditional media options, because the costs are just too high. Television advertising, for example, is generally more expensive than radio advertising. In 2020, Quibi aired a 30-second Super Bowl ad, introducing a streaming service that did not officially launch until April of that year. Many viewers were not sure what the company was or what service it offered. Quibi disappeared in less than a year. The $5.6 million Super Bowl ad was not the sole reason for the company's failure, but early-stage expenditures without results do not help.[1] The lower costs and more targeted nature of company websites have led many small firms to choose electronic media and social marketing strategies.

17-1c Promoting the Characteristics of Products or Services

If the product is of high unit value, such as manufacturing machinery, personal selling will likely be a vital ingredient in the mix. Personal selling is also an effective method for promoting highly technical products, such as industrial insulation products, because a customer's knowledge about them is usually limited. On the other hand, nonpersonal advertising is more effective for a relatively inexpensive item, like disposable razors.

The characteristics of services are not always as easy to point out as the characteristics of a tangible product. The promotional strategy should focus on how the service will solve a problem or make life better for the customer. Customer interest can quickly be lost if the promotion concentrates on how the service is performed.

17-1d Learning from Competitors

It is natural to want to stand out from the competition and try different tactics from those that established companies are using. You may discover, though, that your competitors have already tried your idea and found that it did not attract buyers. So, if everyone in your industry is using the same types of promotions, there may be a reason.

17-1e Listening to Customers

Keep in mind that successful communication includes feedback. Find out whether your customers are posting positive or negative comments about your company or your products online. Pay attention to the comments posted about other businesses to learn why customers are purchasing from them instead of from you. Consider meeting with a group of customers from time to time to get suggestions on how you can serve them better. No promotional activity will be successful day in and day out, for extended periods of time. You need to stay alert in order to make changes when your current techniques start to wear out.

Communicating with existing and prospective customers does not come without a price. Virtually every option you consider will have a cost. Think about all the promotional messages that come your way every day and all the sources from which they come. There are many stories about failed businesses that wasted money on poorly planned marketing efforts. This is an area where you need to take budgeting seriously.

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17-2 Determining the Promotional Budget

17-2 Explain methods of determining the appropriate level of promotional expenditures.

In Chapter 16, you learned that there is no magic formula for determining the right price for what you are selling. The same is true when figuring out how much a small business should spend on promotion. Four approaches that small business owners often use include the following:

1. Budgeting a fixed percentage of sales.
2. Spending whatever is left over after other expenses are covered.
3. Spending at the same level as competitors.
4. Determining how much is needed to achieve objectives.

17-2a Budgeting a Fixed Percentage of Sales

Many small businesses operate in stable markets with predictable revenue streams. In such cases, the simplest method of determining how much to budget for promotion is to earmark promotional dollars based on a percentage of sales. A firm's own past experiences should be evaluated to establish a promotion-to-sales ratio. If 2 percent of sales, for example, has historically been spent on promotion with good results, the firm can safely budget 2 percent of forecasted sales for future promotion. Secondary data on industry averages can also be used for comparison. Professional and industrial associations typically collect these data and report them to their members. A variation on the percentage-of-sales approach is to use a percentage of profits.

A major shortcoming of allocating a percentage of sales is a tendency to spend more on promotion when sales are increasing and less when they are declining. When the economy is booming, do you really need to spend more to attract customers? In a recession, however, using promotion to stimulate sales may be the most important way to let people know why they should be doing business with you. Of course, this strategy does not make sense for new firms with no historical sales figures on which to base their promotional budgets.

17-2b Spending Whatever Is Left Over

Using whatever is left over to support promotional efforts after all other activities have been funded occurs all too often in small businesses. This is sometimes described as the "all you can afford" method. The decision about promotional spending might be made only when a media representative sells an owner on a special deal that the business can afford.

Small business owners should always have objectives for the money that they spend—and they should always be alert for new promotional opportunities. But, they should do so only after all other expenses have been covered.

17-2c Spending at the Same Level as Competitors

As mentioned earlier, sometimes competitors are doing things right. You should always ask yourself why competitors are using a particular promotional medium and spending money in a certain pattern throughout the year. The answer may be that they've learned something about people's shopping and buying habits. By duplicating the promotional efforts of close competitors, a business will be spending at least as much as the competition in the hope of reaching the same customers. If the competitor is a large business, this method is clearly not feasible. However, it can be used to react to short-run promotional tactics by small competitors.

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Of course, this approach may result in copying competitors' mistakes as well as their successes. And the biggest pitfall can be that it makes you lazy. You don't want to ignore something that could really move your business forward. And if you design a new promotional strategy, realize that competitors may try to copy it. They may increase their budgets to keep you from stealing their customers, and you could find yourself in an ad war.

17-2d Determining How Much Is Needed to Achieve Objectives

With your promotional budget, you may be trying to increase sales or profits, get more prospects to visit your website, gain better name or brand recognition for your company or your product, or simply increase the number of people reached by your message. Determining how much you need to accomplish your goals requires a comprehensive analysis of the market with a link to the firm's objectives. You should know how your target market is getting information. Is a new social medium becoming popular? Do your customers need to be introduced to your product, or are they looking for it? The alternatives for spending promotional dollars are increasing every day.

17-3 Explain how websites and social media are changing promotional practices.

17-3 Promotion Using Websites and Social Media

As of January 2021, it was estimated that there were 4.66 billion active Internet users. This is sometimes referred to as the global digital population, and at that time, it represented 59.5 percent of the world's population.[2] Companies like The Dyrt, described in the Spotlight feature, recognize the opportunities presented by the billions of active mobile Internet users globally. According to the Pew Research Center, 72 percent of Americans are connecting with one another via social media sites.[3] Companies that fail to recognize how websites and social media are changing the ways that people communicate and process information are not likely to prosper. We'll help you gain a better understanding of what this means for small business owners by first looking at creating and managing websites and then discussing the promotional opportunities offered by social media.

17-3a The Small Business Website

If you are not thinking about marketing when you set up and manage your company's website, you are missing opportunities and doing damage to your business. Numerous decisions must be made prior to launching a site. Three critical start-up tasks are related to the likely promotional success of a corporate website:

1. Creating and registering a site name.
2. Building a user-friendly site.
3. Promoting the website.

Creating and Registering a Site Name

The Domain Name System (DNS) allows users to find their way around the Internet. Selecting the best domain name for a corporate website is an important promotional decision. Popular domain designations are .com, .net, .biz, .info, and .org. Follow the rules carefully to avoid problems when you register. The U.S. Small Business Administration provides details on registering a domain name and meeting other requirements for online business practices.[4]

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Since a domain name gives a small business its online identity, it's desirable to select a descriptive and appealing name. While entrepreneurs may want to use the name of their business, they may discover that it has already been taken. There is plenty of advice available on the Internet for creative approaches to selecting a name.[5]

MPFPHOTOGRAPHY/SHUTTERSTOCK.COM

Building a User-Friendly Website

First impressions are important, and a high-quality Web design gives a small e-commerce business the opportunity to make a good first impression on each visitor. Many technical specialists are available to help design and build a site. Our purpose in this chapter is simply to provide some useful ideas about website design (refer to Exhibit 17.1).

Websites fail to retain customers for many reasons. One of the most frequent problems is slow downloads. Online shoppers are impatient, and the slightest inconvenience sends them away. If your firm is conducting a considerable amount of online business, a slow website translates into lost sales revenue. Lost revenue can be direct (for example, missed sales, if you're selling online) or indirect (for example, loss of customer confidence, if you're providing Web-based solutions to clients). The more important a website is to your business, the less you can afford to have it perform slowly or, worse, experience downtime.

Websites will also fail if they do not satisfy visitors' information needs. Frequently, this is because designers look inward to the business for Web design ideas, rather than outward to customer needs. Some experts recommend that firms integrate social networking into their websites from the beginning.[6]

Exhibit 17.1 Website Design Guidelines

- **Select and register your domain name**. Comply with registration rules, and choose a descriptive and user-friendly name.
- **Choose a Web host**. Determine the primary purpose of your website, and then locate a host that best fits that purpose (types of hosts include e-commerce, blogging, business, and similar options).
- **Decide on the layout**. Design a site that balances attractiveness with the ability to interact.
- **Provide easy navigation**. Do not overload a page. Enable users to access any content with as few clicks as possible.
- **Stay consistent in style**. Inconsistency in headings, fonts, page layouts, color schemes, and terms only confuses visitors and appears amateurish.
- **Make sure the website can be accessed by multiple devices**. Users may search for your company from smartphones and tablets, as well as desktops and laptops.
- **Engage in search engine optimization (SEO)**. Serious competitors are applying SEO strategies to improve their websites' visibility. Don't be left behind.
- **Keep the website fresh**. Review your site frequently to remove outdated material, introduce new links, experiment with new formats, and make other changes.
- **Include a call to action**. Think again about your purpose, and invite users to take the action you are seeking.
- **Supply contact information**. Be sure that visitors know who you are and how to get in touch with you.

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Sources: Google, "Web Design Guidelines," https://www.bing.com/newtabredir?url=https%3A%2F%2Fsupport.google.com%2Fbusinesssitebuilder%2Fanswer%2F1657560%3Fhl%3Den, accessed August 5, 2021; Andy Crestodina, "Web Design Standards: 10 Best Practices on the Top 50 Websites," https://www.orbitmedia.com/blog/web-design-standards, accessed August 5, 2021; and Jamie Juviler, "9 Guidelines & Best Practices for Exceptional Web Design and Usability," https://blog.hubspot.com/blog/tabid/6307/bid/30557/6-guidelines-for-exceptional-website-design-and-usability.aspx, accessed August 5, 2021.

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Promoting the Website

A Web address can be promoted both to existing customers and to prospects by including the URL on print promotions, business cards, letterhead, and packaging. Special direct mail and radio campaigns can also be designed for this purpose. Additionally, a website can be promoted by placing banner advertisements on other websites, where a quick click will send users to the advertised site.

Search engine optimization (SEO) is the process of increasing the volume and quality of traffic to a particular website. The higher your small business ranks in search engine results, the more visitors it will attract. An important goal is to make your website as search engine–friendly as possible.

Keep in mind, too, that there are many specialized search engines. You can find guidelines for designing and submitting your website by visiting search engine websites.[7]

17-3b Social Media

Social media comprise social networking and microblogging sites, as well as other means of online communication, where users share personal messages, information, videos, and other content. The pervasiveness of social media has resulted in the introduction of new terms and new definitions of some words. (Inbound marketing and sales platform HubSpot provides an extensive list of social media marketing terms.[8]) Smartphones, tablets, and other mobile devices are helping business owners find entirely new ways of reaching customers and prospects.

Among the many lessons for small business owners is that they cannot absolutely control how their businesses are viewed by consumers. Today's customers are often members of communities that are sharing real-time information about the products and services being offered. Entrepreneurs may find that they need qualified experts to guide them through the social media maze, just as many expect accountants to coach them through their financial statements.

Promoting businesses, products, and services through social media can be intimidating, if only because of the vast array of options available. However, the same entrepreneurial attitude that helps an owner create and manage a small business can be applied to reach customers through online communications. Stay alert for the rapid changes these technologies will continue to bring.

17-3c Additional Ways to Promote Your Product or Service on the Internet

Many other strategies are available for those wishing to promote their products or services online. They involve social networking sites, direct email promotion, reciprocal advertising and hyperlinks, blogs, mobile devices, apps, and quick response codes.

Social Networking Sites

Hundreds of social networks are available and accessible for small businesses to join communities, make contacts, introduce products and services, build customer relationships, and otherwise promote their ventures' products or services. Deciding which networks to use and how to use them, and staying active and involved by sharing information and monitoring what others are doing require resources that very few small businesses have.[9]

Which networks will connect you with current and prospective customers and help you to discover what your competitors are doing? What new technologies may affect your

social media
Social networking and microblogging sites, as well as other means of online communication, where users share personal messages, information, videos, and other content.

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business? What social and cultural changes may affect your sales? Some networks are more general in nature, while others specialize. Your competitors' websites will help you to determine which networks they are encouraging visitors to click and join. Those are the networks that competitors think work best for them. There are different ways of ranking social networking sites, but some of the most popular sites include YouTube, Facebook, Instagram, WeChat, Pinterest, Snapchat, LinkedIn, Twitter, WhatsApp, and Reddit.[10]

Direct Email Promotion

Before social networking sites became dominant, **email promotion**, in which electronic mail is used to deliver a firm's message, provided and still provides a low-cost way to target customers and achieve high response rates. As more and more businesses began using email for this purpose, however, customer inboxes became cluttered. While many recipients are reluctant to open some email messages, fearing they may contain harmful computer viruses, businesses nevertheless continue to rely on this strategy, with many increasing their budgets for email marketing.[11]

Two obstacles to email promotion have arisen. First, the Can-Spam Act, which took effect on January 1, 2004, established standards regarding the use of commercial email and is enforceable by the Federal Trade Commission (FTC).[12] Second, anti-spam software, which sometimes also block legitimate emails, have become popular. Before sending a promotional message by email, marketers should consider testing their message by using a preview tool. Previewing allows viewers to see advertisements that may be delivered as emails without customers having to download them to their computers. MailWasher and SpamButcher are examples of software packages that permit previews.

Reciprocal Advertising and Hyperlinks

A **hyperlink** is a word, phrase, or image that a user may click on to go to another part of a document or website or to a new document or website.[13] As promotional tools, hyperlinks are typically reciprocal. This enables readers to move from one website to another that may have information that relates to their original search or complements what the original website is offering. In this way, companies can give visitors more information by providing links to websites maintained by others. Hyperlinks may be free to the linked parties if those parties believe that the connections are mutually beneficial. Otherwise, one company may have to pay a per-click charge to the other if it is seeking to obtain business from those using the primary website.

Blogs

The word *blog* is a contraction of the term *weblog*. **Blogs** are online journals that offer a writer's experiences, opinions, and more. The term may even refer to the website itself. Bloggers often include hyperlinks to complement or supplement the ideas they have presented. The websites are generally intended to be interactive, allowing viewers to leave comments. Many business owners have set up blogs related to their companies and products. This can be done for free on such websites as WordPress.com or Blogger.com. An owner can then comment on other blogs that may have related topics, each time including links back to their company blog. Recall that, in Chapter 16, we introduced you to Marty Zwilling of Startup Professionals in a Living the Dream profile. Zwilling used blogging to attract attention to the business and the services it offered.

Mobile Devices

Technological changes and consumer and commercial uses of mobile devices have exploded in recent years, along with the opportunities that these products offer to

email promotion
Delivery of a firm's message by electronic mail.

hyperlink
A word, phrase, or image that a user may click on to go to another part of a document or website or to a new document or website.

blog
An online journal that offers a writer's experiences, opinions, and more.

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small firms. According to the Pew Research Center, in 2021, 97 percent of adults in the United States owned a cell phone, 85 percent had a smartphone, and 53 percent owned computer tablets.[14]

A variety of wireless, handheld computing devices allow people to access information from wherever they are. When you are ready to promote your company and its products and services on these mobile devices, keep in mind that your website may need to be reformatted to fit smaller portable screens. You want a clear layout with easy navigation.

Apps

App is shorthand for *application*—specifically, a specialized software program. You are probably well acquainted with apps for a variety of uses, including how to get along in a college community. With the widespread use of smartphones, individuals, businesses, nonprofit organizations, and even government agencies offer apps to stay in contact and provide information to people on the go. As an example, take a look at the United States government's list of apps that can be downloaded at usa.gov/mobile-apps.

Large corporations use apps to make sure that their customers can reach them. Small business owners must take this method of communication seriously in order to compete and promote their companies effectively. An app should not cost your business more than the revenue it brings in. While you don't have to invest in the most technologically advanced app, you should think about how people can have fun when they click on your app. For example, Flickr can be used to share photos, perhaps showing how your customers are enjoying your products. Twitter could be used to update your customers with real-time notifications, while Pinterest can build community among customers with similar interests. And don't forget that when people use their mobile devices, they want responses and information *now*!

app
Abbreviation for a specialized software program.

Small business owners avoid social media promotion at their risk. Exhibit 17.2 offers some guidelines for social media marketing. Strategies and technologies are

Exhibit 17.2 Social Media Marketing Guidelines

Dos	Don'ts
• Do tell stories personalizing your brand and company. Post videos of customers using and enjoying your products.	• Don't overpromote. Provide more useful information than promotional information.
• Do build relationships with opinion leaders, including journalists. Show an interest in what others are writing about. Bloggers and reporters often ask questions that you or someone in your company may be able to answer.	• Don't waste your time on the wrong network. Just because "everyone" seems to be on Facebook doesn't mean that your customer will look there for what you are selling. Make sure you know your target customers and where they get their information.
• Do ask your customers to review the products they buy from you. People trust the endorsements and recommendations of other customers more than those of someone who works for you.	• Don't expect your customers to be perfect. They will make spelling errors typing in keywords. Keep common misspellings associated with your product and business in your search engine list to help people find you.
• Do keep it quick and short. Even 280 characters can be too long at times.	• Don't use hype, slang, or abbreviations. They all look like spam and make your brand look cheap.
• Do take keywords seriously. Keywords bring people to your site. Emphasize the keywords that your customers search for in your URL, in title tags, and in headings.	• Don't overinvest in social media at the expense of building content on your own website.

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Sources: Based on Anita Campbell, "7 Simple Steps for Mastering Social Media," https://www.sba.gov/blog/7-simple-steps-mastering-social-media, accessed August 7, 2021; Nancy Rothman, "Social Media for Small Business Owners—9 Top Strategies, https://meetedgar.com/blog/social-media-strategies-small-business/, accessed August 7, 2021; and Christina Newberry, "How to Use Social Media for Small Business: 12 Simple Tips," https://blog.hootsuite.com/social-media-tips-for-small-business-owners/, accessed August 7, 2021.

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changing so fast, though, you cannot assume that what is working for you today will still work tomorrow. And keep in mind that until recently, an unsuccessful advertisement could be quickly pulled and forgotten. Now it lives on online, tarnishing the image of the company that spent good money to create it.

Quick Response Codes

Another tool for electronic communication that small business owners are using is the **quick response (QR) code**. A QR code is a square bar code that connects to a website, a video, or some other Web content. The bar code makes it easy for someone to access your site without typing in a URL. Prospective customers just scan the QR code with their phone camera or webcam. Business owners are finding lots of value in these codes. A QR code on a business card can be scanned to an address list. They can also announce events and promotions for a company, providing days, times, locations, and other information. They may include an email message that encourages a response. Connecting people to videos may generate the most attention.[15]

17-4 Personal Selling in the Small Firm

17-4 Describe personal selling activities.

As much as social media seem to be taking over the world, face-to-face contact still counts. Through personal selling, you can use body language to convey your message, answer questions and resolve problems immediately, and build confidence. When you are starting a new business, this may be your most important marketing tool. Small business owners should always think of themselves as personal sales representatives for their companies. Wherever you go as a business owner, you are the company to the people you meet. Your interpersonal skills may come into play in any number of ways. People you meet inside or outside of your business form judgments based on how they react to you. They also form judgments based on their interactions with any of your employees. All employees should know that they are making impressions that could lead to sales or could send customers to another business.

For many products, **personal selling**—a face-to-face meeting with a customer—is the best way to make a presentation and close a sale. Many small business owners had to learn new lessons during the 2020 pandemic lockdown when face-to-face meetings were suddenly on a computer screen or a smartphone or some other device. Many of those lessons carried over into the new normal. Personal selling includes the activities of both inside salespeople of retail, wholesale, and service establishments and outside sales representatives, who call on business customers and final consumers. In a small business, all employees in the company must think of themselves as salespersons. A customer who walks into a business or places a phone call or sends an email to a business should not have to wait very long to be taken care of by the owner or a certain employee with a particular job title—everyone must be ready to meet the customer's needs. The entrepreneur's responsibility is to make sure that all employees are prepared to do personal selling.

Before hiring a sales force for your company, calculate the costs and expected returns. This can be an expensive form of promotion per sale. For a small business, personal selling is labor intensive. It takes you and your employees away from the many other activities that may be critical to keeping your business alive.

quick response (QR) code
A square bar code that connects to a website, a video, or some other Web content.

personal selling
A face-to-face meeting with a customer.

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Living the Dream

Matching the Salesperson to the Customer

It was November of 2007 when Police Sergeant Tanya Czack had enough. For the sixth time in six months, she had damaged her uniform, on this occasion tearing her pants when jumping a fence chasing suspects. Tanya complained to her sister-in-law Denise Czack, and they started brainstorming about designing safe and comfortable pants for women in public safety. The result was the creation of a new venture, Her BlueWear Uniforms (HBWU).

Tanya and Denise discovered that existing producers did not see a large market and therefore were not willing to produce attire for women law enforcement personnel. For the Czacks, however, the opportunity to reach a market of nearly 400,000 women was very attractive. The design of HBWU's pants allows a holster to sit properly for firearm access rather than riding up to a woman officer's ribcage. The weight of the gun belt can be at the wearer's natural center of gravity, improving balance and reducing the likelihood of injury. HBWU also produces a vest that has a lower extension than the standard version and covers more of a woman's vital organs. On the company's website, prospective customers can complete a quiz and do a virtual fitting.

Tanya's experience in law enforcement gave her insight into the customers in their target market and the pain they were experiencing. Denise had worked in marketing and as a sales manager and felt her strength would be in selling the products. Her first effort was at a conference attended by 300 female police officers. She sold five pairs of pants. Tanya understood the problem. Law enforcement officers are trained to be suspicious of what other people say. The light went on for the cofounders, and Tanya made the next pitch. She could look the cops in the eye and describe the discomfort they went through every day. This time, they sold 45 pairs of pants and got recommendations from some of the attendees that opened other doors.

This led to a new sales strategy. Tanya and Denise began hiring saleswomen, and everyone was a police officer. They had no problem finding qualified salespeople. Many police officers work unpredictable hours for relatively low pay. Most police departments permit their personnel to work part-time at other jobs, and being a sales representative for HBWU was less risky and more flexible than many other options an officer might have. The sales representatives attended trade shows with Tanya and Denise, called on local police departments, and promoted the clothing on social media. According to Denise, "The trick is to have salespeople who can break down our customers' guard and get them to listen."

Sources: https://www.herbluewear.com/, accessed August 8, 2021; Jordan Heller, "Build a Better Sales Force," *Entrepreneur*, October-November 2019, p. 23; and GunLinkSHOT, "Designers for New Police Gear for Women at SHOT Show," http://blog.gunlink.info/2012/01/18/designers-of-new-police-gear-for-women-at-shot-show/, accessed August 8, 2021

17-4a The Importance of Product Knowledge

Effective selling is built on a foundation of product knowledge. A salesperson is expected to give individual attention to a prospect, perhaps being ready to negotiate and customize a product or service to fit a special need. With thorough knowledge, the salesperson can explain the product's or service's advantages, uses, and limitations and can educate customers by answering questions and countering objections. Communication in this form of promotion should be interactive. Customers are seldom experts on the products they buy. However, they can immediately sense a salesperson's knowledge or ignorance. Personal selling degenerates into mere order-taking when a salesperson lacks product knowledge.

17-4b The Sales Presentation

The heart of personal selling is the sales presentation to a prospective customer. Being a good listener is essential, but you should have a good idea of what you or your sales

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representatives will be ready to say. At this crucial point, an order is either secured or lost. Some standard practices that have been found to lead to success include prospecting and practicing the sales presentation.

Prospecting

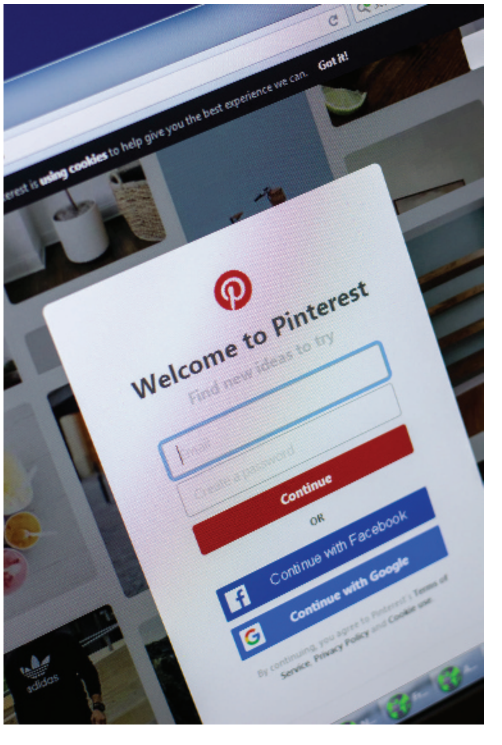
A preliminary step leading to an effective sales presentation is **prospecting**, which is the systematic process of continually looking for new customers. With expanding options and rapid changes in communication technology, it is better to think of prospecting as both looking for new customers and making it easy for new customers to find you. Prospecting also includes consideration of whether a potential customer can be well served by the company. This is especially important in distinguishing true prospects from casual browsers when they initiate contact with you. Small business owners must use their limited resources wisely.

One of the most important skills a small business owner can have is the ability to network. We have emphasized networking via social media, and you will read more about the process of developing and engaging in mutually beneficial relationships in Chapter 19. For now, we want to point out how building relationships through business and social interactions can lead to *personal referrals*. If you are able to demonstrate to friends, customers, and other business contacts that you deliver on your promises, that you have solutions to their problems and the products or services that can make their lives better, those contacts may open other doors for you. They may let you use their names when introducing yourself to others. At a minimum, they can provide word-of-mouth endorsements, often the strongest recommendation you can get.

Another source of prospects is *impersonal referrals* from media publications, public records, and directories. Newspapers and magazines, particularly trade magazines, often identify prospects by reporting on new companies and new products. Engagement announcements in a newspaper can serve as impersonal referrals for a local bridal shop. Public records of property transactions and building permits can be impersonal referrals for a garbage pick-up service, which might find prospective customers among home buyers or those planning to build houses or apartment buildings.

prospecting
A systematic process of continually looking for new customers and making it easy for new customers to find you.

A high-tech variation of impersonal referrals takes place on various social networking sites such as Facebook and Pinterest, where more and more subscribers are providing reviews of the establishments they patronize. Keep in mind that reviews posted on such websites can be positive or negative. Develop a strategy for responding to online criticisms.[16]



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Prospects can also be identified without referrals through *marketer-initiated contacts*. Phone calls or mail surveys, for example, help locate possible buyers. Finally, inquiries by a potential customer that do not lead to a sale can still create a “hot prospect.” Small furniture stores may require their salespeople to fill out a card for each person visiting the store. These *customer-initiated contacts* can then be systematically followed up by phone calls or social media connections, and prospects can be notified of special sales. Some customers may become followers on your company’s Twitter account and receive notification through Twitter of special offers. Contact information should be updated periodically. Firms with websites can similarly follow up with visitors who have made inquiries online.

Practicing the Sales Presentation

Nothing substitutes for practice before making a sales presentation. Everything may be clear in your mind, but that does not guarantee

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that the right words will come out of your mouth. Successful salespeople recognize that style can count as much as content. One way to learn about your own style is to record the presentation in order to study it later and improve your delivery.

The best salespeople have done their homework. They have not only practiced their presentations, but they have also studied their prospective customers. They have thought about possible customer objections to the product and are prepared to handle them. Knowing something about customers' wants and needs will prepare you for most of their likely objections. Most objections can be categorized as relating to (1) price, (2) product, (3) timing, (4) source, (5) service, or (6) need. Training can be helpful in teaching sales staff how to deal with customers' objections.

Successful salespeople also develop techniques for attracting a customer's attention, for presenting reasons to buy, for responding to objections, and for closing a sale. Some of the best strategies are shown in Exhibit 17.3.

17-4c Cost Control in Personal Selling

We have already explained that personal selling efforts can be expensive. You may not be spending as much on a salesperson as on an advertising campaign, but neither are you reaching as many people. Cost considerations are especially important for a new business that generally has very limited resources. While nothing can substitute for an entrepreneur's personal efforts to sell products and services and to represent the image and reputation of the firm, time spent selling is time away from other activities required for keeping the business open and operating.

Additionally, in the start-up and early-growth stages, a business may not have funds to support a full-time sales staff. The most cost-efficient mode of selling may be to use *sales or marketing representatives*, who are self-employed or work for a company whose purpose is to represent multiple businesses, thereby spreading out the costs of selling. They will not focus on your products alone, as your own employees would,

Exhibit 17.3 Successful Sales Techniques

- **Be honest.** Your prospect has to discover only one misrepresentation to lose all trust and confidence in you. You want customers who will come back to you and tell others how good you are.
- **Know your audience.** Are you talking with the decision maker, or does this person need approval from someone else? How is your product or service used by this customer?
- **Know how much time you have, and get to the point.** Many people recognize that time is their most valuable asset. Be sure to respect that. If you can't make clear in the first sentence or two why you're there, you'll lose your prospect's interest.
- **Prepare an outline, and rehearse.** Be sure to cover all critical issues and logically order your presentation. Then test your ideas on others. Do they understand your message?
- **Be relevant, and engage the customer.** Ask enough questions to know what is important to your prospective customer and how you can help him or her. Think of your presentation as a *conversation*. Be a better listener than a speaker.
- **Believe in what you are selling, and be enthusiastic.** Be able to genuinely convey what makes your product or service better for the customer than anyone else's. But recognize that the world's best salespeople still hear "no" more than "yes." Do not let that discourage you.
- **Use visuals.** Size, technology requirements, safety, and other issues might limit your ability to show your product. Nevertheless, visual representations help project customers into a situation where they better understand what the product will do for them.
- **Get reactions from the prospect.** If the prospect does not ask questions, it is a sign that you have not communicated your message successfully. Be ready with questions of your own, questions that will solicit more than yes-or-no answers. You want to know what is preventing you from getting the results that you seek. You want to know how to make the prospect happy.

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Sources: Based on Kelley Robertson, "Creating a Powerful Sales Presentation," http://www.businessknowhow.com/marketing/sales-presentation.htm, accessed August 9, 2021; Kevin Davis, "10 Tips for Winning Sales Presentations," http://www.businessknowhow.com/marketing/winslspres.htm, accessed August 9, 2021; and Rhonda Abrams, "As a Small Business Owner, You Will Have to Be a Salesperson at Some Point. Here Are Some Successful Sales Techniques," https://www.usatoday.com/story/money/columnist/2021/04/21/successful-small-businesses-sales-techniques-close-sale/7309583002/, accessed August 9, 2021.

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but your company will have to compensate them only as merchandise is actually sold. Think of them as your partners. Provide any sales aids they may need to make their job easier. Keep communication channels open, and let them know that you are committed to making them successful.

17-4d The Compensation of Salespeople

Salespeople will not be motivated for the same reasons that an owner is. You may be in love with your product or service; you may be seeking to change the world. But your employees want to get paid. Nevertheless, they can be motivated by nonfinancial compensation as well as money. Research studies on small businesses have identified noncash incentives that relate to firm performance.[17]

Nonfinancial Compensation

Personal recognition and the satisfaction of reaching a sales quota are examples of nonfinancial rewards that motivate many salespeople. Small retail businesses sometimes post a photograph of the top salesperson of the week or month for all to see. An engraved plaque or other recognition may also be given as a more permanent record of sales achievements.

Nonfinancial compensation may also relate to personal and career advancement. Rewards for being a desired employee include opportunities for promotion, advanced education and training, and job security. Business owners should be aware that effective sales personnel are often competitive. They gain a sense of accomplishment by measuring their achievements against those of their peers. Some companies run internal competitions, which can be motivational. If the competition creates hostility among sales personnel, however, consider alternatives such as measuring performance against past achievements or industry standards.

Financial Compensation

As much as employees may believe in your vision for the firm, they have to take care of themselves and their families. Two basic plans used for financial compensation are commissions and straight salary. Each plan has specific advantages and limitations for the small firm.

Many small businesses prefer to use commissions as compensation, because such an approach is simple and directly related to productivity. A certain percentage of the sales generated by a salesperson represents the commission the salesperson has earned. Revenue is generated for the firm, so the money is readily available to pay the salesperson. Such a plan incorporates a strong incentive for sales effort—no sale, no commission! On the negative side, a salesperson's job is always about more than just making the sale. Personnel on commission might be less likely to provide follow-up service or complete after-sale paperwork or other tasks that the business requires.

The straight salary form of compensation provides salespeople with income security, regardless of sales made. However, working for a straight salary can potentially reduce a salesperson's motivation by providing income despite low performance or no sales at all.

Many businesses combine the salary and commission forms of compensation. Salary usually represents the larger part of compensation for a new salesperson. As the salesperson gains experience, the ratio is adjusted to provide more money from commissions and less from salary. And do not put a cap on what a salesperson can earn through commission. Many companies have lost their top producers by limiting incentives. Why would you stop rewarding someone who is making money for your business?

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Whatever plan you choose should incorporate sales volume targets with a time frame for accomplishment, typically a month or a year. Additionally, the sales staff should know what the minimum expectations are for their performance. Beyond sales, these expectations can also include customer development, repeat sales, service efforts following sales, and other activities that contribute to the success of the company.

17-5 Identify advertising options for a small business.

17-5 Advertising Practices

Along with personal selling, advertising is likely to be part of the promotional strategy for your business. Advertisements are most often communicated to businesses and consumers through media, such as television, radio, magazines, newspapers, direct mail, billboards, and the Internet.

17-5a Advertising Objectives

To use your money wisely, you should decide what your goals are when you advertise. **Advertising** is a strategy to sell by informing, persuading, and reminding customers of the availability or superiority of a firm's products or services. Without product or service strengths, such as quality and efficiency, advertising will not be enough to help your business survive and grow. Advertising must always be viewed as a complement to a good product and never as a replacement for a bad product.

The importance of honesty in advertising cannot be overstated. An entrepreneur should avoid creating misleading expectations, as such expectations are likely to leave customers dissatisfied. There is nothing wrong in speaking glowingly of a product or service that you believe in. But no false claims should be made.

At times, advertising may seem to be a waste of money. It can be expensive and may add little direct value to a product or service. Many start-up companies believe that Internet exposure will generate sales immediately. Google has found, however, that many ads are never viewed.[18] Google and other Internet providers offer advice and services that small businesses should consider adopting to improve their chances for success. Small business owners need to stay up to date with changes in technology and societal behavior.

advertising
A strategy to sell by informing, persuading, and reminding customers of the availability or superiority of a firm's products or services.

product advertising
A presentation designed to make potential customers aware of a specific product or service and create a desire for it.

institutional advertising
A presentation of information about a particular firm, designed to enhance the firm's image in order to make its product advertising more credible and effective.

17-5b Types of Advertising

The two basic types of advertising are product advertising and institutional advertising. **Product advertising** is designed to make potential customers aware of a particular product or service and create a desire for it. **Institutional advertising**, on the other hand, conveys information about the business itself. It is intended to make the public aware of the company and enhance its image so that its product advertising will be more credible and effective.

Most small business advertising is of the product type. Small retailers' ads often stress products, such as weekend specials at a local supermarket or sportswear sold exclusively in a women's clothing store. It is important to note, however, that the same advertisement can convey both product and institutional themes. With advertising, you are prospecting for customers who want your product, so the ideal solution is that they clearly understand the best place to buy it is from your company. This may be approached in a variety of ways. A firm may stress its product in newspaper advertisements, for example, while using institutional advertising on websites. Decisions regarding the type of advertising to be used should be based on the nature

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of the business, industry practice, available media, and the objectives of the firm.

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17-5c Advertising Specialists

An entrepreneur cannot be an expert in everything. Small business owners often contract with outside companies and individuals for accounting services, legal advice, transportation, and more. It is not unusual to rely on others' expertise to create promotional messages. Advertising agencies represent just one of several resources that can provide this specialized assistance. The services offered by ad agencies include the following:

- Graphic design, artwork, and even printing for specific advertisements and/or commercials.
- Recommendations for media with the greatest "pulling power" for your product or service.
- Copywriting for traditional ads, as well as for blogs, press releases, and other promotional materials.
- Assistance with trade shows and merchandise displays.
- Website design and social media management.
- Mailing and email list management.

Since advertising agencies charge fees for their services, an entrepreneur must be sure that the return from those services will be greater than the fees paid. Of course, with the high level of technology currently available, creating advertisements in-house is becoming increasingly common among small firms. Some business owners are assisted by suppliers, who may furnish display aids and even entire advertising programs to their dealers. Trade associations can also provide helpful assistance. In addition, an advertising medium itself can provide some of the same services offered by an ad agency.

17-5d Frequency of Advertising

Determining how often to advertise is an important and highly complex issue for a small business. Obviously, advertising should be done regularly, and attempts to stimulate interest in a firm's products or services should be part of an ongoing promotional program. Continuity reinforces the presence of the company as the place for customers to buy when they are ready.

One-shot advertisements that are not part of a well-planned promotional effort lose much of their effectiveness in a short period. Of course, some noncontinuous advertising may be justified, such as advertising to prepare consumers for the acceptance of a new product. Such an approach may also be used for holidays and seasonal events. Many products and services have some seasonal demand—landscaping services in warm months, snow removal in cold ones, costumes at Halloween, flowers on Valentine's Day. Deciding on the frequency of advertising involves a host of factors, both objective and subjective. This is another reason for entrepreneurs to seek professional advice.

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17-5e Where to Advertise

Not everyone is a serious prospect for your business. You have to identify the market segment most likely to buy the products and services you offer and to buy them from you rather than other sources. This means restricting your advertising, perhaps by geography or customer type. You cannot afford to be all things to all people. From among the many media available, a small business owner must choose those that will provide the greatest return for the advertising dollar.

The most appropriate combination of advertising media depends on the type of business and its current circumstances. Furniture retailers and auto dealers use local television and newspaper ads. Television keeps their name and products in front of consumers, making them easy to remember when customers are ready to shop and buy. And when someone is ready to purchase a car or some furniture, they are likely to look in newspapers and go online to compare products and prices. Hotels and restaurants near busy highways rely on billboards to attract patrons to their locations. Retirement communities and assisted-living facilities may obtain mailing lists from senior citizen centers and use direct mail to reach their target market. The current stage of communications technology demands that business owners consider the inclusion of a company website as part of their Internet promotional strategy in any combination of advertising media. Websites are the first step in identifying prospective sources of products and services by many consumers and businesses.

To make an informed selection, entrepreneurs should learn about the strengths and weaknesses of each medium, as presented in Exhibit 17.4. Study this information carefully, noting the particular advantages and disadvantages of each medium.

Exhibit 17.4 Advantages and Disadvantages of Major Advertising Media

Medium	Advantages	Disadvantages
Internet	Ability to target demographics; easy to update; relatively short lead time required for creating Web-based advertising; natural fit with social networking	Possible difficulty in measuring ad effectiveness and return on investment; not all consumers have access; firms in industries where technology changes rapidly must be careful not to leave obsolete products on display; service issues
Newspapers	Geographic selectivity and flexibility; short-term advertiser commitments; news value and immediacy; year-round readership; high individual market coverage; co-op and local tie-in availability; short lead time	Little demographic selectivity; limited color capabilities; low pass-along rate; may be expensive
Magazines	Good reproduction capabilities, especially for color; demographic selectivity; regional selectivity; local market selectivity; relatively long advertising life; high pass-along rate	Long-term advertiser commitments; slow audience buildup; limited demonstration capabilities; lack of urgency; long lead time
Radio	Low cost; immediacy of message; can be scheduled on short notice; relatively no seasonal change in audience; highly portable; short-term advertiser commitments; entertainment carryover	No visual treatment; short advertising life of message; high frequency required to generate comprehension and retention; distractions from background sound; commercial clutter
Television	Ability to reach a wide, diverse audience; low cost per thousand viewers; creative opportunities for demonstration; immediacy of messages; entertainment carryover; demographic selectivity with cable stations	Short life of message; some consumer skepticism about claims; high campaign cost; little demographic selectivity with network stations; long-term advertiser commitments; long lead times required for production; commercial clutter
Direct Mail	Ability to target respondents; provides a detailed and personalized message	May be tossed out as "junk" mail; rising costs per qualified prospect
Outdoor Media	Repetition; moderate cost; flexibility; geographic selectivity	Short message; lack of demographic selectivity; high "noise" levels may distract audience

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Living the Dream

Playing Games and Watching Ads

Talk about a win-win-win solution! Uber and Lyft passengers get the chance to play games and win cash. The drivers earn money if enough passengers play the games. Advertisers have captive audiences when passengers look at their promotional messages before playing the games. And Octopus Interactive makes all this happen by supplying the tablets to drivers for passengers to use and receiving payments from the advertisers.

Drivers have set-ups for the tablets in the back seats of their vehicles. Passengers see "Play Octopus" and, during what are typically about 15-minute rides, they can play trivia and interactive games, receive public service announcements, public health and safety notices, and win prizes. There is no charge to the passenger for using the tablet.

Cofounders Bradford Sayler and Cherian Thomas launched Octopus Interactive in 2018. According to the company's website, Octopus Interactive is "the world's largest rideshare advertising network." The two entrepreneurs had collaborated earlier on an app, Spotluck. Downloaders could hit a spin button that would randomly bring up a local restaurant that offered a discount to the patrons, solving the problem of where to go to eat. When Sayler and Thomas decided they had an idea that would be even more fun and have more growth potential, Octopus Interactive was born, with Spotluck serving as the parent company.

The stereotypical Lyft or Uber rider is a millennial with disposable income. This is an attractive customer segment for many companies. Some of the advertisers that partnered with Octopus early in its history include product companies like Red Bull and marketing agencies like Omnicom. A review of data collected from users shows the average passenger playing the game as being 32 years old with a bachelor's degree or higher. The percentage of those identifying as male is slightly higher than female.

To qualify for a free tablet, a driver must have at least 100 rides per month. Drivers get paid each month that they reach that target and can also earn money by referring new drivers. Octopus reports that the drivers who provide its tablets receive higher tips and better ratings.

The company's website provides details for prospective advertisers. Advertisers, whether large or small, can see how they will be charged, what the demographics are for the market they would be targeting both nationally and locally, the data they would be able to access to learn more about their audiences, and the metrics they could use to assess the effectiveness of their ads.

Sayler, Thomas, and their team have grown to a national presence in a relatively short period of time with what is a relatively small team. In 2020, Octopus Interactive announced plans for international expansion, beginning with Canada. Thomas, in his role as CEO, is now in give-back mode. He sponsors entrepreneurship competitions at his alma maters, Hood College and Georgetown University.

Sources: https://playoctopus.com/, accessed August 11, 2021; https://www.spotluck.com/, accessed August 11, 2021; Kerry Flynn, "A Startup Is Putting Ads inside Ubers and Lyfts," https://digiday.com/future-of-tv/octopus-lets-advertisers-reach-uber-lyft-passengers/, accessed August 11, 2021; Brett Helling, "How Drivers Can Use Play Octopus to Earn More Money," https://www.ridester.com/play-octopus-earn-more/, accessed August 11, 2021; and Hugh S. Moore, "Octopus Interactive Announces International Expansion and Continued Rideshare Rebound," https://www.globenewswire.com/news-release/2020/10/07/2105028/0/en/Octopus-Interactive-Announces-International-Expansion-and-Continued-Rideshare-Rebound.html, accessed August 12, 2021.

17-6 Sales Promotion

17-6 Discuss the use of sales promotional tools.

A more traditional marketing practice, which is also used on websites and mobile devices, is sales promotion. Generally, **sales promotion** includes any promotional technique, other than personal selling or advertising, that stimulates the purchase of a particular product or service. The term is defined on Merriam-Webster.com as "activities and devices designed to create goodwill and sell a product, *especially*:

sales promotion An inclusive term for activities and devices designed to create goodwill and sell a product.

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selling activities (as use of displays, sampling, demonstrations, fashion shows, contests, coupons, premiums, and special sales) that supplement advertising and personal selling, coordinate them, and make them effective."

For best results, sales promotion typically is used in combination with personal selling and advertising. Social media companies enable small firms to compete head-on with their large competitors in cost-efficient ways through sales promotion. Many businesses make use of Foursquare and similar platforms, which allow them to introduce online loyalty programs.

Next, we briefly examine four of the most widely used promotional tools: specialties, trade show exhibits, coupons, and publicity.

17-6a Specialties

There are countless specialty items, including calendars, pens, key chains, coffee mugs, and shirts. Almost anything can be used as a specialty promotion, as long as each item is imprinted with the firm's name or other identifying slogan. Contact information is also often included.

The distinguishing characteristics of specialties are their enduring nature and tangible value. The key to an effective specialty item is that it lasts—the customer or client has the tangible, visible item for months or years, keeping the name of your company or product in front of them. As functional products, they are worth something to recipients. Specialties can be used to promote a product directly or to create goodwill for a firm. They are excellent reminders of a firm's existence.

Finally, specialties are personal. They are distributed directly to the customer in a personal way, they can be used personally, and they have a personal message. A small business needs to retain its unique image, and owners often use specialties to achieve this objective. More information on specialties is available on the website of Promotional Products Association International (ppai.org).

17-6b Trade Show Exhibits

Advertising often cannot substitute for trial experiences with a product, and a customer's place of business is not always the best environment for product demonstrations. Trade show exhibits allow potential customers to get hands-on experience with a product.

Trade show exhibits are of particular value to manufacturers. The greatest benefit of these exhibits is the potential cost savings over personal selling. Trade show groups claim that the cost of an exhibit is less than one-fourth the cost of sales calls, and many small manufacturers agree that exhibits are more cost-effective than advertising. Experienced exhibitors offer the following helpful tips regarding trade shows:[19]

- *Check out the trade show's history*. Does the show regularly attract large crowds? Will the show be adequately promoted to your potential customers?
- *Apply for a speaking opportunity*. Many shows have keynote speakers and breakout sessions on special topics. Also, having a customer speak on your behalf makes a great impression.
- *Pick a good location for the booth*. It will cost you extra, but a good location could be critical in a large show. Corner booths are best.
- *Prepare a professional-looking display*. You do not need to have the biggest, flashiest booth on the trade show floor to attract attendees. But signs, photographs of your products, and other business-related elements used in the display should appear to be professionally prepared.

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- *Have a sufficient quantity of literature on hand.* Have plenty of professional-looking brochures or other handouts to distribute, and have them prepared well in advance of the show.
- *Bring the right staff.* You want someone who believes in the product and who enjoys talking with strangers.
- *Have the right giveaways.* Consider using the specialty promotion items just described. Don't waste money on novelty items that no one will use.
- *Find a partner.* You can cut your costs by paying for a portion of the space in another vendor's booth.
- *Follow up.* Have a plan for following up on leads as soon as you get home from the show.

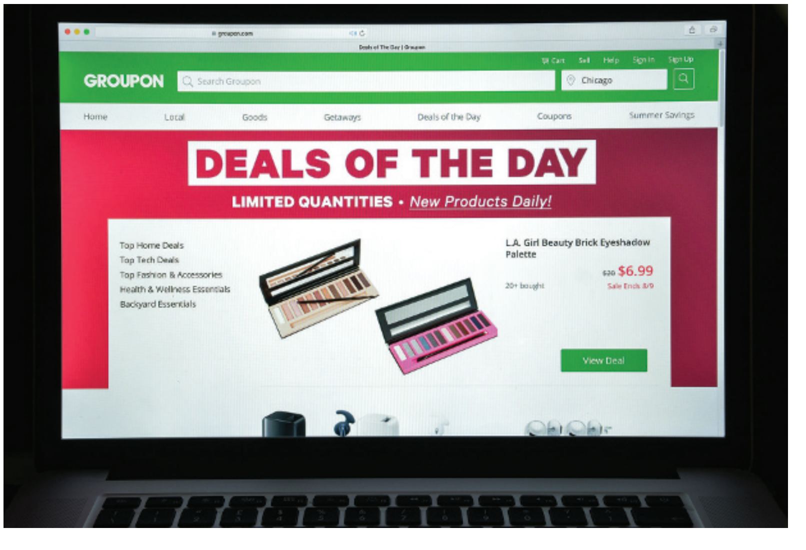
17-6c Coupons

Coupons have been used as promotional tools for over a hundred years. Coca-Cola is credited with being the first company to use coupons. Asa Candler, a cofounder of the Coca-Cola Company, gave handwritten notes to customers that they could exchange for a free glass of Coke. The first official coupon was issued by C. W. Post, offering one cent off the price of a box of Grape-Nuts cereal. Consumers continue to cut coupons from newspapers and magazines, use coupons received through direct mail, and download them from the Internet.[20] Not only do they attract customers to purchase products, but coupons also have value even if they are not used. A study by University of Virginia professors found that consumers who received but did not redeem coupons actually increased their purchasing from the stores associated with the coupons.[21]

The world of couponing changed with Groupon. The company was launched in 2008, in response to the frustration that its founder, Andrew Mason, felt when trying to get a reply from a major corporation. Mason decided that collective action from large numbers of customers would get more attention and designed a platform that uses social media to gain commitments from individuals until a critical mass is reached. Groupon negotiates deals with businesses for reduced prices on merchandise and services that go into effect once the tipping point is reached—that is, when enough people have signed up for a coupon to obtain the discounted item.[22]

publicity
A promotional strategy that provides visibility for a business at little or no cost.

Groupon has spawned competitors, such as LivingSocial and SocialTwist. Many small businesses use these platforms to attract business in the hope of gaining returning customers. Some, however, have actually lost money, offering too large a discount and not retaining customers for the long term.[23] But others have taken actions to reduce their risks and build sales.



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17-6d Publicity

Of particular importance to small firms is **publicity**, which provides visibility for a business at little or no cost. Publicity can be used to promote both a product and a firm's image. It is a vital part of public relations for the small business. Some entrepreneurs find ways to use social media to publicize their ventures. One technique involves following

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blogs of opinion leaders in your industry or ones that target your customer segments. Some allow you to respond to their blogs and mention your company, products, or services. A good publicity program requires regular contacts with the news media. As explained in Exhibit 17.2, journalists are opinion leaders. You can help them as much as they can help you, if you and your business are the source of engaging stories.

Examples of publicity efforts that incur some expense include underwriting school yearbooks and sponsoring youth athletic programs. While the benefits are difficult to measure, publicity is nevertheless important to a small business and should be used at every opportunity. The return on a relatively small investment can be substantial.

17-6e When to Use Sales Promotion

A small firm can use sales promotion to accomplish various objectives. For example, small manufacturers can use it to stimulate channel members—retailers and wholesalers—to market their product. Wholesalers can use sales promotion to encourage retailers to buy inventory earlier than they normally would, and retailers, with similar promotional tools, may be able to persuade customers to make a purchase.

At its core, successful promotion is all about effective communication. The sender (a small business) must have a message that intended recipients (in the target market) receive or find, understand, and act on. However, this is not a simple exercise. Many decisions must be made along the way—decisions regarding the size of the promotional budget, the promotional mix, the nature and placement of advertising, the identification of high-potential prospects, participation in trade shows, and many more. Rapid changes in technologies and in social behavior mean that companies of all sizes will make promotional errors along the way—and you will, too. Your job is to learn from those mistakes. Stay alert for better ways to serve your customers and to get the word out about why they should do business with you.

17-1. Describe the communication model and the factors that determine a promotional mix.

- The basic communication model involves a sender, a message, a channel, and a receiver.
- An effective promotional strategy is influenced by the geographical nature of the market and includes the promotional mix, the promotional budget, the characteristics of the product, learning from competitors, and listening to customers.
- A promotional mix is a blend of nonpersonal, personal, combined, and special forms of communication aimed at a target market.

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17-2. Explain methods of determining the appropriate level of promotional expenditures.

- Earmarking promotional dollars based on a fixed percentage of sales is a simple method for determining expenditures.
- Spending only what can be spared after other expenses have been covered is a widely used approach to promotional budgeting.
- Spending as much as the competition does is a way to react to short-run promotional tactics of competitors.
- The preferred approach to determining promotional expenditures is to decide what it will take to do the job through a comprehensive analysis of the market.

17-3. Explain how the Internet and social media are changing promotional practices.

- Companies that fail to recognize how the Internet and social media are changing the ways that people communicate and process information are not likely to prosper.
- Websites should have a descriptive and appealing name and be user-friendly.
- Efforts must be taken to promote websites to both existing and prospective customers.
- Search engine optimization is a necessary activity to attract visitors to a small business website.
- Through social networking and microblogging, customers share real-time information about products and services.
- Many tools are available for engaging in marketing and promotion through social media, such as email, reciprocal advertising, hyperlinks, blogs, and apps. Your website may need to be reformatted to fit the smaller screens of mobile devices.
- Small business owners must stay informed about social media options, such as quick response (QR) codes.

17-4. Describe personal selling activities.

- Effective selling is based on a salesperson's knowledge of the product or service, as well as their study of prospective customers.
- A sales presentation is a process involving prospecting, practicing the presentation, and then making the presentation.
- Prospecting is the systematic process of continually looking for new customers and making it easy for new customers to find you.
- Cost control is very important in personal selling.
- An entrepreneur is first and foremost a salesperson for the enterprise.
- The most attractive compensation plan for salespeople combines commissions and straight salary.

17-5. Identify advertising options for a small business.

- Common advertising media include television, radio, magazines, newspapers, direct mail, billboards, and the Internet.
- Product advertising is designed to promote a product or service, while institutional advertising conveys information about the business itself.
- Sources for assistance with advertising include advertising agencies, suppliers, trade associations, and advertising media.
- A small firm must decide how often and where to advertise.

17-6. Discuss the use of sales promotional tools.

- Sales promotion includes any promotional technique, other than personal selling and advertising, that stimulates the purchase of a particular product or service.
- Typically, sales promotional tools are used in combination with advertising and personal selling.
- Four widely used sales promotional tools are specialties, trade show exhibits, coupons, and publicity.

Key Terms

advertising p. 456
app p. 450
blog p. 449
email promotion p. 449
hyperlink p. 449
institutional advertising p. 456
personal selling p. 451
product advertising p. 456
promotion p. 443
promotional mix p. 443
prospecting p. 453
publicity p. 461
quick response (QR) code p. 451
sales promotion p. 459
social media p. 448

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Discussion Questions

1. Why is sales promotion considered a communication model?
2. Discuss the advantages and disadvantages of each approach to budgeting funds for promotion.
3. What do you need to do to obtain a domain name?
4. What guidelines should you follow in designing your website?
5. If you were opening an office furniture store, how would you select a social networking site to introduce yourself to prospective customers?
6. Describe a system of prospecting that could be used by a health care spa. Incorporate the techniques presented in this chapter.
7. Assume that you have the opportunity to "sell" your course instructor on the idea of eliminating final examinations. Prepare a sales presentation using the techniques in Exhibit 17.3.
8. What are the advantages and disadvantages of compensating salespeople by salary? By commissions? What do you think is an acceptable compromise?
9. What would be your first choice for an advertising medium if you owned a rental car agency? Why?
10. What sales promotion specialty items does your school offer? Which one is your favorite? Why? How could it be improved?

You Make the Call

Situation 1

He wanted a career as a pro football player, but the NFL didn't call him back. After he helped a woman with her fitness training, she later told him that he changed her life. Ron "Boss" Everline reported, "It was at that moment that I knew I could do something bigger than me." That led to the growth of Just Train, a company of personal trainers. The company website, just-train-wip.webflow.io/, provides plenty of information about programs and merchandise, as well as testimonials, including one from Kevin Hart. It wasn't the website that jumpstarted the company, though. It was Everline's aggressive promotions on Instagram (where he has built a base of hundreds of thousands of followers) and YouTube. Those platforms enabled him to show prospective clients what Just Train has to offer.

Question 1 Watch some of Everline's videos. Do they make it clear what the company is all about and how to become a customer?

Question 2 What other promotional strategies might Everline have used? Do you think any of them might have been better than the social media approach he took?

Question 3 What effect do celebrity endorsements of businesses have on you? Do they give the business more credibility?

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Situation 2

Most of the franchisees of Edible Arrangements would call themselves small business owners. The franchisor, on the other hand, managed over 1,200 units in 2021, clearly a sizeable operation. It was not always that way, however. The founder, Tariq Farid, arrived in the United States with his family when he was 11 years old. As a teenager, he worked for McDonald's, then borrowed $5,000 from family and friends to buy a flower shop, which he soon expanded to four stores. He kept his eyes open and noticed that Americans were consuming more fresh fruit and spending more on gifts. That led him to launch Edible Arrangements, LLC, in 1999. As a self-taught computer expert, Farid designed all the management systems for the company and was a pioneer in online retailing. He saw the Internet as a disruptive technology and took a chance on building a network of companies at a time when many customers were suspicious about putting their credit card numbers into a computer. By maintaining state-of-the-art e-commerce and point-of-sale systems, Farid positioned Edible Arrangements to expand its product offerings and to grow through the COVID-19 pandemic, when customers were looking for home-delivery services.

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Question 1 Many successful business owners demonstrate entrepreneurial tendencies when they are teenagers. What experience did you have as a teenager that might be converted into a new venture? Did you ever start a business of your own?

Question 2 What do you think caught people's attention about Edible Arrangements at a time when ordering products on the Internet was relatively new?

Question 3 Have there been any new online sales promotions that have caught your eye recently? What do you think Tariq Farid and his team need to watch in order to stay ahead of their e-commerce competition?

Experiential Exercises

1. Go to the website of a company from which you have bought something. Based on what you read in this chapter, how effective do you think the website is as a promotional tool? What do you recommend to improve it?
2. Plan a sales presentation. Role-play a presentation in class, and ask your fellow students to critique your performance.
3. Interview a media representative about advertising options for small businesses. Summarize your findings for the class.

Chapter 17 Case

Please see Appendix A for the Chapter 17 Case Study.

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Chapter 18

Global Opportunities for Small Businesses

Looking Ahead

Learning Objectives

The Global Opportunities for Small Businesses chapter addresses globalization and the opportunities (and challenges) it creates for small businesses. By studying this chapter, you should be able to . . .

18-1 **Describe the potential of small businesses as global enterprises.**

18-2 **Identify the basic forces prompting small companies to engage in global expansion.**

18-3 **Compare strategy options for global businesses.**

18-4 **Explain the challenges that global enterprises face.**

18-5 **Recognize the sources of assistance available to support international business efforts.**

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Spotlight on Small Business

CrateBind

https://www.cratebind.com

Relationships are critically important to any business. This concept is well understood by the founders of CrateBind, a custom software development firm based in Dallas, Texas. Relationships have played a significant role in the company's history—even serving as the point of connection in its transformation into the global small business it is today.

Because they are siblings, Brittany and John Harlan have done many things together over the years. But their strong sibling bond turned out to be the foundation for something that would go well beyond participating in a normal family life. In 2014, a few years after Brittany met and married her husband, Jordan Graft, the couple teamed up with John to start a grocery delivery business in Florida. The trio quickly realized the company needed better technology.

"While we were doing the grocery delivery, we ran into some technology challenges and started to pick up software development during that process," John observed. "Ultimately, we enjoyed writing code and building software more than anything else we were working on. We wondered if we could create a business of helping other people solve technology problems."

That led to CrateBind. Along with John's wife, Connie, the team moved back to Dallas in 2015 and founded their own software development firm. Over the next few years, CrateBind worked with a variety of companies from numerous industries, building custom Web and mobile apps. Their clients ranged from start-ups to Fortune 100 companies.

As the company continued to grow in clients and services, so did the team. In 2016, Juan Carlos Hinojo was hired, working remotely from Mexico while he finished school. Eventually, CrateBind sponsored Hinojo to join them at the Dallas location, and the team was very impressed with his work. It became evident that CrateBind needed more employees like him.

Through Hinojo, the team learned about the city of Guadalajara, which has been described as the Silicon Valley of Mexico. The many talented potential employees there sparked the idea of opening a second office. The Guadalajara location opened in 2017, and it has been a great venture for CrateBind.

The founders came to realize that one of the many advantages of having a second office is the ability to learn and grow from people with different experiences and ideas. While 7 of the company's nearly 30 employees work from another country, it is very much one team with one mission. Almost like a family.

"We have worked hard to make the offices feel integrated even though we are 1,000 miles apart," Brittany reports. "We have a livestream of the Guadalajara office continuously running in our Dallas office, and they as well. We can see, chat and interact with them, and do so all the time."

Siblings and spouses. Employee and employer. Domestic and international. For CrateBind, relationships have been crucial to continued growth and success. Moving forward, the goal is to attract a variety of new clients with the same perspective. "Our future is to get better at what we do, continue to refine our process and approach to make our clients more successful, and make it a better place for our employees to work," John maintains. That includes the team in Guadalajara that has worked hard to make CrateBind the thriving small business that it is today—which is exactly what the owners envisioned from the start.

Source: Adapted from Justin Walker, "Developing Relationships," *Baylor Business Review*, Spring 2020, pp. 15–16.

It has been said that "[e]ntrepreneurs form the glue that holds societies together."[1] Stated a different way, entrepreneurship provides much of the energy that drives the modern market economy, as new businesses around the world spur competition and economic growth. And while the number of existing companies across countries varies considerably, the rate of new business creation is relatively consistent. As evidence of this, two-thirds of the countries included in a 2020 global survey had more than 40 percent of respondents reporting that they could identify the existence of high-potential start-up opportunities—and this during a worldwide pandemic![2]

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Regardless of nationality, when entrepreneurs see an opening, they are quick to take advantage of it—no matter where in the world they have to go to make that happen. That's why the founders of CrateBind wasted no time expanding their U.S. operations into Mexico. As explained in the Spotlight feature at the start of this chapter, when they learned about the unique talent pool across the southern border, they took steps to tap into the opportunity.

There was a time when national economies were isolated by trade and investment barriers, differences in language and culture, distinctive business practices, and various government regulations. However, these dissimilarities are fading as market preferences converge, trade barriers fall, and national economies integrate to form a global economic system. This process is central to the trend of **globalization**. Though the drift toward convergence rises and falls some over time, increasing globalization is the norm and will create many new opportunities and competitors as time goes on. And with the impressive long-term rate of economic growth in countries such as China and India, it would be unwise for a small business owner to ignore these emerging market opportunities—and the new competitors that come with them.

As you read in the pages that follow about the challenges of international business and the many decisions that are involved in expanding abroad, you may become convinced that being a global entrepreneur is not for you. This is a common reaction. But the opportunities can be tremendously rewarding, and available resources can help you overcome any obstacles that may stand in your way. Later in this chapter, you will read about the numerous forms of assistance that can help you achieve your global ambitions. As you will see, many small businesses are showing that it can be done. Perhaps yours will be one of them!

18-1 Small Businesses as Global Enterprises

18-1 Describe the potential of small businesses as global enterprises.

The potential of global businesses is clear, but does that potential extend to small companies?

Evidence indicates that small businesses are very active internationally. In fact, the Small Business Administration reports that these enterprises are responsible for an impressive 32 percent of all known U.S. exports.[3]

At the same time, we note that some country environments are more supportive of new venture activity than others. The World Bank assesses this by tracking factors such as the time, cost, and number of procedures required for starting a new business in each nation. These scores span a broad range. For example, Exhibit 18.1 points out that the average cost of launching a new venture, reported as a percentage of per capita income, varies from a low of 3 percent in high-income countries like the United States and the wealthier nations of Europe to a high of 36.3 percent in Sub-Saharan Africa. As the percentage increases, starting a business obviously becomes more difficult to pull off. And, unfortunately, countries that fare worse on this variable tend to rate unfavorably on others as well, which only compounds the challenges for entrepreneurs.

Despite impediments in some regions, recent analyses have shown that a growing number of start-ups are being launched with cross-border business activities in mind. These are often referred to as **born-global firms**.[4] Suranga Herath, CEO of English Tea Shop, which launched in 2010 and now sells fine teas in 50 markets around the world, suggests that there are sound reasons for this trend. First of all, he says, being born global is easier to manage than most people think.

globalization
The expansion of international business, encouraged by converging market preferences, falling trade barriers, and the integration of national economies.

born-global firms
Small companies launched with cross-border business activities in mind.

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Exhibit 18.1 The Cost of Starting a New Business in Different Regions of the World

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Note: Start-up costs are presented as a percentage of each region's per capita income.

But perhaps more important, starting out with this mindset accelerates business growth, just as it did for his company.[5] That is a powerful justification for choosing to take the global path, and early on.

As access to affordable technology increases, talent becomes more mobile, the costs of global travel and communication fall, and trade agreements pry open national markets to foreign competition, entrepreneurs are focusing more and more on international expansion opportunities. In some cases, they may be forced to enter foreign markets in order to compete with firms in their industry that have already done so. But the message is clear: Size does not necessarily limit a firm's international activity. Small companies can build upon their unique resources to become global competitors.

The fact that many firms are going global does not mean that it is easy. The challenges that small businesses face in the international marketplace are considerable. First, a small business owner must decide whether the company is up to the task. To help entrepreneurs assess the impact of going global on their small businesses, the U.S. Department of Commerce publishes *A Basic Guide to Exporting*. This handbook outlines important questions that entrepreneurs should consider when assessing their readiness for the challenges of global business (refer to Exhibit 18.2).

Once small business owners decide to expand internationally, they should study the social, technological, economic, and political forces in foreign markets to figure out how best to adapt their business practices, as well as their product or service, to local circumstances. They may also need to make other adjustments that are necessary to ensure smooth market entry. Small business owners doing business in many foreign

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Exhibit 18.2 Questions to Consider before Going Global

Management Objectives	• What are the company's reasons for going global? • How committed is top management to going global? • How quickly does management expect its international operations to pay off?
Management Experience and Resources	• What in-house international expertise does the firm have (international sales experience, language skills, etc.)? • Who will be responsible for the company's international operations? • How much senior management time should be allocated to the company's global efforts? • What organizational structure is required to ensure success abroad?
Production Capacity	• How is the present capacity being used? • How much additional production capacity will be needed at home and abroad? • What product designs and packaging options are required for international markets?
Financial Capacity	• How much capital can be committed to international production and marketing? • Will the company be able to cover the initial expenses of going global (for example, the costs of finding customers abroad, expanding production to support international sales)? • What other financial demands might compete with plans to internationalize? • By what date must the global effort pay for itself?

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Source: Adapted from International Trade Administration, *A Basic Guide to Exporting: The Official Government Resource for Small- and Medium-Sized Businesses*, as cited in John B. Cullen and K. Praveen Parboteeah, *Multinational Management: A Strategic Approach*, 7th ed. (Cincinnati, OH: Cengage Learning, 2017), Exhibit 7.4.

countries can run into very challenging circumstances. One global entrepreneur summed it up this way:[6]

> Expanding your business into a foreign market . . . can limit your success. Here, I'm talking corruption, potential non-payments and currency risks, for starters. Then there are the endless bureaucratic obstacles you'll face, the ever-shifting regulatory and tax climates and the fallout from geopolitical hot spots: All will add an extra layer of unpredictability which can negatively impact the performance of your company's strategies, business plans and investment.

And those are just *some* of the complications that can arise! For example, when you consider that collecting or paying interest is forbidden in many Islamic countries—just one of many fundamental differences—it becomes clear that navigating the unique hurdles of an international market can be very difficult.

18-2 The Primary Forces Driving Global Businesses

18-2 Identify the basic forces prompting small companies to engage in global expansion.

Given the difficulty of establishing and then operating an international business, why would any entrepreneur want to go global? Among the reasons are some that have motivated international trade for centuries. In 1271, Marco Polo traveled to China to explore the trading of Western goods for exotic Oriental silks and spices, which would then be sold in Europe. Clearly, the motivation to take domestic products to foreign markets and to bring foreign products to domestic markets is as relevant today as it was in Marco Polo's day. Consider, for example, the clothing designer who sells Western wear in Tokyo or the independent rug dealer who scours the markets of Turkey to locate low-cost sources of high-quality products.

Complementing these age-old reasons for going global are motivations that epitomize the core of entrepreneurial drive—that is, the impulse to try new things in new places. These inspired risk takers are always looking to do more than simply expand into

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a profitable market. They recognize that their enterprises are no longer insulated from global challengers and they must consider the dynamics of the new competitive environment.

One way to adjust to these emerging realities is through innovation, which is essential to competitiveness in many industries. Frequently, small businesses that invest heavily in research and development can outperform their large competitors. But as R&D costs rise, they often cannot be recouped from domestic sales alone. Increasing sales in international markets may be the only viable way to recover a firm's investment. In some cases, this may require identifying dynamic markets that are beginning to open around the world and then locating in or near those markets.

As you can see, the motives for global expansion vary. But by and large, these basic forces can be divided into four general categories:

1. Expanding markets
2. Gaining access to resources
3. Cutting costs
4. Capitalizing on special features of location

Within each category fall some tried and true motivations, as well as some newer perspectives that have emerged in more recent years.

18-2a Expanding Markets

More than 95 percent of the world's population live outside the United States, so it follows that globalization greatly increases the size of a U.S. firm's potential market. If you ask entrepreneurs with global ambitions what drives them, their first answer is likely to be that they are thinking mostly about reaching new markets to grow their businesses. At the same time, though, their primary motivation for involvement in some parts of the world may be different from their aspirations elsewhere. For example, many small U.S. companies doing business in Asia are also seeking new markets, even as they are looking to access low-cost component sources or to relocate business processes via outsourcing. Still, the primary motivation is often market seeking.

Countries Targeted

Because the primary motivation for going global is to develop market opportunities outside the home country, the focus of globalization strategies tends to be on countries with the greatest commercial potential. In the past, these were developed countries, with high levels of widely distributed wealth. In more recent years, small companies have been paying greater attention to emerging markets, where income and buying power have been growing more rapidly.

The term *BRICS* is often used to refer to five major emerging economies: *B*razil, *R*ussia, *I*ndia, *C*hina, and *S*outh Africa. These markets have definitely captured the attention of many entrepreneurs for quite some time. And that interest continues to

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grow, as mainstay markets like Europe, Japan, and the United States expand at modest rates while growth in China and India, in particular, remains high when compared to their more developed counterparts—and by quite a margin (refer to Exhibit 18.3). The other BRICS countries (Brazil, Russia, and South Africa) have struggled some in recent years, and nearly all economies around the globe were hammered by the COVID-19 pandemic that started in 2020. Projections for the future growth of the BRICS countries overall are promising, even if it is almost certain that some will not enjoy anything close to the same level of growth and vigor as China and India.[7]

Because of their immense populations and potential market demand, China and India have become the focus of many international firms. Combined, these two nations account for an astounding 40 percent of the world's 7.4 billion inhabitants, thus providing fertile ground for international expansion. Small firms are among the countless competitors battling for position in these emerging markets as they attempt to sell to their new, fast-growing "consuming class."[8]

Products Promoted

International business authority Raymond Vernon observed in the mid-1960s that firms tended to introduce new products in the United States first and then sell them in less advanced countries later, as demand in the home market declined.[9] In other words, they were using international expansion to extend a product's life cycle. Although this approach is effective under some circumstances, it has become less viable as customer preferences, income levels, and delivery systems have become more similar and product life cycles have contracted. Furthermore, consumers in the developing world have become more sophisticated in their tastes and expectations and are no longer the "late adopters" that they were in years past.

Today, products that sell at home are more likely to be introduced very quickly abroad, with little or no adaptation in many cases. Popular television programs, movies, and print media, as well as the Internet, have shaped cultural tastes throughout the world, and this is facilitating the entry of small businesses into international markets. U.S. interests have long held a starring role in the cultural arena, inspiring widespread purchases of products such as jeans and fast food, and generating international fascination with American sports and celebrities. By informing consumers about the lifestyles of others, globalization is creating more common consumer preferences around the world.

Exhibit 18.3 BRICS Markets

Country	Total Population (in millions)	National Wealth (GNI per capita)*	Economic Growth Rate (GDP growth, %)**
Brazil	209	8,580	1.0
China	1,386	8,690	6.9
India	1,339	1,820	6.6
Russia	144	9,232	1.5
S. Africa	57	5,430	1.3
World	**7,530**	**10,366**	**3.2**

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*GNI = Gross National Income (Atlas Method, Current U.S. Dollars), pre-pandemic figures.
**GDP = Gross Domestic Product, pre-pandemic figures.

Source: From data provided by The World Bank, "World Bank Open Data," http://data.worldbank.org, accessed July 6, 2021.

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Highly specialized products can also do well in international markets. As technology makes possible increasingly advanced goods, markets are demanding more differentiated products to satisfy their unique needs and interests. This increases the cost of doing business. However, expanded sales allow the makers of such products to recover the higher costs of product development. Many small companies follow focused business strategies, despite limited domestic market potential. For them, exploiting the advantage of specialized products across several international markets may be even more important than for their large corporate counterparts.[10]

Making the Most of Experience

No matter which countries are targeted or products promoted, international expansion has the potential to provide benefits beyond the standard per-unit profits on additional items sold. As a venture expands and volume grows, it usually can find ways to work smarter or generate efficiencies. Analysts first observed such **experience curve efficiencies** in the aircraft manufacturing industry. They noticed that each time a manufacturer doubled its total output, the production cost per aircraft dropped by 20 percent. In other words, per-unit costs declined by 20 percent when the firm manufactured four units instead of two, declined by another 20 percent when the firm made eight units instead of four, and so on.

What can explain this gain in efficiency? Most credit the outcome to learning effects and economies of scale. **Learning effects** occur when the insight an employee gains from experience leads to improved work performance. Learning effects can also take place at the level of the firm if the experiences of individual employees are shared, leading to improved practices and production routines across the organization. These gains from learning are greatest during the start-up period and gradually decline over time. Efficiencies from **economies of scale**, on the other hand, continue to rise as the business grows and volume increases, because these savings derive from spreading investment costs across more units of output and acquiring more specialized (and thus more efficient) plants, equipment, and employee skills.

Though experience curve efficiencies also apply to purely domestic enterprises, small firms can accelerate gains from them by emphasizing international expansion, assuming they can manage the growth. The benefits of learning effects and economies of scale are especially apparent in start-ups based on complex technologies. The possibility of achieving experience curve efficiencies through accelerated globalization of emerging technologies is likely to stimulate the interest of new ventures and small companies in doing business abroad.

experience curve efficiencies
Per-unit savings gained from the repeated production of the same product.

learning effects
Results that occur when insights, gained from experience, lead to improved work performance.

economies of scale
Efficiencies from expanded production that result from spreading fixed costs over more units of output.

18-2b Gaining Access to Resources

Small firms today may go outside their home countries to gain access to essential raw materials and other factors of production. For example, because computer processing and storage require so much energy, a number of data centers have been moving to Iceland to tap the country's clean, cheap, and dependable supply of power and take advantage of its suitable climate.[11]

> Iceland's big competitive advantage is its 100% emissions-free power, which comes exclusively from hydroelectric dams and geothermal wells. Its relatively consistent, cool temperatures are also just right for data centers to use free-air cooling, not too hot like Denmark in summer, or too cold like northern Sweden.

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The attraction has been so great that the country's government is starting to take steps to slow the growth of the industry there. Expanding the power grid further, lawmakers fear, may put Iceland's pristine environment at risk. That could cut into tourism, which is crucial to the nation's economy. It's a delicate balancing act, in more ways than one.[12]

Though many small firms have pursued international ventures to obtain raw materials and other necessary production inputs, increasingly the focus of their search is skilled labor. As one of many examples, technology companies have been relocating operations or outsourcing work to India for years in order to get access to the workers they need. Despite the infrastructure limitations there, as well as the country's suffocating bureaucracy and worrisome problems with corruption, these firms are lured to India by its remarkable human capital, a necessary resource that is in short supply in the United States. Because the focus of the country's higher education system is so heavily weighted toward technical training, India turns out a very high share of the world's students who earn STEM (Science, Technology, Engineering, and Math) degrees.[13]

There is no question that skilled labor around the world is within the reach of start-ups and other very small businesses. At the same time, the federal H-1B visa program (which permits U.S. companies to employ foreign workers in specialty occupations on a temporary basis) has been cut back in recent years. This has caused employers in the United States to struggle to find the talent they need at home.[14] As a solution, many small businesses have turned to engineers, programmers, and other tech workers in far-off countries. There are definite drawbacks to this approach, but overseas workers often are able to get the job done and done well. Of course, this approach limits the creation of jobs in the United States, but start-ups and other small businesses may have no other choice if they otherwise lack access to the skills that are necessary for their operations.

18-2c Cutting Costs

Many firms go global to reduce the costs of doing business. Among the costs that firms have traditionally reduced by venturing abroad are those related to raw materials, labor, and manufacturing overhead.

While some start-ups are launching as global enterprises, other small businesses are shifting their operations over time to international markets in order to exploit the same advantages. In fact, U.S. businesses of all sizes have been slashing costs by contracting with independent providers overseas (an arrangement called **international outsourcing**) or by relocating their stateside operations abroad (which is sometimes referred to as **offshoring**). These initiatives have been especially popular in countries where highly skilled labor can be accessed at relatively low cost. To provide just one point of comparison, software developers in Ukraine earn less than one-third of what their American counterparts make.[15]

international outsourcing
A strategy that involves accessing foreign business operations through contracts with independent providers.

offshoring
A strategy that involves relocating operations abroad.

For a long time, hardware-based start-ups had difficulty getting traction due to capability limitations. But that has definitely changed as opportunities to shift operations overseas have greatly reduced the cost of bringing products to market. This is enormously important, especially for cash-strapped new ventures. For some time now, small businesses have been creating their prototypes in the United States, turning to Asian manufacturers to produce the products, and then selling them in stores or online.

Though this clearly opens doors for new businesses, working with overseas manufacturers can come with its share of obstacles. Farzan and Jennifer Dehmoubed

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are the creators of the Lotus Trolley Bag, which they describe as "a set of washable bags with attached rods that can be hung inside a shopping cart."[16] The duo came up with the idea for their invention after recognizing a need for reusable bags that could eliminate the cheap plastic bags provided by stores that are prone to tearing and usually end up in the landfill. After a great deal of tinkering with initial variations on the product, they conducted detailed testing of the design, quality, and strength of their informal prototypes and in time came up with a version that fit the bill. To achieve the desired durability, they used a premium-quality nylon and added removable handles, double stitching, and mold-resistant mesh bottoms.[17]

The next step in the launch of the venture involved finding a manufacturing partner. The couple struck a deal with an Asian factory and got off to a great start … sort of. Farzan explains how this chapter in their start-up story unfolded:[18]

> We invested $45,000—the majority of our life savings—in our first inventory. It sold out in 10 days. We were excited. We called up the [Asian] manufacturer and placed another order. We wired them $50,000—everything we made on the first batch and more.
>
> Six weeks later a big container arrived. We had our friends and family help us unload it. We opened up the boxes and looked at the product, and it was nothing like the first set of bags. It looked the same from a distance, but when you actually looked at the stitching and the quality of the printing and the logo, it was not what we had ordered. My wife and I looked at each other and said, "This can't be real."

These setbacks are not at all unusual for small businesses that are just getting started, and they can be overcome by those entrepreneurs who have the motivation and tenacity to work through problems. The Dehmoubeds ultimately were able to get on track, but it took considerable effort. Farzan had to fly to Vietnam twice before he was able to find a suitable manufacturing partner. Rather than risk getting burned twice, the couple hired a company to do a third-party quality check. That service provider would audit each product before it was shipped—literally opening each box, checking the goods, and sending videos as proof of their condition.[19] Other small firms can learn from the experience of the Dehmoubeds.

Like all small businesses, Lotus Trolley Bag is unique. But in many ways, its outsourcing saga followed a familiar storyline. Most entrepreneurs who choose to team up with an international partner or relocate offshore are seeking two things that are so important to the success of small companies: access to employee talent and reduced costs. For some of its operations, at least, Lotus Trolley Bag went abroad to tap into both—and made it work.

The advantages of globalization in reducing labor costs have long been recognized. However, countries have been forming regional free-trade areas and other forms of economic integration to facilitate commerce by reducing tariffs, simplifying commercial regulations, or even—in the case of the European Union—adopting a common currency. These cost-cutting measures can be a powerful inducement to small firms to move into the prescribed area. Since the United States chose to link its economy with that of Mexico, for instance, many foreign firms have chosen to locate production facilities across the southern border to take advantage of reduced tariffs on trade within that region and easy access to the U.S. market. Even though the federal government renegotiated the trade agreement it had with Mexico and Canada (which went into force in 2020), and the United Kingdom has exited the European Union (with other major changes sure to come), there is little question that globalization is here to stay.

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18-2d Capitalizing on Special Features of Location

Some of the benefits of location are simply the result of the unique features of a local environment. For example, Italian artisans have long been well known for their flair for design, and Japanese technicians have shown an extraordinary ability to harness optical technologies for application in cameras, copiers, and other related products. Small companies that depend on a particular strength or resource often find that it makes sense to set up in a region that provides the best location for that type of business.

In some cases, there is no way to be authentic apart from being local. While visiting China, Colin Flahive, who grew up in Denver, Colorado, and his friend, Kris Ariel, a native Californian, found the Western food served there to be boring and uninteresting—but locals were still eating it up. So, in 2004, the pair scraped together the funds to remodel an 87-square-meter storefront into Salvador's, "a Coffee House unlike any on the planet."[20] From their business in Kunming (a city of close to 7 million people), they offer Western products—including premium coffee, homemade natural ice cream, fresh bagels—served from a location with a cozy atmosphere and funky décor.[21] The growth of the coffee house operation has been impressive, employing a staff of more than 30 who enjoy a generous profit-sharing plan and other benefits. The employees even became business owners themselves when Flahive and Ariel turned 10 percent of the enterprise over to them![22]

Sometimes, the appeal of a location is a matter of cachet or brand image. For example, while Chanel might prefer to manufacture its designer handbags in Asia to reduce costs, the company insists instead on producing them in Italy and France. These are both high-cost countries, but they have reputations that match Chanel's luxury image. These nations also have developed unique competencies, honed by hundreds of years of experience, that can accommodate the advanced designs and high quality that give the company its edge. Customers know that the high quality of the brand is scrupulously protected and thus are willing to pay a premium to buy Chanel's products, which covers the high manufacturing costs. But this is just one example. Other country settings provide their own location-specific strengths—including Colombia (high-quality coffee), Japan (anime-based video games), and Switzerland (precision watches)—and firms locate there to tap into those strengths.

Finally, some small businesses are following large client firms to their new locations. As major corporations locate their operations abroad, their small suppliers find it necessary to go global with the client firms to ensure the continuation of important sourcing contracts. A small business owner may have no personal desire to expand internationally, but dependence on a major customer relocating abroad might leave the owner with no alternative. For example, some small companies moving into China are doing so with limited interest in the country's cheap labor and enormous market. But being there is necessary in order to feed the supply chains of corporate customers with ample delivery speed and efficiency.

The motivations for small businesses to go global are numerous, but the ultimate incentive is this: If you fail to seize an international market opportunity, someone else will. Under these conditions, the best defense is a good offense. Establishing a position outside of the domestic setting may preempt rivals from exploiting those opportunities and using them against you in the future.

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Small companies are sometimes pulled toward doing business abroad because of the unique advantages that are available in international locations.

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18-3 Compare strategy options for global businesses.

18-3 Strategy Options for Global Firms

Once an entrepreneur has decided to go global, the next step is to plan a strategy that increases the potential of the firm. For most small businesses, the first step toward globalization is a decision to export a product to other countries or to import goods from abroad to sell in the market at home. These initial efforts are often followed by more sophisticated non-export strategies. Strategy options for global firms, then, include the following:

1. Exporting
2. Importing
3. Licensing
4. Franchising
5. Forming strategic alliances with international partners
6. Locating facilities abroad

18-3a Exporting

Exporting involves the sale of products produced in the home country to customers in another country. The U.S. Small Business Administration (SBA) recently announced that small firms represent just under 97.5 percent of American exporters and contribute, as mentioned previously, around 32 percent of the value of exported goods.[23] In some cases, this activity reflects the reality of international competition. That is, some U.S. companies are steadily moving toward overseas markets because they recognize that foreign-owned companies are already competing against them in the United States. The realities of competition in today's global marketplace have been aptly expressed by expert observers:[24]

> [Firms] are finding their home markets under attack from foreign competitors. This is true in China, where U.S. companies such as Apple, General Motors, and Starbucks are expanding their presence. It is true in the United States, where Japanese automobile firms have taken market share away from General Motors and Ford over the past three decades, and it is true in Europe, where the once-dominant Dutch company Philips has seen its market share in the consumer electronics industry taken by Japan's Panasonic and Sony and Korea's Samsung and LG.

Small businesses face the same competitive conditions, of course. But as the SBA statistics above suggest, entrepreneurs have not been slow to take up the challenge by selling their products and services to customers abroad. In fact, exporting is one of the most popular international strategies among small businesses because it provides a low-cost way to expand into the global arena. Taking this approach, small export companies can market and distribute their products in other countries without incurring the expense of supporting costly operations in those markets. If the financial benefits from international sales more than offset all basic costs plus tariffs that apply, exporting can be a favorable option.

exporting
Selling products produced in the home country to customers in another country.

The Internet has fueled vigorous growth in export activity. Many firms now see an online presence as a powerful tool for increasing their international visibility, allowing them to connect with customers who otherwise would be beyond their reach. Entertainment Earth is an online retailer, started in 1995, and "the 'go-to' source for the latest action figures, bobbleheads, toys, gifts, and collectibles." It wasn't long before

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the founders decided to expand their reach by selling online, and the move has really paid off. Over the years, Entertainment Earth has sold millions of toys and collectibles to clients around the world.[25]

But small businesses don't have to go it alone. Even the smallest of operations can have the world as its sales floor. How is this possible? It's simple: eBay and Amazon. These e-commerce giants can help businesses of any size connect with customers anywhere around the globe, and getting started takes about as much time as it would to apply for a passport!

Perhaps you have always thought that selling internationally would be too much of a hassle to be practical. If so, then it may ease your concern to know that more than 57 percent of eBay's revenue comes from its international business.[26] Not far behind, Amazon reports that just under one-third of the business that runs through its website is global.[27] Both companies would be happy to show you how to add your company's sales to these statistics. To learn more about how to sell your product to customers around the world, check out eBay's "Selling Internationally" tutorial and Amazon's "Global Selling" website. Both can easily be found through a quick Internet search.[28]

Of course, taking the leap into exporting can seem overwhelming for a small business owner, especially at first. Suddenly, you have to worry about and plan for a number of potential new challenges, including the following:

- Communicating in a language other than English.
- Translating payments into dollars from other currencies.
- Setting up international shipping to get products to overseas buyers.
- Modifying products to meet government standards or the unique interests of buyers abroad.
- Lacking powerful government connections, which may very well put your company at a great disadvantage in negotiations.
- Dealing with unfavorable exchange rates, which can make it difficult or even impossible to offer products at competitive prices and still make a profit.

And it can get worse. In some countries, for example, the government may not allow a company to enter its market unless it is willing to reveal the specifics of its core technologies, which are often the bedrock of its competitive advantage.

Nonetheless, export success is clearly within the reach of small companies. Indeed, the number of these firms that export has increased more than threefold since the late 1990s, reaching 300,000 today, which shows that many small companies are having considerable success selling their products and services abroad.[29]

To fuel the fire of growth, the federal government launched an online portal to information and services that can help boost the competitiveness of U.S. companies in the global economy. This assistance can be found at usa.gov/import-export. One important feature of this resource is a set of links that can direct businesses to the support they need to begin exporting or to expand an existing program. It can also be helpful to know that the SBA has created the State Trade Expansion Program (STEP) to help small businesses get connected to the financial assistance they need to expand into international markets. To learn more about the processes involved with export operations, we recommend that you consult the U.S. Chamber of Commerce's *A Complete Guide to Small Business Exporting*[30] and the *Export Business Planner* provided by the SBA.[31] These resources can be especially useful because they have been written to address the specific needs of small enterprises that want to expand internationally.

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Small firms that excel at exporting typically just do their homework to figure out what products would sell in targeted markets—for example, products that local companies cannot yet make for themselves. Then, they often get close to the market and develop personal connections with influential decision makers, getting buy-in and support wherever they can find it.

When searching for customers abroad, start by consulting the informational website of the U.S. Department of Commerce's International Trade Administration (trade.gov/find-buyers-and-partners). It was created for exactly such purposes. Or, you can get in touch with the foreign embassy community (embassy.org), select a country where you want to do business, and email or call the country specialist for assistance. You may be surprised at the leads this can generate. Finally, check with officials from your state to see if they provide assistance. In many cases, an online search for "[insert the name of your state here] foreign trade office" will lead you where you need to go.

18-3b Importing

The flip side of exporting is **importing**, which involves selling products from abroad in the firm's home market. When a small company finds a product overseas that has market potential at home or identifies a product that would sell at home but cannot find a suitable domestic producer, an import strategy may be the best solution.

Connecting with vendors at international trade shows can provide one possible path to import success. Using imported products discovered at such shows, for example, countless small business owners have found success selling fashion accessories online and through physical stores. Because this can provide access to an endless variety of merchandise, such businesses find that they are able to accommodate any kind of style or look that their customers will find attractive and want to buy. Best of all, products sourced in this way are usually very inexpensive and can therefore be sold for a fraction of the prices charged for similar goods at high-end retailers. Since customers like what they are getting and the sources of imported merchandise are only likely to increase in number, small companies that adopt this strategy can often grow very quickly.

importing
Selling products produced in another country to buyers in the home country.

CHARLIE EDWARD/SHUTTERSTOCK.COM

Regardless of the import strategy used, one of the most important factors for success is finding a good product vendor. This sounds easy enough to do, especially in this era of online matching services and communications tools, as well as flexible and affordable travel. Websites like Alibaba.com, GlobalSources.com, MFG.com, and Thomasnet.com seem to bring the goods you need right to your doorstep. However, finding global sourcing partners and then managing relationships with them over the long-term can be challenging.

Many experienced practitioners urge caution at this stage because there is plenty that can go wrong. "Do not rush into sourcing relationships," warns one global trade expert. "Initially obtain a flow of samples. Check, recheck, and check again." He further insists that it is best to buy in limited quantities until the relationship proves reliable, which will require a number of successful (and substantial) transactions first.[32] It often takes an in-person visit to a sourcing partner to know if it can meet the selection, quality, and quantity standards that can support your business. As you may recall, the Dehmoubeds found this out the hard way with their Lotus Trolley Bag start-up when they first tried to work with manufacturers overseas.

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There is no doubt that the importing option can come with challenges. However, it also can hold tremendous potential, especially if you follow a few simple guidelines:

- Learn as much as you can about the culture and business practices of the country from which you will be sourcing to avoid making deal-breaking mistakes.
- Do your research, and be sure to select a source that is not a competitor or a company that hopes to learn from your operations in order to compete against you in the future.
- Protect your intellectual property so that your suppliers cannot easily take it from you. Some entrepreneurs require their sourcing partners to sign nondisclosure agreements so that they cannot patent the item in the country where the sourcing takes place.
- Don't rush the process of forming a relationship with a sourcing partner. You need time to ask difficult questions about important factors such as quality standards and capabilities, manufacturing flexibility, and time to order fulfillment.
- Work out transportation logistics ahead of time. A good freight forwarder can assist you with the mechanics of shipping, as well as help you with the confusing jumble of required documents. To get a sense of the process, review the rules and regulations on the U.S. Customs and Border Protection website at cbp.gov, and read the SBA's notes on "Importing" by searching that term at sba.gov.

At times, the process may seem so complicated that you might wonder if small companies should even be attempting to source from abroad. But it can be done, and with great benefit to your business.

18-3c Foreign Licensing

Importing and exporting are the most popular international strategies among small firms, but there are also other options. Because of limited resources, many small firms are hesitant to go global. One way to deal with this constraint is to follow a licensing strategy. **Foreign licensing** allows a company in another country to purchase the rights to manufacture and sell a different firm's products in overseas markets. The firm buying these rights is called the **licensee**. The licensee makes payments to the **licensor**, or the firm selling those rights, normally in the form of **royalties**, which is a fee paid for each unit produced.

International licensing has its drawbacks. The foreign licensee makes all the production and marketing decisions, and the licensor must share returns from international sales with the licensee. However, foreign licensing is the least expensive way to go global, since the licensee bears all the costs and risks related to setting up a foreign operation.

Small companies tend to think of tangible products when they explore international licensing options, but licensing intangible assets such as proprietary technologies, copyrights, and trademarks may offer even greater returns. Just as Disney licenses its famous Mickey Mouse character to manufacturers around the world, for example, a small branded apparel retailer called Peace Frogs used licensing when it introduced its copyrighted designs in Spain. As Peace Frogs' founder, Catesby Jones, has explained, the company exported its T-shirts directly into larger markets like Japan, but that strategy didn't make as much sense in some countries. For example, Spain's lower per capita income, stronger domestic competition, and high tariffs made licensing a more

foreign licensing
A strategy that allows a company in another country to purchase the rights to manufacture and sell a different company's products in international markets.

licensee
The company buying licensing rights.

licensor
The company selling licensing rights.

royalties
Fees paid by the licensee to the licensor for each unit produced under a licensing contract.

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Living the Dream

Importing Satisfaction to New Yorkers with a Taste for Authentic Asian Veggies

The COVID-19 pandemic changed lives in so many ways. But the negative impact on businesses was especially cruel to small companies.

This was certainly true for Tai and Joseph Boo, a father-and-son duo from Brooklyn, New York. Having emigrated from Malaysia to the United States some years earlier, Tai worked a series of odd jobs and saved up money to start a produce wholesaler called Fresh Goods Trading. His business specialized in selling difficult-to-find vegetables often used in Asian cooking that he would supply to local restaurants.

Tai's business was enjoying great success—that is, until the government mandated lockdowns to deal with the pandemic and restaurants were forced to close for a time. Since New York City was a major epicenter for infections, these establishments ended up remaining closed for a long time. The damage to Fresh Goods Trading was almost immediate. With no restaurant orders to fill, the company found that it was sitting on a warehouse full of perishable produce that had no takers. With no obvious path to making business-ends meet, Tai's son Joe quickly came up with an idea that might provide a solution. Why not start another produce-related business, this time a service that would sidestep the lockdown problem by delivering goods directly to those who requested them? He even had a name in mind for his start-up brainchild: Asian Veggies.

The concept for the new venture first dawned on Joe when he noticed an unserved market need. Grocery delivery services had been popping up soon after the start of the lockdowns, as people were hesitant to go into grocery stores. They were even nervous about waiting in the lines outside of supermarkets for fear of being exposed to the virus. However, when Joe started looking into available delivery services, he soon recognized that none of them offered a selection of Asian produce. But there had to be significant demand; the previous success of Fresh Goods Trading had already made that clear.

Joe was aware that Asian produce was not terribly easy to find in the city. Even for those shoppers who were willing to risk COVID-19 infection by going into grocery stores, getting their hands on fresh Asian produce was not as simple as making a trip to the store down the block. The problem was of particular concern for older Asian Americans, who were most vulnerable to the virus, and yet these customers were the most inclined to eat only those dishes that were everyday fare in their countries of origin. They really needed safe access to Asian produce, as Joe explained when describing his sense of urgency in launching his new business:

> I thought it was crucial because my friends and I [have] parents and relatives [who] are still going to supermarkets and waiting 45 minutes to check out inside. They're putting themselves at risk. So, this is another way people of our generation can order fresh vegetables for their parents, or ourselves, without risking contact.

Joe was convinced that many people needed this service, and they needed it fast. So, on April 16, 2020, only a month after coming up with his initial idea, Joe launched Asian Veggies. His new venture was to be guided by a simple but clearly specified mission: "[To] provide direct access to specialty products that cannot easily be sourced outside of ethnic markets." The company makes this possible by allowing customers in all five of New York City's boroughs, as well as parts of New Jersey and Long Island, to place online grocery orders that are typically delivered the very next day. Since opening, the company has expanded its offerings to include many more options than those previously available from Tai's wholesale produce store. Asian Veggies now delivers 650 different items, including vegetables, fruits, drinks, dry goods, and refrigerated foods.

Joe Boo's small business is, without question, an import operation. And it obviously caters to international market tastes through its domestic sales. But it surprises some to learn that the company really doesn't sell all that much Asia-grown produce. Its sourcing options depend largely on seasons, climates, and growing temperatures. Joe gets much of what he sells from growers in countries like Mexico, Honduras, and Canada where growing conditions happen to be particularly suitable to raising certain kinds of crops that satisfy Asian palates. Asian Veggies does get some of its products directly from Asia, though, to be sure it can give its customers exactly what they want. For example, items such as lotus roots, lychees, and ginger come directly from China. The rest of the company's goods come from various U.S. states.

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Asian Veggies earns the satisfaction of its customers by sharply focusing on their unique international tastes, which come mostly from the dishes they grew up with and prefer. As a result, Asian Veggies has found quick success. By mid-June, less than two months after opening, the start-up was already receiving 1,200 orders a week, which translated to $105,000 in sales. But that was just the beginning. The venture actually grew by an impressive 610 percent in the year following its initial launch, despite its no-frills website. To keep up with demand, Asian Veggies had to hire a dozen warehouse workers and four delivery drivers.

When asked about the future of Asian Veggies, Joe responds, "Well … that's the five-million-dollar question." However, he seems to be in it for the long haul:

> There are a ton of exit strategies, but one option is that I can continue with this venture, see where it takes me, and basically build the business from the ground up, and that's pretty alluring. Right now, I'm leaning toward that option, because I'm starting to realize that this could be something a lot bigger.

Money may not grow on trees, but there is plenty of "green" to be made in the business of greens. That potential obviously did not escape Joe Boo's notice. There is no doubt that the continued success of Asian Veggies would be good for him and his family. But it would also be a wonderful bonus for Greater New York, given the demonstrated demand for the imported produce Joe has to sell.

Sources: https://asian-veggies.com/pages/about-us, accessed June 18, 2021; David Brand, "LIC-Based Asian Vegetable Wholesaler Pivots to Meet New Yorkers' Needs," *Queens Daily Eagle*, July 14, 2020, https://queenseagle.com/all/lic-based-asian-vegetable-wholesaler-pivots-to-meet-new-yorkers-needs, accessed June 18, 2021; Cathy Erway, "A New Delivery Service Specializes in Asian Produce," *Grub Street*, May 14, 2020, https://www.grubstreet.com/2020/05/asian-veggies-com-is-a-new-source-for-asian-vegetables.html, accessed June 18, 2021; and Jean Hanks, "Asian Veggies: Delivering More Than Just Produce to Service New York's Asian Community," *Woman Around Town*, April 13, 2021, https://asian-veggies.com/pages/about-us, accessed June 18, 2021; Personal communication with Joseph Boo, June 10, 2021.

attractive option there. So, Peace Frogs licensed the rights to manufacture its product to a Barcelona-based apparel maker.[33] From that agreement, Peace Frogs was able to generate additional revenue, but with almost no added expense.

Foreign licensing can also be used to protect against the growing problem of **counterfeit activity**, or the unauthorized use of a company's intellectual property or manufacture of its products. If a firm in a foreign market is granted licensing rights, it can become a powerful local champion to help ensure that other firms do not use protected assets in an inappropriate way.

18-3d International Franchising

International franchising is a variation on the licensing theme. As outlined in Chapter 4, the franchisor offers a standard package of products, systems, and management services to the franchisee, which provides capital, market insight, and hands-on management. Although international franchising was not widely used before the 1970s, today it is the fastest-growing market-entry strategy of U.S. firms, with Canada as the dominant market, followed by Japan and the United Kingdom. This approach is especially popular with U.S. restaurant chains that want to establish a global presence. McDonald's, for example, has raised its famous golden arches in more than 100 countries around the world.[34] But small companies are drawn to international franchising as well, especially in countries where credit is readily available, financing barriers are weak, and demand for U.S. goods and services is strong.

Danny Bensusan is the owner of Blue Note, a premier jazz club in Manhattan that opened its doors in 1981. Considered one of the top venues in the world for jazz and other

counterfeit activity
The unauthorized use of a company's intellectual property or manufacture of its products.

international franchising
A strategy to sell a standard package of products, systems, and management services to a company in another country.

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Living the Dream

A Small Company That Refused to Get Mugged by Counterfeiters

Sometimes terrifically great ideas can be the product of really bad experiences. That was certainly the case for Jayme Smaldone when, in 2009, he spilled a cup of coffee that ruined a computer. But he was able to turn the accident into an idea that would eventually lead to a thriving small business.

After the coffee-spill incident, Smaldone decided that there had to be a better design for coffee mugs—one that would avoid tipping. So, he and a team of engineers started working to come up with an improved design. Out of their efforts came the Mighty Mug, launched in 2011, with one simple objective: "Stop spills before they happen."

Smaldone and his team were not alone in wanting such a solution—the Mighty Mug Kickstarter campaign snared 2,000 backers in no time. These fans of the concept were impressed by Mighty Mug's patented no-spill design with its SmartGrip feature. This technology allows the mug to cling tightly to almost any smooth surface, making it nearly impossible to knock over, while maintaining an easy and natural lift when the user is ready to take a sip.

Based on validation of demand from the Kickstarter response, the company was able to sign deals with giant retailers like Target, Office Depot, and Bed Bath & Beyond. This prompted Smaldone to expand his product line to include other mug-related products, and soon Mighty Mug was distributing merchandise around the world.

But success gets noticed, so it wasn't long before competitors started trying to copy Mighty Mug's designs and SmartGrip technology. At first, the fakes presented little more than a minor distraction—until the company lost its $5 million deal with Bed Bath & Beyond to one of these knockoffs. That was a wake-up call, and Smaldone knew then that he had to act. Two clear options came to mind: He could fight the case in court, or he could file a complaint with the International Trade Commission (ITC). Since going to court would be costly, Smaldone decided to pursue the second option instead.

Figuring an ITC complaint probably would not be sufficient to protect his patent and his brand, Smaldone decided to take matters into his own hands and do what he could to address the problem. After tracking down as many counterfeit mugs as he could find, Smaldone ordered one of each to get a closer look. But when these products arrived, he soon noticed a pattern: They all had come from China. What caught his attention even more, though, was the price. Every option came with free shipping, with one of the mugs boasting a *total* price of $5.69. Smaldone puzzled as to how this could even be possible since the shipping charges alone on a Mighty Mug were $6.30. Something wasn't stacking up.

Investigating further, Smaldone learned that China enjoyed extremely low shipping rates because it was classified by the United Nations as a developing country. This status gave Chinese operators, among others, an enormous competitive edge over companies from the United States and other advanced nations—even in their own markets. Upset when he found out about this outdated provision, Smaldone took a train to Washington, D.C., and met with government officials to bring the situation to their attention.

Smaldone realized that he would need to take legal action, but that could take years. In the meantime, Mighty Mug stood to lose an estimated $15 to 20 million in sales to competitors. As a stopgap measure, he decided to turn to a service called Red Points to help curb the counterfeiting problem as much as possible. Red Points works by combining keyword monitoring and image recognition with machine learning to automate the process of finding and taking down knockoff products. It certainly saved Smaldone time and money by not having to go through the process manually. Red Points was able to identify close to 100 websites that were selling fake Mighty Mugs and removed nearly 4,300 illegitimate products. This helped the company recapture sales that it had previously been losing.

Smaldone is determined to fight back and solve two problems. First, distributors in countries where counterfeiting is rampant often become cautious about carrying products because they can't differentiate legitimate goods from fakes. This obviously results in lost business. Second, if customers are unable to distinguish Mighty Mug products from much lower-quality sham alternatives, it puts the company's reputation at risk. It only takes a few bad reviews from unhappy buyers (who don't realize their mug is actually a bogus copy) to damage the brand's reputation, which then discourages others from purchasing.

Smaldone's efforts have yielded undeniable progress. As a result of his prodding, the U.S. government was able to make regulatory changes that allow countries to charge foreign-based firms higher shipping rates. This has helped

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to create a more level playing field between domestic and foreign competitors. Mighty Mug has also reclaimed its deserved sales and first-rate brand reputation, leading product reviewers to give it the highest of marks. None of this would have been possible if counterfeits were still an active threat to the company's brand and a drain on its resources.

Sources: Alistair Charlton, "Best Travel Mug 2021: Re-useable Coffee Cups for Drinking on the Go," *Smarter Living*, March 11, 2021, https://www.t3.com/us/features/best-travel-mugs, accessed July 9, 2021; "Mighty Mug: A Spill and a Dream," https://themightymug.com/pages/about-us, accessed July 9, 2021; Jayme Smaldone, "To Save His Company, This Founder Turned to Congress (and Won!)," *Entrepreneur*, January 28, 2020, https://www.entrepreneur.com/article/344393, accessed July 9, 2021; and "Toppling Fakes: How Mighty Mug Is Protecting Their Innovative Brand from Counterfeiters," https://www.redpoints.com/case-study/mighty-mug, accessed July 9, 2021.

forms of music, this club has attracted the attention of international businesspeople who have opened franchises of their own in Brazil, China, Italy, and Japan. As a result, the club has successfully established itself as the world's first franchised jazz club network.[35] Blue Note has proved that there is more than one way for a small business to globalize.

18-3e International Strategic Alliances

Moving beyond licensing and franchising, some small businesses have expanded globally by joining forces with large corporations in cooperative efforts. An **international strategic alliance** allows firms to share risks and pool resources as they enter a new market, usually matching the local partner's understanding of the target market (culture, legal system, competitive conditions, etc.) or its access to low-cost labor with the technology or product knowledge of its alliance counterpart. One of the advantages of this strategy is that the partners take comfort in knowing that they are not "going it alone." But, of course, the parties involved will have to share the rewards as well, so this is obviously a trade-off.

Small companies can use international strategic alliances in many different ways to gain advantage. In some countries, however, these businesses might not have a choice as local law sometimes requires ventures operating there to be majority owned (51 percent or more) by citizens of the host country. But there are other possible disadvantages to consider, as indicated by the U.S. International Trade Administration:[36]

> A major potential drawback, especially in countries that limit foreign companies to minority participation, is the loss of effective managerial control. As a result, you may experience reduced profits, increased operating costs, inferior product quality, exposure to product liability, and environmental litigation and fines. U.S. companies that wish to retain effective managerial control will find this issue important in negotiations with the prospective joint venture partner and the host government.

To avoid disappointing results or absolute disaster with a shared venture, it pays to follow a few basic guidelines:

- Assess whether you have what it takes to make a joint venture work.
- Choose your partner carefully, and make sure you understand one another.
- Commit resources needed to establish and develop the relationship over time.

international strategic alliance
An organizational relationship that allows companies in different countries to pool resources and share risks as they enter new markets.

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- Retain experienced legal counsel to create a sound joint venture agreement.
- Clearly communicate performance expectations, but be flexible, as needed.
- Be prepared to exit the joint venture if it doesn't work out by spelling out termination conditions in the joint venture agreement.

Even with careful forethought and sound planning, lots of surprises are sure to arise. But this doesn't mean that an international joint venture is the wrong option for your global aspirations. It only indicates that the road to global success can sometimes be a little bumpy. It's part of the adventure of international business.

18-3f Locating Facilities Abroad

A small business may choose to establish a foreign presence of its own in strategic markets, especially if the firm has already developed an international customer base. Most small companies start by locating a production facility or sales office overseas, often as a way to reduce the cost of operations. In other cases, there is simply no way to launch or grow a business apart from having a presence in one or more international locations.

This was the case for David Harmatz and two of his friends, Daniel Saxe and Daniel Smetana. After graduating from college, the trio were looking for a good business opportunity, and they found it in 2004 in gritty Isla Colon, Panama, when they happened to run into the owner of the Mondo Taitu hostel. Learning that the owner was eager to sell the place, Harmatz and his friends cobbled together the funds to buy the ramshackle clapboard house and signed on as the new proprietors.[37]

The friends' initiation into business ownership could best be described as trial by fire. Right from the start, they faced all kinds of problems, with employees (atrocious customer service was turning guests away), power outages, serious water leaks—you name it. The young and inexperienced small business owners had to learn Spanish—and fast!—but they also had to grow as businesspeople. In 2006, they bought a second hostel in Bocas del Toro, Panama, which they sold three years later for nearly four times what they paid for it. They wanted to create "a strong, well-received business that puts smiles on people's faces."[38] It seems that they hit the mark. But their experience shows that sometimes there is no way around having to own assets abroad to make a venture possible.

Some small business owners choose to open an overseas sales office and find that this can be a very effective strategy, but it is usually best if they wait until sales in the local market are great enough to justify the move. An overseas office is costly to establish, staff, manage, and finance, so anticipated advantages are sometimes difficult to achieve. Traditionally, U.S. firms often locate their first international sales office in Canada, though European expansion is also common, with the English-speaking United Kingdom and Ireland being very popular locations. Still others have selected Asia, because of its economic dynamism and fast-growing consumer demand.

When small firms purchase a foreign business from another firm, this is known as a **cross-border acquisition**. This is essentially what David Harmatz and his friends did when they bought the Mondo Taitu hostel, though the acquisition was relatively modest in scale. Some with grander ambitions may choose to start a **greenfield venture**, by forming from scratch a new wholly owned subsidiary in another country. Unfortunately, either option is likely to be fraught with difficulties and therefore is best reserved for small business owners with the drive, commitment, and resources necessary to succeed with these strategies.

cross-border acquisition
The purchase by a business in one country of a company located in another country.

greenfield venture
A wholly owned subsidiary formed from scratch in another country.

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Go-it-alone strategies are complex and costly. They offer maximum control over foreign operations and eliminate the need to share generated revenues, but they also force companies to bear the entire risk of the undertaking. With a greenfield venture, a firm may have much to learn about running an enterprise in a foreign country, managing host-country nationals, and developing an effective marketing strategy. The commercial potential of a wholly owned international subsidiary may be great, but the hassles of managing it can be even greater. This option is not for the faint of heart.

18-4 Challenges to Global Businesses

18-4 Explain the challenges that global enterprises face.

Small businesses face challenges. *Global* small businesses face challenges on a significantly larger scale. However, the success of enterprising entrepreneurs in international markets proves that small firms can do better than survive—they can thrive! But success undeniably requires careful preparation. Small business owners must recognize the unique complications facing global firms and adjust their plans accordingly. Beyond managing cultural differences, entrepreneurs need to pay attention to political risks, economic risks, and the likely challenges of doing business in countries where they want to extend operations.

18-4a Political Risk

The potential for a country's political forces to negatively affect the performance of businesses operating within its borders is referred to as **political risk**. Often, this risk is related to the instability of a host nation's government. Potential problems range from threats as trivial as new regulations that restrict the content of television advertising to a government takeover of private assets. Political developments can threaten access to an export market, require a firm to reveal trade secrets, or even demand that all work be completed in-country.

Many large corporations maintain a risk assessment office with staff trained to determine the risk profile of the individual countries for which they have planned projects. Because small firms cannot afford the cost of staffing such an office, some turn to inexpensive tools for risk assessment. One helpful resource is *Euromoney* Country Risk, a platform that provides access to analyses by global risk experts and offers a general sense of the political risks that companies will face when doing business abroad. Small businesses can develop international growth plans using these insights and make appropriate adjustments to their strategies. It's not a perfect method, but it is low cost and far better than planning a global strategy with no information at all.

political risk
The potential for political forces in a country to negatively affect the performance of businesses operating within its borders.

18-4b Economic Risk

Economic risk is the probability that a country's government will mismanage its economy and affect the business environment in ways that hinder the performance of firms operating there. Economic risk and political risk are therefore related. Two of the most serious problems resulting from economic mismanagement are inflation and fluctuations in exchange rates. While a more complete discussion of these factors is beyond the scope of this book, it is important to recognize that inflation reduces the value of a country's currency on the foreign exchange market, thereby decreasing the value of cash flows that a firm receives from its operations abroad.

An **exchange rate** represents the value of one country's currency relative to that of another country—for example, the number of Mexican pesos that can be purchased

economic risk
The probability that a country's government will mismanage its economy in ways that hinder the performance of firms operating there.

exchange rate
The value of one country's currency relative to that of another country.

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with one U.S. dollar. Sudden or unexpected changes in this rate can be a serious problem for small international businesses, whether they export to that market or have a local presence there.

Mary Ellen Mooney of Mooney Farms recognized the potential of exporting her sun-dried tomato products to France and came close to striking a deal with a local distributor some years ago, but the negotiations fell through when the exchange rate between the dollar and the euro changed.[39] To understand her dilemma, suppose the French distributor was willing to pay €5 (5 euros) for a package of sun-dried tomatoes. If the dollar and the euro were exchanged one to one, Mooney could convert €5 to \$5. If \$4.50 covered costs of production, transportation, insurance, and so on, then Mooney would earn a \$.50 profit (\$5.00 – \$4.50) per unit. But if the dollar were to *increase* in value relative to the euro, the situation would change drastically. Assume that the exchange rate changed to \$.80 per €1. Then units selling for €5 would yield only \$4 each (5 × \$.80), which would result in a \$.50 loss on every sale.

Clearly, a good deal can quickly fall apart if exchange rates take a turn for the worse. This risk is especially serious for small companies that are just getting established in international markets. To protect against exchange rate shifts, many small American firms choose to state their contracts in U.S. dollars, but this can give competitors an edge if they are willing to sell in the buyer's currency.

It can also lead to nonpayment if unfavorable shifts make goods or services too expensive for a foreign customer. The International Trade Administration of the U.S. Department of Commerce recommends that small firms use more sophisticated financial strategies and risk management tools, including forward contracts and options, which can be easy to deal with, even for a small business owner (refer to Chapter 14 of the ITA's *Trade Finance Guide: A Quick Reference for U.S. Exporters* for details).[40]

18-4c The Ease of Doing Business Index

The World Bank started publishing annual *Doing Business* reports in 2003 to draw attention to the impact that regulatory conditions have on economic growth and development. The index is based on a survey of more than 15,000 local experts, including "lawyers, business consultants, accountants, freight forwarders, government officials, and other professionals routinely administering or advising on legal and regulatory requirements."[41] Following a very careful methodology, the process uses data related to 11 key sets of indicators—including the difficulty of starting a business, getting credit, and enforcing contracts—to create a ranking for 190 countries. This information can easily be used to shape the international expansion decisions of small businesses.

In Exhibit 18.4, countries are color-coded to indicate the relative ease of doing business in each—green represents "go" countries, which are relatively business friendly; yellow signifies countries that are somewhat more challenging, where companies should "proceed with caution"; and red identifies "stop and think very carefully" countries, where small businesses are likely to have even more difficulty.

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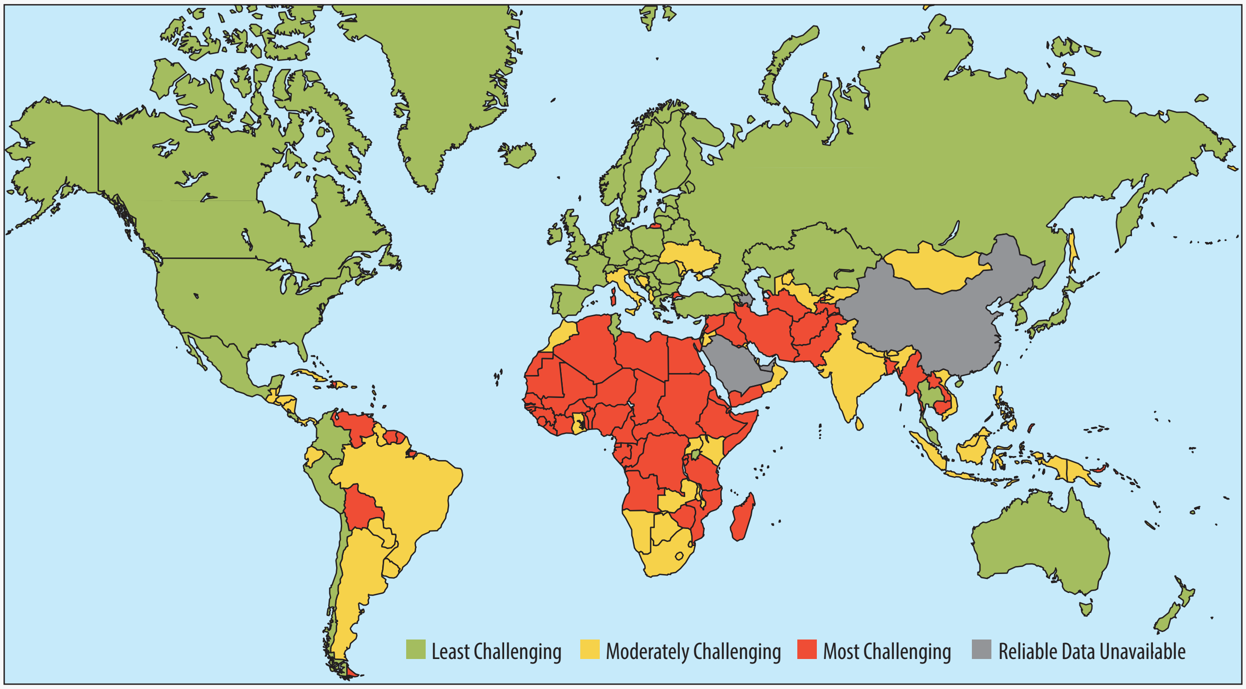
Exhibit 18.4 Ease of Doing Business in Different Countries



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Source: The World Bank, "Ease of Doing Business Rankings," https://www.doingbusiness.org/en/rankings, accessed July 9, 2021.

While color coding is not a part of the index, the data provided are very helpful for planning. Conducting business internationally will never be as easy as doing business at home—it is likely to stretch managerial skills and resources to the limit. Global commerce can complicate every task and raise difficult questions related to every function of the firm. However, the motivations to go global are sound, and others have already proved that it can be done. You can do it, too, if you plan carefully and take advantage of the resources available to help you achieve your global aspirations.

18-5 Assistance for Global Enterprises

18-5 Recognize the sources of assistance available to support international business efforts.

Help is available to small companies with international aspirations—you need only open your eyes to find it. Once you decide to enter the global marketplace, you will be amazed at how many resources are available to assist you.

18-5a Analyzing Markets and Planning Strategy

Among the many activities required to prepare a small firm for the challenges of going global, two are especially fundamental to success abroad: Finding international markets that fit the company's unique potential and putting together a game plan for entry into targeted markets.

A small business should begin its research by exhausting secondary sources of information. The U.S. government offers a number of publications on how to identify and tap into global market opportunities. Also, the Small Business Administration (SBA) stands ready to help small companies expand abroad. Many of the SBA's

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international programs and services are delivered through its Office of International Trade, which has been specifically created "to enhance the ability of small businesses to compete in the global marketplace."[42]

One excellent source of information about global business that is especially useful to small companies is *A Complete Guide to Small Business Exporting* (mentioned earlier in the chapter), which is provided by the U.S. Chamber of Commerce.[43] Available online free of charge, this resource provides an overview of exporting that is useful for both new and experienced exporters. It is designed to guide small firms through the complexities of doing business abroad, with sections focused specifically on the benefits of exporting for small businesses, taking account of the risks involved, deciding what goods or services to export, determining which export markets would be optimal for your company, knowing how to reach foreign consumers, accessing export financing, learning about international shipping options, and other important topics.

Although not focused on small businesses alone, a website maintained by the International Trade Administration of the U.S. Department of Commerce (trade.gov) supplies helpful insights about international expansion. General business publications, such as *The Economist, Financial Times,* and *The Wall Street Journal*, can also be useful, as they provide timely, in-depth analyses of world trade markets and business issues. They are available at very reasonable subscription rates. Beyond these resources, many state and private organizations supply trade information, trade leads, and company databases. TradePort (tradeport.org), one example of many such sources, offers information to promote international trade with California-based companies.

Talking with a trusted practitioner who has had experience doing business in a targeted foreign market can be a valuable way to learn about it. Conversations with government officials or employees who have lived there can also be very helpful. However, in most cases, it will probably be necessary to study a foreign market by visiting the country personally. A representative of a small firm can do this either as an individual or as a member of a group that is organized for the purpose of exploring new international business possibilities.

18-5b Connecting with International Customers

Numerous resources are available to help a small company connect with customers in targeted international markets. They include trade leads, trade missions, and trade intermediaries.

Trade Leads

Trade leads are essential in identifying potential customers overseas. Accessed most often via the Internet, they offer an inexpensive way to establish vital links with buyers and suppliers in target markets. One good online source of trade leads is provided by the globalEDGE portal maintained by the International Business Center at Michigan State University (globaledge.msu.edu/global-resources/trade-leads). This website offers a wealth of international business resources, including leads that can direct a company to valuable partners in most of the world's markets. The International Trade Administration has created a free online trade-leads database (export.gov/trade-leads) that can also help you get connected with potential selling opportunities around the world. In addition to leads, it provides a wealth of instructional resources, specific country-market intelligence reports, news about available support programs and trade events, and links to countless websites that provide other valuable trade-related insights.

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Trade Missions

Joining a trade mission is another excellent way to evaluate a foreign market and connect with overseas customers. A **trade mission** is a planned visit to a potential international market, designed to introduce U.S. firms to prospective foreign buyers and to establish strategic alliances. These missions usually involve groups of five to ten business executives and are set up to promote international sales. Members of the group typically pay their own expenses and share in the operating costs of the mission. Foreign governments sometimes sponsor trade missions in order to promote business links with U.S. firms.

Trade Intermediaries

Perhaps the easiest way to break into international markets is to use a **trade intermediary**. Similar to the assistance wholesalers provide with domestic sales, trade intermediaries distribute products to international customers on a contract basis. These agencies tap their established network of contacts, as well as their local cultural and market expertise. In short, an intermediary can manage the entire export end of a business, taking care of everything except filling the orders—and the results can be outstanding. For example, American Cedar, Inc., wanted to expand the market for its cedar wood products overseas. With the assistance of a trade intermediary, the firm was able to generate 30 percent of its total sales from exporting. Then-company president Julian McKinney recalls how the story unfolded: "We displayed our products at a trade show, and an export management company found us. They helped alleviate the hassles of exporting directly. Our products [were] distributed throughout [Europe] from a distribution point in France."[44] An export management company is only one of the many types of trade intermediaries. Exhibit 18.5 describes the trade intermediaries that can best provide the assistance needed by small businesses.

trade mission
A trip organized to help businesses connect with potential foreign buyers and establish strategic alliances in an international market.

trade intermediary
An agency that distributes a company's products on a contract basis to customers in another country.

Exhibit 18.5 Trade Intermediaries Most Suited for Small Businesses

Confirming House (Buying Agent)	• Works for foreign firms that are interested in buying U.S. products. • "Shops" for lowest possible price for requested items. • Is paid a commission for its services. • Is sometimes a foreign government agency or quasi-governmental firm.
Export Management Company	• Acts as the export department for one or several producers of products or services. • Solicits and transacts business in the names of the producers it represents or in its own name in exchange for a commission, salary, or retainer plus commission. • May provide immediate payment for the products or services by arranging financing or directly purchasing products for resale. • Usually has well-established networks of foreign distributors already in place.
Export Trading Company	• Acts as the export department for producers or takes title to the product and exports it under its own name. • May be set up and operated by producers. • Can be organized along multiple- or single-industry lines. • Can represent producers of competing products.
Export Agent, Merchant, or Remarketer	• Purchases products directly from the manufacturer, packing and marking these product according to its own specifications. • Sells the products overseas under its own name through contacts and assumes all risks. • Requires the producer to give up control of the marketing and promotion of its product.
Piggyback Marketer	• Is a manufacturer or service firm. • Distributes another firm's product or service.

Source: Adapted from U.S. Department of Commerce, *A Basic Guide to Exporting*, 11th edition, Chapter 5, "Methods and Channels," https://legacy.trade.gov/Guide_To_Exporting.pdf, accessed July 9, 2021.

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18-5c Financing for Small Global Enterprises

The more information small firms have about direct and indirect sources of financing, the more favorably they tend to view foreign markets. Sources of this information include private banks and the Small Business Administration.

Private Banks

Commercial banks typically have a loan officer who is responsible for handling foreign transactions. Large banks may have an entire international department. Exporters use banks to issue commercial letters of credit and to perform other financial activities associated with exporting.

A **letter of credit** is an agreement to honor a draft or other demand for payment when specified conditions are met. It helps to ensure that a seller will receive prompt payment. A letter of credit may be revocable or irrevocable. An irrevocable letter of credit cannot be changed unless both the buyer and the seller agree to the change. The process of establishing a letter of credit is quite involved and can be very confusing. However, banks and other financial institutions that offer this service have expert staff who can explain how these documents work and will walk you through the process.

A guarantee from a reputable bank that the exporter will indeed be paid is critical to a small business that has stretched its resources to the limit just to enter the global game and thus cannot afford an uncollected payment. But what if the small business is on the import end of the exchange? How will its interests be protected? The letter of credit provides security for the receiving firm as well, because the exporter does not receive payment from the bank until it has released the title, or proof of ownership, of the delivered goods. Once the product has been shipped and the title transferred, the exporter receives a document called a **bill of lading** to confirm this. This document must be received before the bank will pay on the letter of credit. In brief, the letter of credit ensures that the exporter will receive payment only when the goods are delivered, and it also guarantees that the exporter will be paid.

Small Business Administration

The Small Business Administration (SBA) serves small U.S. firms primarily through its regional, district, and branch offices. Small businesses that are either already exporting or interested in doing so can receive valuable information from the SBA through its U.S. Export Assistance Centers (USEACs) located in nearly two dozen cities throughout the country. Through these offices, you can get connected to conferences and seminars, instructional publications, and export counseling. Co-located with other government agencies that can help small firms grow internationally, USEACs can help exporters explore available options and develop a plan of action that will be tailored to their specific needs.[45]

A growing number of small firms are choosing to participate in international business for various reasons, with new motivations continuing to emerge in the forever-evolving competitive landscape. Whatever your reasons are for entering the global arena, your company is certain to confront serious challenges that purely domestic firms do not have to face. However, assistance is available in abundance from a number of private and public sources. With a little help and a lot of hard work, your company can succeed in the global marketplace.

letter of credit
An agreement issued by a bank to honor a draft or other demand for payment when specified conditions are met.

bill of lading
A document indicating that a product has been shipped and the title to that product has been transferred.

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18-1. Describe the potential of small businesses as global enterprises.

- Many start-ups and even the smallest of businesses continue to expand internationally; in fact, start-ups and small businesses are responsible for almost one-third of all known U.S. exports.
- Some small companies called born-global firms are being launched with cross-border business activities in mind.
- Before going global, it is important for a small business owner to determine whether their company is up to the task.
- Small business owners who decide to go global must study the social, technological, economic, and political forces in a foreign market to determine how best to adapt their business practices, as well as their products or services, to ensure smooth market entry.

18-2. Identify the basic forces prompting small companies to engage in global expansion.

- The basic forces behind global expansion are expanding markets, gaining access to resources, cutting costs, and capitalizing on special location features.
- Since more than 95 percent of the world's population live outside the United States, globalization greatly expands the size of a firm's potential market.
- The large emerging markets known as the BRICS countries (*B*razil, *R*ussia, *I*ndia, *C*hina, and *S*outh Africa) are attracting small firms that wish to tap their enormous market potential (especially in India and China).
- Because of converging preferences and delivery systems around the world, products that sell at home are more likely to be introduced very quickly abroad, often with little or no adaptation necessary.
- Small businesses with a highly differentiated product may need international markets in order to increase sales enough to recover product development costs.
- Going global can accelerate gains from experience curve efficiencies (resulting from learning effects and economies of scale), especially for start-ups based on complex technologies.
- Small businesses may go global to gain access to resources, including raw materials and skilled workers. They can also cut their costs in these areas and in manufacturing overhead.
- Businesses of all sizes have been slashing costs by contracting with independent providers overseas (international outsourcing) or relocating their stateside operations abroad (offshoring).
- Small businesses may want to capitalize on the special features of an international location to create authenticity by being local, to enhance a brand's reputation, or to follow a large client firm.

18-3. Compare strategy options for global businesses.

- Exporting, or selling items produced at home to foreign buyers, can be facilitated by using the Internet to increase firms' international visibility.
- Importing should be used when products manufactured abroad have market potential at home.
- Foreign licensing allows a company in another country to purchase the rights to manufacture and sell a different firm's products in overseas markets.
- International franchising, the fastest-growing market-entry strategy for U.S. firms, is a strategy to sell a standard package of products, systems, and management services to a company in another country.
- International strategic alliances allow firms to share risks and pool resources with overseas partners as they enter a new market.
- Some small firms may purchase a foreign business from another firm through a cross-border acquisition. Others may even start a greenfield venture by forming from scratch a new wholly owned subsidiary in another country.

18-4. Explain the challenges that global enterprises face.

- Political risk is the potential for a country's political forces to negatively affect the performance of small businesses operating there. It varies greatly across nations.
- Economic risk is the probability that a government will mismanage its economy and affect the business environment in ways that hinder the performance of firms operating there (most notably through inflation and fluctuations in exchange rates).

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- The World Bank's annual *Doing Business* reports can help a small company gauge the overall level of difficulty of entering a specific country market, based on legal and regulatory requirements.

18-5. Recognize the sources of assistance available to support international business efforts.

- Numerous public and private organizations provide assistance to small businesses in analyzing markets and planning an entry strategy.
- Small businesses can connect with international customers by reviewing sources of trade leads, joining trade missions, and using the services of trade intermediaries.
- For assistance in financing its entry into a foreign market, a small firm can turn to private banks (which can issue letters of credit) and programs initiated by the Small Business Administration.

Key Terms

bill of lading p. 492
born-global firms p. 469
counterfeit activity p. 483
cross-border acquisition p. 486
economic risk p. 487
economies of scale p. 474
exchange rate p. 487
experience curve efficiencies p. 474
exporting p. 478
foreign licensing p. 481
globalization p. 469
greenfield venture p. 486
importing p. 480
international franchising p. 483
international outsourcing p. 475
international strategic alliance p. 485
learning effects p. 474
letter of credit p. 492
licensee p. 481
licensor p. 481
offshoring p. 475
political risk p. 487
royalties p. 481
trade intermediary p. 491
trade mission p. 491

Discussion Questions

1. What is a "born-global" firm? What factors are encouraging the increase in the number of these companies?
2. What are the most important questions small business owners should consider when assessing their readiness for the challenges of going global?
3. In general, do you think it is wise for small firms to engage in international business? Why or why not?
4. Why is it important for a small business to conduct careful analyses of the social, technological, economic, and political forces in a foreign market before making the decision to enter it?
5. What are the four primary forces driving small businesses to enter the global business arena? Which do you think is the most influential? Do you think any of these motivations are likely to remain powerful forces ten years from now? Twenty years from now?
6. Why is exporting such a popular global strategy among small businesses? Do you think this should be the case?
7. What impact has the Internet had on the globalization of small firms? How do you think small companies will use the Internet for business in the future?
8. What strategies other than exporting can small businesses adopt? In view of the unique needs and capabilities of small firms, what are the advantages and disadvantages of each of these strategies?
9. What are the three main challenges that small businesses face when they go global? What strategies can a small company use to deal with each of these challenges?
10. What forms of assistance are available to small global firms? Which is likely to be of greatest benefit to small companies? Why?

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You Make the Call

Situation 1

Jesse Acevas recognized the advantages of outsourcing software development work when he decided to start Victoris Consulting International, an information technology company. He has considered linking up with a service provider in Bangalore, India, because the wages are very low, the pool of well-trained employees is deep, and technical skills are strongly emphasized in the system of higher education there. But India is a long way from the company's home office in Phoenix, Arizona, which means greater travel costs, dealing with the hassle of working between time zones that are nearly opposite one another, and communication delays. There have also been reports of problems with infrastructure limitations (including poor or dropped Internet and phone connections), as well as the cost and quality of completed work. Finally, the cultural gap would be significant, even though most educated workers in India speak English.

Acevas has also been in touch with an operation in Guadalajara, Mexico. His contacts there tell him that the skilled workers he needs are available, the cultural gap is limited, turnover is very low, and technical staff will not need special visas to travel between Mexico and project sites in the United States. However, wages there are significantly higher than in Bangalore, university graduates in Mexico receive little practical training, and the law makes it very difficult to fire staff once they are hired.

The clock is ticking. Acevas needs to line up employees for three big contracts he is currently negotiating, and his potential clients all want to get their projects started within a month or so of a final decision. If he closes even two of the three deals, he will have much more work than his staff in the United States can handle. He will need additional employees—he's just not certain where to go for outsourcing support.

Question 1 What additional information would be helpful to Acevas as he ponders this decision?

Question 2 What additional advantages and disadvantages should Acevas consider when choosing between offshoring this work to India and "nearshoring" it to Mexico?

Question 3 Which location would you choose—India or Mexico? Build a case to support your final decision.

Situation 2

Aaron Altmann is the founder of Sacred Earth, which imports 16-ounce bags of soil from Israel for use at groundbreakings, burials, and other ceremonial events. The product holds special significance for people of various religious faiths, and each parcel of Sacred Earth is certified to be genuine by a rabbi in Jerusalem. The company sells the soil for $29.95 per bag.

The obstacles the company has had to overcome have been numerous. For example, import operations can be very difficult to set up, especially if they involve organic matter. Soil products cannot be imported without the permission of the U.S. Department of Agriculture, which requires that they be treated, tested, and formally approved. The new venture had to bear these costs on top of normal business expenses, such as obtaining the soil and then shipping, packaging, storing, marketing, and delivering it to buyers. Altmann worked with scientists to come up with a soil-cleaning process that satisfies U.S. import regulations, giving his start-up a competitive advantage over would-be rivals.

Altmann is now considering ways to expand the market and the potential of his young company. For example, he is thinking about marketing his soil product to Christian Evangelicals, as well as a number of other applications that include using the soil to feed potted plants, to promote good luck, or even to save as a keepsake. The future looks promising, but for now Altmann can take pleasure in knowing that his import operation is finally off the ground . . . in more ways than one.

Question 1 In your opinion, what new country markets would be likely to hold the greatest potential for additional sales for Altmann's company?

Question 2 Of the major strategy options mentioned in this chapter, which is Altmann currently following? Which of the other strategies would offer the safest path to further global expansion? The fastest path? The best path? Why?

Question 3 What are the greatest challenges Altmann is likely to face in the future? What sources of assistance would you suggest that he use as he takes on those challenges?

Situation 3

The U.S. Commercial Service recently announced that it is organizing a trade mission to Mexico to help American companies sell environmental services there. The focus on the trip is specifically on solid waste recycling and wastewater treatment. John Shira is thinking about joining the group in an effort to find customers for services provided by his company, HydroUV Systems. His green start-up is based on a patented technology that uses ultraviolet light to destroy disease-causing microorganisms in municipal wastewater and can deliver impressive results with great efficiency.

Several other small business owners are considering the mission with the objective of exploring potential market opportunities. In an initial briefing, it was reported that Mexico has a population of over 127 million and is one of the fastest-growing export markets in the Americas for small and medium-size U.S. companies. Because most of this growth has been occurring

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in the large urban centers of the country, the infrastructure for wastewater treatment in the big cities has been especially strained. However, health conditions in the more rural sections of the country have been persistently more dire, despite state-spending programs in recent years that have attempted to help bring these areas closer to national standards. These are not good signs, generally speaking. But since government budgets in Mexico are always squeezed, Shira has concluded that the promise of HydroUV Systems' technology to provide cost-effective solutions in controlling water-borne disease may be very attractive to municipal managers.

Mexico has the second largest economy in Latin America. It also has a rich cultural history, considerable human diversity, and abundant natural resources. At the same time, though, the World Bank reports that the country has been underperforming relative to similar nations for more than three decades. Since 1980, the economy has experienced relatively lackluster growth of just over 2 percent a year, on average—that is, until the COVID-19 pandemic hit in 2020 and drove the economy down by a punishing 8.2 percent. This has had deep impacts on firms, employment, households, and local governments. The country's post-pandemic recovery will depend on several factors, chief among them being how well the government manages public health, economic growth trends in the United States (by far Mexico's most important trading partner), and the availability of private investment. If the country can regain its footing in the years to come, it should be able to provide a higher quality of life for all of its citizens.

Question 1 Do you think a business like HydroUV Systems could prosper in Mexico? Why or why not?

Question 2 What challenges and risks do you think Shira should anticipate if he decides to do business in Mexico? What could he do to manage those challenges and risks and increase his chance of success in the market?

Question 3 Do you think Shira should try to join the trade mission that the U.S. Commercial Service is organizing? What other options might be available to help him connect with potential customers in Mexico?

Source: "The World Bank in Mexico," March 29, 2021, https://www.worldbank.org/en/country/mexico/overview, accessed July 13, 2021.

Experiential Exercises

1. Conduct phone interviews with 10 local small business owners to see if they engage in international business. Discuss their reasons for going global or for choosing to do business only domestically.
2. Contact a local banker to discuss the bank's involvement with small firms participating in international business. Report your findings to the class.
3. Review recent issues of *Entrepreneur, Inc., Fast Company*, and other small business publications, and be prepared to discuss several articles related to international business.
4. Do an online search to find an article about a small business that first expanded internationally using an entry strategy other than exporting. From what you understand of the company's situation, suggest guidelines that could lead a firm to go global with non-export strategies.
5. Consult online sources to develop a political/economic risk profile for a given country. Select a small company, and explain what it would have to do to manage these risks if it were to enter the market of the profiled country.
6. Speak with the owner of a small international company. Which sources of assistance did that entrepreneur use when launching the global initiative? Which sources did the entrepreneur find most helpful? Which did the entrepreneur find least helpful?

Chapter 18 Case

Please see Appendix A for the Chapter 18 Case Study.

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Chapter 19

Professional Management and the Small Business

Looking Ahead

Learning Objectives

This chapter will provide an overview of the needs, challenges, and adjustments that are involved in managing a small business—especially as it grows. By studying this chapter, you should be able to . . .

19-1 Describe the entrepreneur's leadership role.

19-2 Explain the small business management process and its unique features.

19-3 Identify the managerial tasks of entrepreneurs.

19-4 Describe the problem of time pressure and suggest solutions.

19-5 Discuss the various types of outside management assistance.

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Spotlight on Small Business

Learning to Lead at ASRV Sportswear

https://asrv.com.

Jay Barton, founder and CEO of activewear clothing brand ASRV Sportswear, believes consumers are far too complacent about what they wear. More to the point, he maintains that they should be able to expect their clothes to improve their lives, whether or not they are exercising.

He came up with the idea for ASRV (which stands for "All Season Recreation Versatility," if anyone is asking) and its performance-improving designs in 2014 after searching for apparel to fit his busy lifestyle, only to come up emptyhanded. He wanted clothing he could wear to and from client meetings, casual coffee shops, and the gym, but that kind of apparel was nowhere to be found. So, Barton did what has always come naturally to him as a born entrepreneur: He started ASRV Sportswear to create the products that *he* needed, figuring others would want them, too.

Apparently, he was on to something. In ASRV's first year, the company sold $750,000 worth of product. And it has doubled in size every year since then, reaching sales of $18 million in 2020. But Barton maintains that the key to ASRV's success has not come from flashy advertising campaigns or huge marketing budgets; rather, it has been the result of creating compelling products that excite consumers. It seems he is right. The company now can claim 250,000 customers, including pro athletes and celebrities. Perhaps as important for the future, ASRV's rapid rise has allowed Barton to forge very strategic relationships with industry giants like Kevlar, DuPont, Oakley, and Reebok.

Barton was only 23 when he founded ASRV, but this was not his first start-up rodeo. As an entrepreneurially driven kid, Jay launched his first venture at age 9 when he decided to sell T-shirts to his classmates. The business was incredibly popular. In fact, it was *too* popular—and too much of a distraction, which is why his school told him he would have to stop using the campus as his sales floor!

In the years that followed, he tried other ventures, mostly selling sunglasses and watches. But these efforts didn't really pan out as expected. So, when the time came to launch ASRV, Barton was determined that his new venture would represent an authentic brand, not just an opportunity to sell something. Specifically, he resolved to connect with his customers in a special way, knowing them on as personal a level as possible. This emphasis is clear from the company's stated brand philosophy:

> ASRV's . . . activewear was originally created for the person seeking a championship or some form of external achievement. We view these as potential side effects of our efforts, but not the ultimate goal. We exist for the individual who relentlessly chases the next challenge, in search of that beautiful place of optimal challenge and ability, where we find our deepest sense of purpose.

With his personal compass reset, Barton set out to create the products people truly need and want. Key to this is a focus on the latest available textile technology and intuitive designs. This means ASRV apparel is not only stylish and authentic, but it is also practical, durable, and of high quality.

But leading a dynamic and growing company means adjusting to new leadership demands. Used to working alone, Barton admits that he found it challenging to direct and coordinate the efforts of a team as large as the one needed to run a company the size of ASRV. Stepping into that role would require a different mindset, one that would inspire employees to fall in behind his vision for the business. Barton figured this could best be done by empowering each of them to think and act for themselves.

Cultivating an entrepreneurial culture was the only path to creating the innovation and smart designs essential to the company's unique value proposition. In the transition, Barton has managed to leverage his strengths as an individual—namely, his pioneering, risk-taking inclinations and his natural ability to connect with and understand consumers—and translate them into a culture that clearly works for ASRV.

Leading in this way has taken the company to its current success and will help to ensure its continued success going forward. But adjustments were definitely necessary to make this possible. That is simply par for the entrepreneurial course, a corner that most small business owners have to turn at some point to keep their enterprises moving forward. Barton's experience shows that it can indeed be done.

Sources: "ASRV: Our Philosophy," https://asrv.com/pages/relentless-pursuit-info, accessed July 9, 2021; "ASRV's Playbook for Launching Authentic Brands," *Assembled Brands*, February 13, 2020, https://assembledbrands.medium.com/asrvs-playbook-for-launching-authentic-brands-f2f0ef2e401c, accessed July 9, 2021; "Forging the Future of Apparel—and Fitness," *Inc.*, October 27, 2020, https://www.inc.com/brandedcontent/forging-the-future-of-apparel-and-fitness.html, accessed July 9, 2021; and "Jay Barton: Founder, ASRV Sportswear," *Forbes*, 2021, https://www.forbes.com/profile/jay-barton/?sh=167acf6d4057, accessed July 9, 2021.

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Celebrated poet Williams Wordsworth once observed, “The child is father of the man,” suggesting that childhood experiences tend to shape a person’s direction later in life. In a similar way, a start-up leaves its imprint on the established company it eventually becomes, although the two are very different. A start-up’s needs are unique, so adjustments will be necessary sooner or later.

Unless you plan to remain a tiny one-person business forever, you are sure to encounter leadership and management problems. When they occur, you must find ways to integrate the efforts of employees and give new direction to the business.

As explained in the Spotlight on Small Business at the start of this chapter, Jay Barton learned from experience at his start-up that if you don’t have the natural ability to direct and coordinate the effort of your team, you will have no choice but to develop these skills as your venture grows. This is absolutely necessary if production employees, salespeople, administrative staff, and other personnel are to work together effectively. Even long-established businesses need vigorous leadership if they are to avoid stagnation or failure. This chapter examines the leadership challenges facing entrepreneurs and the managerial activities required as firms mature and grow.

19-1 Small Business Leadership

19-1 Describe the entrepreneur’s leadership role.

Leadership roles differ greatly, depending on the size of the business and its stage of development. For example, an enterprise that is just getting started will face problems and uncertainties unlike those of a family firm that has been functioning well over two or three generations. We must begin, therefore, with the recognition that leadership cannot be reduced to simple rules or processes that fit all situations.

19-1a What Is Leadership?

The question of how to define leadership is simple, but the answer is not. Eric Paley, managing partner of venture capital firm Founder Collective, offered the following description:[1]

> Being a leader means focusing your team on the key priorities. You need to build consensus on these priorities, set goals, evaluate performance against those goals, and change course when necessary. Great leaders build credibility with their team by making a plan, executing it effectively, and demonstrating that it was the right plan.

In other words, leadership involves pointing the way and getting others to follow willingly. It is far more focused on the destination than on the details of getting there, though good leaders know that *how* you get there also matters. An entrepreneur must convey their vision of the firm’s future to all other participants in the business so that they can contribute most effectively to the accomplishment of the mission. Although leaders must also engage in more routine processes, particularly as the company grows, the first task of the small business owner is to create and communicate a vision for the company.

19-1b Leadership Qualities of Founders

An entrepreneur is a trailblazer who enlists others, both team members and outsiders, to work with them in a creative endeavor. Others may then buy into this vision for the business as they join their efforts with those of the entrepreneur.

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In a totally new venture, the founder faces major uncertainties and unknowns. Therefore, individuals who are launching promising start-ups, with the prospect of attaining significant size or profitability, need to have certain qualities. One of the most important traits is tolerance for ambiguity. Because of the uncertainty involved in starting a new business, entrepreneurs must also be adaptable, able to adjust to unforeseen problems and opportunities. These basic qualities can be useful in many business settings, but they are never more important than in the start-up situation.

19-1c What Makes a Leader Effective?

Many people assume that a business leader must have a flashy, highly charismatic, "I'm-in-charge" personality to be effective, but this is not the norm and certainly is not required—in fact, this attitude can sometimes be counterproductive. Effective leadership is not so much about wanting to *be* in charge as it is about having the ability to *take* charge by setting the right priorities, finding good people and sorting them into the right roles, and then making the relationships work for everyone involved. This general formula was confirmed by an extensive analysis of data compiled from more than 15,000 interviews with CEOs and other high-level executives.[2]

Of course, setting priorities for the business assumes that a leader has a strong sense of where the company should be going. That individual also needs to be committed to serving as a role model so that others will feel motivated to follow. This is precisely the point made by entrepreneur and angel investor Amy Rees Anderson in her comments to *Forbes* magazine:[3]

> True leaders know who they are and what they stand for. They know their values and the rules they will abide by, regardless of the circumstances they face. They allow their people to understand the values they are committed to uphold, which lays a foundation for the rules their people will be expected to adhere to . . . .
>
> True leaders have integrity. Integrity is the very core of their influence. Living the values they profess to believe is what gives them credibility and allows others to place their trust in them. True leaders are able to say "do as I do" rather than just "do as I say," because they lead by example.

Clearly, effective leadership is based not on a larger-than-life personality but, instead, on guiding a company toward constructive business accomplishments. In most small firms, leadership is personal. The owner-manager is not a faceless unknown but an individual whom employees see and relate to in the course of their normal work schedules. This situation is entirely different from that of large corporations, where most employees never see the chief executive. If the employer–employee relationship is good, employees in small enterprises develop strong feelings of personal loyalty to their employer.

In a large corporation, the values of top-level executives must be filtered through many layers of management before they reach those who make and sell the products. As a result, the influence of those at the top tends to be diluted by the process. In contrast, personnel in a small company receive the leader's messages directly. This face-to-face contact facilitates their understanding of the leader's vision as well as their stand on integrity, customer service, and other important issues. In the end, this infused sense of purpose, high standards, and achievement can actually create a competitive advantage for the small business over its corporate rivals.

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19-1d Leadership Styles

Leaders use many different styles of leadership. Some styles may be better suited to certain situations, but most leaders choose from a variety of approaches as they deal with different issues. Psychologist Daniel Goleman and his colleagues have identified six distinct leadership styles. In their study of nearly 4,000 managers, they found that effective leaders shift fluidly and often between the first four styles listed below, and they make very limited but skillful use of the last two styles:[4]

1. The *visionary* mobilizes people toward a shared vision.
2. The *coach* develops people by establishing a relationship and trust.
3. The *team builder* promotes emotional bonds and organizational harmony.
4. The *populist* builds consensus through participation.
5. The *paragon* sets challenging and exciting standards and expects excellence.
6. The *general* demands immediate compliance.

An entrepreneur may use different styles at different times when attempting to draw out the best of the organization and its employees. Although it should be used sparingly, general-style leadership might be necessary and expected in a genuine emergency situation, but it would not be appropriate in most settings.

For most entrepreneurial firms, leadership that recognizes and values individual worth is strongly recommended. Some decades ago, many managers were hard-nosed autocrats, giving orders and showing little concern for those who worked under them. Over the years, this style of leadership has given way to more sensitive and effective approaches, and solid evidence indicates that employees find these styles to be far more motivating. For example, a massive survey of 64,000 people in 13 countries asked respondents to identify the traits of modern leaders that they find to be the most desirable. At the top of the list were qualities like patience, expressiveness, flexibility, and loyalty.[5] And this stands to reason. In today's hypercompetitive business environment, companies have to demand more and more output from fewer and fewer people just to stay in the game, and the stress is taking its toll.

To maintain a sense of balance, leaders must attend to the emotional needs of their anxious employees by helping them see that they are part of something important and by communicating appreciation, concern, and support.[6] To get results in a business world transformed by the speed of the Internet and increasingly saturated with competitors from every corner of the globe, you need to take a caring approach with employees. An editor at *Inc.* magazine put it this way: "It takes a tender person to lead a tough company."[7]


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Danny Meyer appears to have struck the right balance. Making it in the restaurant business is tough, but it seems that just about everything Meyer starts in the industry turns to gold. He owns some of New York's best and most popular restaurants, along with a few barbecue establishments, the Shake Shack burger chain, and even a catering business. His success is undeniable, but the road to results required some fundamental adjustments. Meyer recalls a time early on when his managers and waiters were continually testing him by disregarding his standards for excellent service. Responding to advice

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from a highly respected and successful mentor, Meyer came up with his own unique management approach—he calls it *constant, gentle pressure*. A *Financial Times* article described Meyer's approach in this way:[8]

- Problems are going to arise, conspiring to throw everything out of balance, but Meyer is committed to moving things "back to center," where they should be. That's the "constant" feature of his approach.
- But he always responds in a way that nudges his employees in the right direction to keep them motivated in a positive way. That's why he calls it "gentle."
- He also insists on excellent performance, however, overseeing the details of every table—even to the point of moving an out-of-place saltshaker to its proper place. That's where the "pressure" comes in.

It's a management style that works. Meyer's success in the restaurant business has been very impressive.

In many cases, progressive managers seek some degree of employee participation in decisions that affect personnel and work processes. Often, the focus is on important features of the business, such as shaping the mission of the firm or establishing everyday workplace practices. Managers may carry this leadership approach to a level called **empowerment**. The manager who uses empowerment goes beyond solicitation of employees' opinions and ideas by increasing their authority to act on their own and to make decisions about the processes they're involved with. This sends the message that management trusts them to do the right thing, which tends to elevate employee morale as well as performance. It also frees up time for owners and managers to take care of other pressing business challenges.

The research is clear: Effective leaders create tremendous business value. According to Bill Pasmore, senior vice president at the Center for Creative Leadership, "Leaders who make choices to operate in a more participative way—who operate on principles of high engagement, versus bureaucracies that treat people as if they were cogs in a machine—see a 30 percent improvement in performance."[9] That's because engaged employees are more productive and customer-focused, which leads to greater firm profitability. This does not mean that leadership traits such as decisiveness, resilience, and confidence are no longer valued—research has shown that these are also desirable leadership qualities—but they must be balanced with a more sensitive touch if a leader is to have greater impact.[10]

19-1e Shaping the Culture of the Organization

Over time, an organization tends to take on a life of its own. As indicated in Chapter 2, an organizational culture begins to emerge in every small business, establishing a tone that helps employees understand what the company stands for and how to go about their work. It is the factor that determines the "feel" of a business, the "silent teacher" that sets the mood for employee conduct, even when managers are not present.

A company's culture does not emerge overnight. It unfolds over the lifetime of the business and usually reflects the character and style of the founder. (You may recall that we discussed the founder's imprint on organizational culture in the family business in Chapter 5.) Because of its power to shape how business is conducted, the culture of the organization should not be left to chance. If founders are honest in their dealings, supportive of employees, and quick to communicate, they will likely set a standard that others will follow.

An entrepreneur can create an innovative cultural environment by setting aside their ego and opening up to the ideas of others, supporting experimentation through

empowerment
Authorization of employees to make decisions or take actions on their own.

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the elimination of unnecessary penalties for failure, and looking for and tapping into the unique gifts of all employees. Like empowerment, creating an organizational culture that fosters innovation tends to draw employees into the work of the company and often provides a boost to commitment and employee morale.

Deliberate physical design efforts can also influence the organizational culture, thereby helping to shape the way people in the organization think, how they interact, and what they achieve together. Intentional steps can be taken to set the tone of business. For example, a collaborative climate can be cultivated in open-office layouts by seating team members near one another. This creates more occasions for employees to run into one another and start idea-generating conversations, though the noise and lack of privacy created can inhibit concentration and deep thinking.[11] At the same time, giving “higher-ups” private offices while everyone else has to work out in the open can send the wrong message. It also cuts off the flow of ideas and communication. Research and experience have made it clear that relatively simple adjustments in physical space can have a profound effect on the mindset that employees assume at work.

The rapid rise of remote work in recent years definitely presents a wrinkle when it comes to shaping the culture of a small business. Employers have very little control over employees’ physical workspaces when they are working from home or other remote locations, but they can certainly provide information regarding the factors that contribute to a healthy work environment. Indeed, we would argue that a well-defined organizational culture is even more important in remote-work situations since it can provide the sense of shared purpose that allows employees to see and understand their role within the larger enterprise. This means that values and expectations related to performance outcomes, interpersonal interactions, teamwork, attention to detail, the need for experimentation and risk-taking, and other facets of culture should be carefully worked out in advance and clearly communicated.

Another factor that can shape culture is hiring new employees based on their attitude, style, and fit with the personality of the company. However, we need to point out that this practice is at the center of an unfolding debate. Some hiring professionals argue that few companies define their culture precisely enough to make “culture fit” objective and measurable, which allows the selection process to be more subjective than accurate and can lead to decreased diversity. Other experts contend that bringing on employees whose personal style and approach are out of line with the culture of the company risks setting them up for unhappiness and longer-term failure. This is why a sophisticated corporation like Google can use cutting-edge people analytics to evaluate potential new employees while still trying to size up an applicant’s “Googleyness” (another way of referring to the firm’s one-of-a-kind culture).[12] Which view is correct? As the opposing positions above suggest, the answer to that question remains unsettled for now.

It should be less controversial to affirm that, in large part, running a business is a mental sport, and those who have the right frame of mind are most likely to win. Therefore, every leader should strive to incorporate a positive, “can-do” attitude into the organizational culture. You can work on your own attitude and inspire others to follow your lead. Attitude often is everything, in life and in business. Whether an event is mentally framed as a setback or a positive life experience is entirely up to you. If all the parking spaces close to the store are full, taking one farther away can be seen as a chance to get some exercise. A new competitor can present a fresh reminder of why it is so important to serve your customers to the best of your ability. And a lost sale can show you how to improve your product or adjust your presentation so that many more sales can be generated in the future. Develop a positive mindset, and let it shape the culture of those you have hired to work alongside you.

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19-2 Explain the small business management process and its unique features.

19-2 The Small Firm Management Process

Small business owners face challenges that differ greatly from those of corporate executives. Some of those challenges may arise with necessary changes to leadership and management processes as the firm moves from a start-up to the point where it may employ a full staff of **professional managers**, trained in the use of more advanced management methods.

professional managers Managers who use systematic, analytical methods of management.

19-2a From Founder to Professional Manager

The way businesses and other organizations are managed can vary greatly. The extremes of very unskilled and highly professional types of management represent the ends of a continuum. At the less-developed end are entrepreneurs and other managers who rely largely on past experience, rules of thumb, and personal whims in giving direction to their businesses. In most cases, their mental models for managing are based on the way they were treated in earlier business experiences or in family relationships. Other entrepreneurs and managers take a more sophisticated approach. They are analytical and systematic in dealing with management problems and issues. Because they emphasize getting the facts and working out logical solutions, their routines are sometimes described as more methodical in nature.

The challenge for small firm leaders is to develop a professional approach, while still retaining the entrepreneurial spirit of the enterprise. This can be especially difficult because founders of new businesses are not always good organization members. As discussed in Chapter 1, they are creative, innovative, risk-taking individuals who have the courage to strike out on their own. Indeed, they are often propelled into entrepreneurship by precipitating events, sometimes involving their difficulty in fitting into conventional organizational roles. But even very capable entrepreneurs may fail to appreciate the need for good management practices as a company grows.

Scott Leibs, executive editor of *Inc.* magazine, points out that many experts believe it is extremely difficult, indeed impossible in many cases, for entrepreneurs to make the transition from founder to professional manager:[13]

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> Some founders . . . can get a company through the first couple of stages of growth, but no further. They don't know their weaknesses, or understand the real reasons for their company's success, and they want to make every decision rather than cede control as the company outgrows what any one person can manage.

When an entrepreneur cannot make the transition as the venture grows and becomes more complex, and refuses to hand the reins of control to someone better suited to take over, the enterprise is very likely to fail. This is a common problem—so common that investors actually have a name for it: *founderitis,* or "founder's syndrome."

Although many entrepreneurs are professional in their approach to management and many corporate managers are entrepreneurial in that they are truly innovative and are willing to take risks, a founder's more simplistic methods can act as a drag on business growth. This, in turn, can have a significant impact on the value of the venture. Noam Wasserman, who directs the Founder Central Initiative at the University of Southern California, determined just how great this effect can be by studying 6,130 start-ups over an eight-year period. In those ventures where the founder stayed on as CEO or chairman after two years, the companies' valuations fell by an average of 17.1 to 22 percent. The impact was twice as great for those start-ups where the founder held both positions.[14] The message is clear: Founders should carefully consider the high cost of hanging on beyond the point where the venture needs new leadership.

Ideally, the founder should be able to add a measure of professional management without sacrificing the entrepreneurial spirit and basic values that have given the business a successful start. But some can't "turn that leadership corner" and are, in time, replaced. Recognizing the trend, *Inc*. reported that 27 percent of the top entrepreneurial, fast-growing, middle-market businesses that its team of researchers surveyed no longer were run by their founders.[15] On the other hand, we would caution that research has shown that replacing a founder CEO can have a negative impact on levels of innovation, which can show up as significant decreases in measures like patent activity and other risk-taking initiatives.[16]

Expanding Beyond the Comfort Zone

Although some large corporations experience poor management, small enterprises seem particularly vulnerable to this weakness. Many small firms are marginal or unprofitable businesses, struggling to survive from day to day. At best, they earn only a meager living for their owners.

It is common to hear about businesses that become successful, are praised for their problem-solving wizardry, and start to take on high-prestige customers. But it is precisely at that point when many companies start to lose their business grip. When these ventures were small, with perhaps a few dozen employees and a handful of projects in the pipeline, they were able to perform quite well. But when they expanded beyond some comfortable point, problems began to mount. Suppliers started to gripe about late payments, customers became unhappy because of delayed deliveries and shoddy workmanship, and employee morale began to drift. This can easily be the beginning of the end, and bankruptcy is all too often the final outcome. In the postmortem, it becomes clear that the cause of failure in many cases was a lack of professional management. The good news, however, is that poor management is neither universal nor inevitable.

Managing the Constraints That Hamper Small Businesses

Managers of small firms, particularly new and growing companies, are constrained by conditions that do not trouble the average corporate executive—they must face the

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grim reality of small bank accounts and limited staff. A small firm often lacks the money for slick sales brochures, and it cannot afford much in the way of marketing research. The shortage of cash also makes it difficult to employ an adequate number of support staff. Such limitations are painfully apparent to managers who move from large firms into positions in small companies.

MassChallenge, a nonprofit that has been accelerating the growth and development of promising, high-impact start-ups in several locations around North America, offers some observations on key differences between managing in a large corporation and running a new venture. As explained on the organization's website:[17]

> A startup, especially in the early stages, can't afford to hire consultants and specialists to help make their vision become a reality. That's why a CEO needs to be a jack of all trades. They need to be good at wearing several hats and solving a lot of different problems. Once they fix a problem or tick an item off a to-do list, CEOs are always asking, what's next? There's no room for the phrase "that's not my job" in the CEO role. Instead, they're always thinking strategically about what they can do to push the company forward. And last but not least, they're a leader.

Because small firms typically have few specialized staff members, most small business managers have no choice but to be generalists. Lacking the support of experienced specialists in such areas as marketing research, financial analysis, advertising, and human resource management, the manager of a small firm often must make decisions in these areas without the expertise that is available in a larger business. This limitation may be partially overcome by using outside management assistance (some sources of which are discussed later in this chapter). But coping with a shortage of internal professional talent is part of the reality of managing an entrepreneurial company.

19-2b Firm Growth and Managerial Practices

As a newly formed business becomes established and grows, its organizational structure and pattern of management will need to be adjusted. To some extent, management in any organization must adapt to growth and change. However, the changes involved in the early growth stages of a new business are much more extensive than those that occur with the growth of a relatively mature business.

A number of experts have proposed models related to the growth stages of business firms.[18] These models typically describe four or five stages of growth and identify various management issues related to each step. The model that we offer focuses mostly on the managerial challenges that go along with each of these phases of expansion.

Exhibit 19.1 shows four stages of organizational growth characteristic of many small businesses. As firms progress from Stage 1 to Stage 4, they add layers of management and increase the formality of operations. Though some companies skip the first stage or two by starting as larger businesses, thousands of small ventures make their way through each of the stages pictured in the exhibit and described here:

Stage 1: The start-up at this point is simply a one-person operation. Some firms begin with a larger organization, but the solo venture is by no means rare. In fact, many businesses remain one-person endeavors indefinitely.

Stage 2: Eventually, the entrepreneur becomes a player-coach, which implies continuing active participation in business operations. In addition to performing the basic work—whether making the product, selling it, writing checks, keeping records, or other activities—the entrepreneur must also coordinate the efforts of others.

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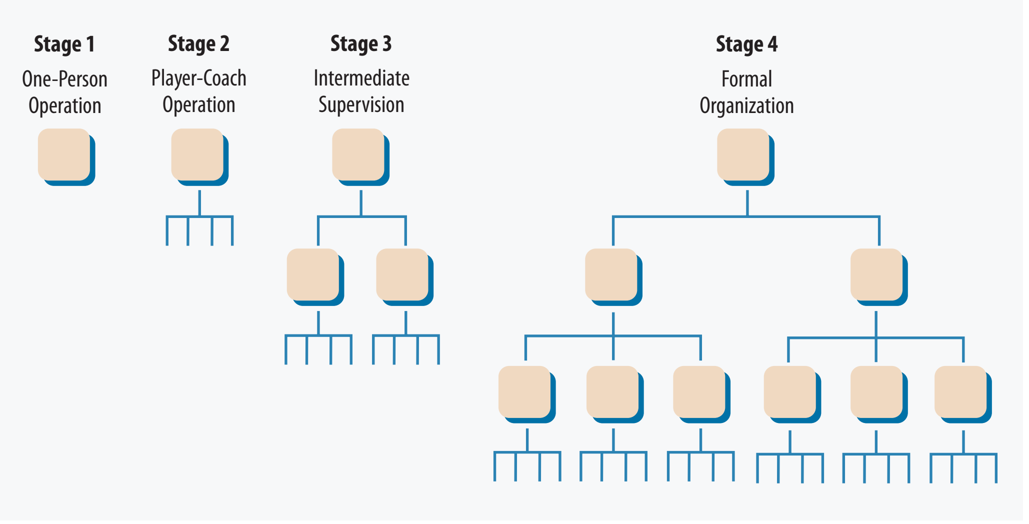
Exhibit 19.1 Organizational Stages of Small Business Growth



Stage 3: A major milestone is reached when an intermediate level of supervision is added. In many ways, this is a turning point for a small firm, because the entrepreneur must rise above direct, hands-on management and work through an intervening layer of management.

Stage 4: Conversion to formalized management typically requires that the company begin to adopt written policies, prepare plans and budgets, standardize personnel practices, computerize records, put together organizational charts and job descriptions, schedule training conferences, set up control procedures, and so on.

While some formal managerial practices may be adopted prior to Stage 4, these steps outline a typical pattern of development for successful firms. Flexibility and informality may be helpful when a business is first started, but growth requires greater formality in planning and control. Tensions often develop as the traditional easygoing patterns of management become dysfunctional. Entrepreneurs will need to demonstrate great skill if they want to preserve a "family" atmosphere while introducing professional management.

From Stage 1 to Stage 4, the pattern of entrepreneurial activities changes. The small business owner becomes less of a doer and more of a leader and manager. Those with strong "doing" skills often have weak managing skills, and this is understandable. Most entrepreneurs build businesses on their specialized capabilities. For example, they may know software development inside and out, have a knack for raising money, or possess enviable selling skills. However, when it comes to tasks like assessing talent in others, they often come up short. This limitation can be a serious problem, although sometimes the personal talent or brilliance of the entrepreneur can enable a business to survive while the necessary skills are being acquired.

Small firms that hesitate to move through the various organizational stages and acquire the necessary professional management often limit their rate of growth. On the other hand, some small businesses may attempt to grow too quickly. If an entrepreneur's primary strength lies in product development or selling, for example, a quick move into Stage 4 may saddle the entrepreneur with managerial duties and deprive the organization of their valuable talents.

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An entrepreneur plays a different role in starting a business than in operating the firm as it becomes more fully developed. And the personal qualities involved in starting a venture differ from the qualities required to manage over the long haul. This helps to explain why so few new ventures actually become established businesses with staying power. Growing a business requires maturation and adaptation on the part of the entrepreneur.

19-3 Identify the managerial tasks of entrepreneurs.

19-3 Managerial Responsibilities of Entrepreneurs

So far, our discussion of the management process has been very general. Now it is time to look more closely at how entrepreneurs organize and direct a company's operations. Their responsibilities include the following:

1. Planning activities
2. Creating an organizational structure
3. Delegating authority
4. Controlling operations
5. Communicating effectively
6. Negotiating

19-3a Planning Activities

Beyond creating an initial business plan to guide the *launch* of a new venture (the focus of Chapter 6), most entrepreneurs also plan for the ongoing operation of their enterprises. However, the amount of planning is typically less than ideal and tends to be haphazard and focused on specific and pressing issues—for example, how much inventory to have on hand, whether to buy a new piece of equipment, and so on. Circumstances affect the degree to which formal planning is needed, but most businesses can function more profitably by increasing the amount of planning done by managers and making it more systematic.

A firm's basic path to the future is spelled out in a document called a **long-range plan**, or **strategic plan**. As noted in Chapter 3, strategy decisions concern issues such as identifying niche markets and establishing features that differentiate a firm from its competitors. But planning is important, even in established businesses, to ensure that changes in the business environment can be addressed as they occur.

Short-range plans are action plans designed to deal with activities in production, marketing, and other areas over a period of one year or less. An important part of a short-range operating plan is the **budget**, a document that expresses future plans in monetary terms. A budget is usually prepared each year (one year in advance), with a breakdown of figures for each month or quarter. (Budgeting is explained in much greater detail in Chapter 22.)

Investing the time and effort required to plan effectively can pay off for a small business in a number of ways. The likely benefits can include the following:

- The process of thinking through the issues confronting a company and developing a plan to deal with those issues can improve productivity.
- Planning provides a focus for a firm: Managerial decisions over the course of the year can be guided by the annual plan, and employees can work consistently toward the same goal.
- Evidence of planning increases credibility with bankers, suppliers, and other outsiders.

long-range plan (strategic plan)
A firm's overall plan for the future.

short-range plans
A plan that governs a firm's operations for one year or less.

budget
A document that expresses future plans in monetary terms.

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Managing time during the course of the business day is another important planning activity for small business managers, who all too often succumb to what is sometimes called the "tyranny of the urgent." In other words, they can easily become distracted by fighting the everyday fires of business. This makes it easy to ignore or postpone planning to free up time and energy to concentrate on more urgent issues in areas such as production and sales. And, just as quarterbacks who are focusing on a receiver may be blindsided by blitzing linebackers, managers who have neglected to plan may be bowled over by competitors. (Personal time management is discussed in more depth later in the chapter.)

19-3b Creating an Organizational Structure

While entrepreneurs may give direction through personal leadership, they must also define the relationships among the firm's activities and among the individuals on the firm's payroll. Without some kind of organizational structure, operations eventually become chaotic and morale suffers.

The Unplanned Structure

In very small companies, the organizational structure tends to evolve with little conscious planning. Certain employees begin performing particular functions when the company is new and retain those functions as it matures.

This natural evolution is not necessarily bad. In fact, a strong element of practicality often characterizes these arrangements. The structure is forged through the experience of working and growing, rather than being pulled out of thin air or copied from another firm's organizational chart. However, unplanned structures are usually far from perfect, and growth typically creates a need for organizational change. The entrepreneur should therefore examine structural relationships periodically and make adjustments as needed for effective teamwork.

Chain of Command

A **chain of command** refers to superior–subordinate relationships with a downward flow of instructions, but it involves much more. It is also a channel for two-way communication. As a practical matter, strict adherence to the chain of command is not advisable. An organization in which the primary channel of communication is rigid will be bureaucratic and inefficient. At the same time, frequent and flagrant disregard of the chain of command quickly undermines the position of the bypassed manager. There is need for balance, and getting this right requires reasonable care and heads-up management.

In a **line organization**, each person has one supervisor to whom that individual reports and looks for instructions. All employees are directly engaged in the firm's work—producing, selling, and performing office or financial duties. Most very small firms (for example, those with fewer than 10 employees) use this form of organization.

A **line-and-staff organization** is similar to a line organization in that each person reports to a single supervisor. However, a line-and-staff structure also has staff specialists who perform specific services or act as management advisers in particular areas (as illustrated in Exhibit 19.2). Staff specialists may include a human resource manager, a production control technician, a quality control expert, and an assistant to the president. The line-and-staff organization, in some form, is used in many small businesses.

chain of command
The official, vertical channel of communication in an organization.

line organization
A simple organizational structure in which each person reports to one supervisor.

line-and-staff organization
An organizational structure that includes staff specialists who assist management.

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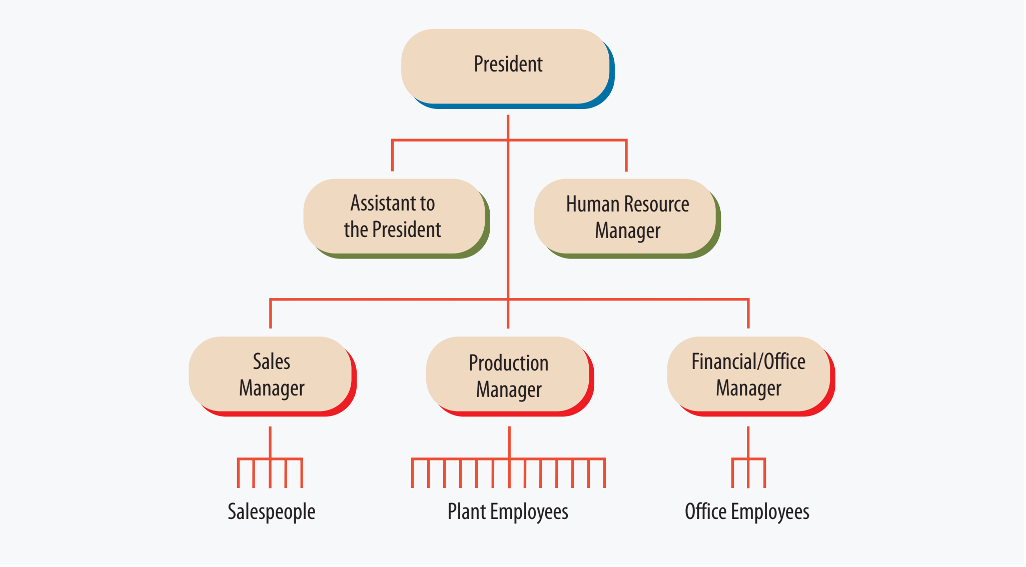
Exhibit 19.2 Line-and-Staff Organization



Span of Control

The **span of control** is the number of employees who are supervised by a manager. Although some experts have stated that six to eight people are all that one individual can supervise effectively, the optimal span of control is actually a variable that depends on a number of factors. Among these factors are the nature of the work and the manager's knowledge, energy, personality, and abilities, as well as the extent and effectiveness of the use of communication tools in the organization. In addition, if the abilities of subordinates are better than average, the span of control may be broadened accordingly.

As a very small firm grows and adds employees, the small business owner's span of control is extended. Eventually, the attempted span of control exceeds the entrepreneur's reach, demanding more time and effort than they can devote to the business. It is at this point that the entrepreneur must establish intermediate levels of supervision and dedicate more time to management, moving beyond the role of player-coach.

This having been said, it is important to know that research has shown that businesses that work hard to create strong horizontal relationships between teams or units across the organizational structure tend to be far more effective. The focus needs to be on "idea flow" throughout the organization, which involves both "engagement" within teams or departments and "exploration," or frequent interaction between those teams. This has been aptly described as "a team of teams," and it makes the company more able to respond quicker and more effectively to the fast-changing and complicated environments in which it does business.[19]

span of control
The number of employees who are supervised by one manager.

delegation of authority
The process of granting to subordinates the right to act or make decisions.

19-3c Delegating Authority

Through **delegation of authority**, a manager grants to subordinates the right to act or to make decisions. Turning over some functions to subordinates by delegating authority frees the superior to perform more important tasks.

Although failure to delegate may be found in any organization, it is often a special problem for entrepreneurs, given their backgrounds and personalities. Because they frequently must

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pay for mistakes made by subordinates, owners are inclined to keep a firm hold on the reins of leadership in order to protect the business. Some of the problem is simply a matter of habit and momentum; in other cases, it is rooted in a personal need for control.

Vlad Enculescu/Shutterstock.com

Many entrepreneurs have become accustomed to doing everything themselves, which makes it difficult to turn over some tasks to others when the business grows and they truly need help with their expanded responsibilities. Some owners also may simply feel the need to continue doing those things that made the firm successful or conclude that they just do them better than any of their employees. Besides, delegating a task means dealing with people, which, naturally, is messier than doing the job yourself, right? Regardless of the underlying concern and hesitation, the end result is the same: insufficient delegation and the piling up of work that needs more focused attention.

Inability or unwillingness to delegate authority can become apparent in a number of ways. For example, subordinates who have to clear even minor decisions with the boss may flood the owner with a constant stream of requests in order to resolve issues that they lack the authority to settle. This keeps the owner exceptionally busy—rushing from assisting a salesperson to helping iron out a production bottleneck to setting up a new filing system. Entrepreneurs often have to work long hours, and those who have difficulty delegating compound the problem.

Small business owners must learn to loosen their grip on responsibility if they want their ventures to grow. A more helpful mindset is that which Jason Fried, co-founder of Web applications company Basecamp, expressed when he commented, "I'd much prefer that [my employees] make decisions; I hired them for their expertise, after all."[20] But the true power of delegating authority goes much deeper. It can release in subordinates the same force that motivates entrepreneurs: the thrill of getting to call the shots. This is not to say that delegation is a cure-all for management challenges. In fact, turning over duties can easily lead to its own problems as a result of a subordinate's carelessness or some other failure. But this can be minimized if the handover is managed well. We offer the following suggestions to ease the transition:

- Accept the fact that you will not be able to make all of the decisions anymore. If you don't, you will blunt the venture's potential to grow and develop.
- Prepare yourself emotionally for the loss of control that small business owners feel when they first start to delegate. This is completely natural.
- Carefully manage the process of finding, selecting, hiring, and retaining employees who are trustworthy enough to handle greater responsibility. In other words, keep an eye on the future when you hire new staff.
- Move forward one step at a time. Start by delegating those functions that you don't do well and are most comfortable giving up. Even then, continue to provide reasonable oversight to smooth the transition and to ensure the quality of the work.
- Plan to invest the time needed to coach those who are taking over new responsibilities so that they can master the required skills. The first thing to do is to write job descriptions to help minimize confusion.

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Living the Dream

You May Not Be the Best "You" After All: Charlie Chaplin

Most people know Charlie Chaplin's name. That's because he was one of the biggest stars ever to grace the silver screen. His signature look was as memorable as they come: bowler hat, mustache, ill-fitting clothes, and that unmistakable chuckle-generating walk. He was an ever-present sight to movie goers across the country, beginning with his 1913 film debut, *Making a Living*. But it was his performance in *The Tramp* a few years later that launched the downtrodden dreamy character for which he became famous. He officially appeared in 82 films in all over his very productive career, not counting several unfinished works.

By 1915, Chaplin had starred in 37 popular productions. These, along with the explosion of Tramp-celebrating books, songs, toys, and look-alike dolls, made him as rich as he was famous. He had become such a celebrated entertainer that contests started popping up all around the country to see who could look, act, and walk most like Chaplin's famous on-screen character. As a joke, Chaplin decided to enter one of these competitions that was put on by a theater in San Francisco, but he kept his true identity secret. Though he surely did his best, it may surprise you that he didn't win! In fact, it wasn't even close! By all reports, Chaplin placed 20th out of a field of 40 contestants.

What does this have to do with small businesses? Gene Marks, a nationally known author, columnist, consultant, and entrepreneur, explains what can be learned from this amusing story:

> [W]hether or not Chaplin came in 20th place in his own look-alike contest isn't important. What's important is that 19 other people did a better job than him at being him. Chaplin, of course, was still the brains and the creative energy behind his work. But he also empowered others to follow his lead, do what he did, and prove that they could be just as good at looking, behaving and carrying out his actions like him as The Tramp. In fact, 19 people even did it better. He didn't even need to be there to be The Tramp. Others did his job for him.

This anecdote underscores the importance of delegation—something at which Chaplin, himself, was not very good. As actor and director for many of his films, Chaplin had a habit of involving himself in every aspect of production, taking over tasks that would normally be handled by assistant directors or other crew members. For example, he was known to direct hundreds of extras into place during crowd scenes, choose camera shutter speeds, and come up with his own sound effects. After having hired specialists, experts, and technicians to do exactly those jobs, this apparent impulsiveness made little sense—and his habit of micromanaging created serious problems. It was reported that Chaplin even insisted on telling Paulette Goddard, his co-star and future wife, how to dress and do her hair and makeup, and this put a great strain on both their personal and professional relationships.

To be fair, many powerful leaders struggle with turning loose tasks and delegating them to others. But developing this mindset can be one of the most important keys to success in business. Adopting a few best practices can go a long way toward making this transition. For example, it is critical to know what and when to delegate. Leaders must learn how to focus on high-priority responsibilities—that is, those that will have the greatest impact on overall enterprise performance. The rest should be delegated to others. Perhaps it will help to view this as an opportunity to train, grow, and develop your team. This would include empowering them to be self-starters and to take ownership of their work. When subordinates feel in control and responsible for what they do, it is more likely that they will complete their work efficiently and with high quality. The key is taking time to figure out what to delegate, how to delegate it, and to whom to delegate it.

Delegating tasks that can be done by others gives a leader more time to spend on those tasks that only they can handle. This might include big-picture challenges like working out the firm's overall strategy or identifying important future trends and opportunities. Perhaps just as important, it could also free up the time needed to achieve a healthier work–life balance and prevent burnout or other career-threatening hazards. It can certainly help to create an organization that is more steady and sustainable.

If Chaplin had learned to allow his supporting crew to do the jobs they were hired to tackle, he may have been able to achieve even greater success—in both his

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professional and personal lives. Unfortunately, we are left only to imagine what might have been.

Sources: Roger Durling, "Modern Times," Santa Barbara International Film Festival, March 21, 2021, https://sbiff.org/modern-times, accessed June 28, 2021; Gene Marks, "That Time Charlie Chaplin Came in 20th Place … in a Charlie Chaplin Look-alike Contest," *Entrepreneur*, January 5, 2021, https://www.entrepreneur.com/article/362402, accessed July 8, 2021; Sabina Nawaz, "You're Delegating. It's Not Working. Here's Why," *Harvard Business Review*, November 12, 2020, https://hbr.org/2020/11/youre-delegating-its-not-working-heres-why, accessed June 28, 2021; Ellen Wulfhorst, "Charlie Chaplin: The Life Story You May Not Know," *Stacker*, June 28, 2021, https://stacker.com/stories/11895/charlie-chaplin-life-story-you-may-not-know, accessed July 9, 2021.

- Make delegation meaningful. Focus on results, and give subordinates the flexibility to carry out assignments. To realize the benefits of delegation, you must build leadership in subordinates, who can then take on more advanced and complex tasks.

If you want to turbocharge the success of your delegation efforts, think carefully about those you ask to join your venture. If you hire smart and responsible employees who can do the job better than you could ever hope to do it, delegating will actually *reduce* your stress level, and you will be able to focus your time and attention on the things you do best.

19-3d Controlling Operations

Despite good planning, organizations never function perfectly. As a result, managers must monitor operations to discover deviations from plans and make corrections when necessary. These managerial activities serve to keep the business on course.

The control process begins with the establishment of standards, which are set through planning and goal setting. Planners translate goals into norms (standards) by making them measurable. A goal to increase market share, for example, could be expressed as a projected dollar increase in sales volume for the coming year. Such an annual target may, in turn, be broken down into quarterly target standards so that corrective action can be taken early if performance begins to fall below the projected level.

As Exhibit 19.3 shows, performance measurement occurs at various stages of the control process: at the input stage, perhaps to determine the quality of materials purchased; during the process stage, perhaps to determine if a machine is operating within predetermined tolerances; and at the output stage, perhaps to check the quality of a completed product.

Corrective action is required when performance deviates significantly from the standard in an unfavorable direction. To prevent the problem from recurring, such action must be followed by an analysis of the cause of the deviation. If the percentage of defective products increases, for example, a manager must determine whether this is caused by substandard raw materials, untrained workers, equipment failure, or some other factor. For a problem to be effectively controlled, corrective action must identify and deal with the true cause.

19-3e Communicating Effectively

Another key to a healthy organization is effective communication—that is, getting managers and employees to talk with one another and openly share problems and ideas. The result is two-way communication, which is a far cry from the old-fashioned idea that managers give orders and employees simply carry them out.

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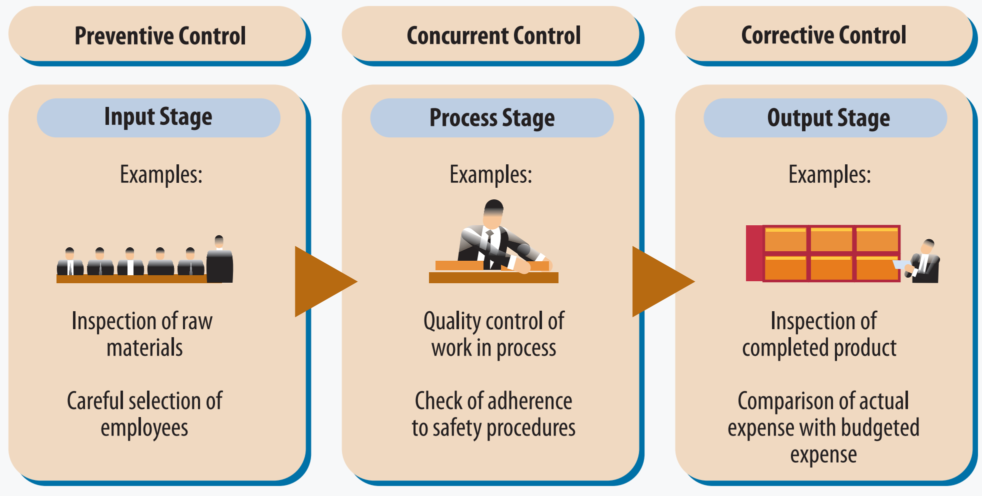
Exhibit 19.3 Stages of the Control Process



Research has shown that effective staff communication is crucial to business success, especially as it leads to greater employee engagement. As evidence of the positive follow-on effects, a major study conducted by Gallup, a highly respected organization best known for polling, found that engagement was favorably related to 11 important performance outcomes, including higher work unit productivity, reduced absenteeism, and lower employee turnover. And this has implications for the bottom line, as the study also found a 23 percent difference in overall firm profitability when comparing high-engagement companies to those that were low on this measure.[21] Because effective communication plays a critical role in facilitating engagement, it should be taken very seriously. Unfortunately, workplace communication is never perfect, so there is always room for improvement.

To communicate effectively, managers must be willing to tell employees where they stand, how the business is doing, and what the firm's plans are for the future. While negative feedback may be necessary at times, giving positive feedback to employees is the primary tool for establishing good human relations. Perhaps the most fundamental concept managers need to keep in mind is that employees are people, not machines. They can quickly detect insincerity but respond to honest efforts to treat them as responsible and professional. In short, an atmosphere of trust and respect contributes greatly to good communication.

Communication Tools

Many practical tools and techniques can be used to stimulate two-way communication between managers and employees. Here are some that may work for you and your enterprise:

- Periodic performance review sessions to discuss employees' ideas, questions, complaints, and job expectations.
- Microsoft Teams or Zoom to conduct one-on-one meetings, to brainstorm, or to promote small-group collaboration.

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- Instant messaging platforms like Slack for informal or "fun" communication and community/culture building.
- Physical or virtual bulletin boards to keep employees informed about developments affecting them and/or the company.
- Blogs for internal communication, especially in companies that have open organizational cultures and truly want transparent dialogue.
- Microblogging tools (like Twitter and Yammer) to enable employees to communicate, collaborate, and share brief thoughts and observations about the business in real time.
- Physical or virtual suggestion boxes to solicit employees' ideas on possible improvements.
- Wikis set up to bring issues to the surface and draw feedback from employees.
- Formal staff meetings to discuss problems and matters of general concern.
- Breakfast or lunch with employees to socialize and just talk.

These methods and others can be used to supplement the most basic of all channels for communication—the day-to-day interactions between each employee and their supervisor.

Public Speaking

Entrepreneurs must also make presentations to outside groups, from pitching product ideas at trade shows to selling bankers on the need for funding to offering keynote speeches at trade association events. The need for public speaking skills is sure to increase as the company grows and develops.

However, the fear of public speaking is one of the most common phobias (ranking even above the fear of dying!), and an inability to communicate in public can hold back the progress of the business. The good news is that, through practice, you can keep your stage fright under control (if that is a problem), and you can certainly improve your delivery. Exhibit 19.4 provides some tips that will help you develop confidence in your speaking skills and be more interesting as a presenter.

19-3f Negotiating

When operating a business, entrepreneurs and managers must personally interact with other individuals much of the time. Some contacts involve outsiders, such as suppliers, customers, bankers, realtors, and business service providers. Typically, the interests of the parties are in conflict, at least to some degree. A supplier, for example, wants to sell a product or service for the highest possible price, and the buyer wants to purchase it for the lowest possible price. To have a successful business, a manager must be able to reach agreements that both meet the firm's requirements and contribute to good relationships over time.

Even within the business, personal relationships pit different perspectives and personal interests against one another. Subordinates, for example, frequently desire changes in their work assignments or feel that they are worth more to the company than their salary levels indicate. Managers in different departments may compete for services offered by a maintenance department or an IT unit.

The process of developing workable solutions through discussions or interactions is called **negotiation**. We are all negotiators in our daily lives, both inside and outside our family relationships. Conflicting interests, desires, and demands require that we reconcile, or negotiate, differences in order to live and work together peacefully.

negotiation
The process of developing workable solutions through discussions or interactions.

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Exhibit 19.4 Presentation Tips

1. **Do your homework.** Know the purpose of the presentation and to whom you will be presenting. If you can find out in advance who will be attending your presentation, you will be able to adapt your comments to their needs and concerns.
2. **Know your material.** The better you know what you plan to talk about, the more you can concentrate on the delivery. Being prepared inspires confidence.
3. **Be interactive.** Listeners may be lulled into disinterest when they are not engaged. Find ways to get the audience involved in what you have to say. Don't, for example, read from your notes for extended periods of time—doing so will ensure that the communication goes in only one direction, and your audience will know it immediately.
4. **Make vivid mental connections in the minds of listeners.** Telling stories helps, but so can other tools and techniques. For example, use props to focus attention, or employ a metaphor throughout the presentation to draw listeners back to a central theme. Humor is entertaining and can provide comic relief, but it can also be used to make a point unforgettable.
5. **Emphasize relevance.** Your listeners are busy people, so be sure to deliver information that they will find useful and worth their time.
6. **Be dynamic, but be yourself.** Let your listeners know that you are passionate about the topic by the way you invest yourself in the presentation. It is much easier for an audience to remain engaged when the presenter is energetic and uses inflections, gestures, movement, and facial expressions to show it. Maintaining eye contact communicates that you want to connect with each individual in the room, which is motivating.
7. **Use PowerPoint with care.** Text-laden slides can produce the same effect as sleeping pills. If a picture paints a thousand words, then adding pictures and graphics can certainly help the audience access the ideas you want to convey (as long as they are not flashy to the point of distraction). Limit the text on each slide, and do not read from the slides you are showing. Try to imagine how you would respond to the slides if you were not particularly interested in the topic, and then make adjustments accordingly.
8. **Dress appropriately.** Although your audience may be wearing more casual clothing, dress in business professional attire. Avoid distracting clothing (like a tie that draws attention away from what you have to say), and check to be sure that everything you're wearing is clean, unwrinkled, and in order before standing up to speak.
9. **Avoid food and drink that make speaking difficult for you.** Caffeinated drinks and sugary foods can make you jittery, which will only add to your nervousness. If you find that you need to clear your throat often after consuming certain foods or beverages, avoid them before speaking engagements.
10. **Practice, practice, practice.** The more presentations you give, the more you will feel confident while giving them. And one of the best ways to conquer stage fright is to spend time speaking in front of others. Recognize that your discomfort with public speaking is likely to fade with experience at the podium.

Many people consider negotiation to be a win–lose game; that is, one party must win and the other must lose. The problem with this concept of negotiation is that if parties feel that they have lost, they may go away with thoughts of getting even in subsequent dealings. Clearly, such feelings do not contribute to good long-term relationships. In contrast, other negotiators advocate a win–win strategy. A win–win negotiator tries to find a solution that will satisfy at least the basic interests of both parties.

Implementing a win–win strategy in relationships involves thinking about one's own interests while also exploring those of the other party. After clarifying the interests of the involved parties and their needs, the negotiator can explore various alternatives to identify their overall fit, looking for a solution that will produce a plan that is workable for all. There are situations in which a win–win solution is impossible, but a positive solution should be pursued whenever it is feasible to do so. And, of course,

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a foundation for successful negotiation is created by developing strong relationships between the negotiating parties, which can facilitate cooperation.

Want to sharpen your skills as a negotiator? We highly recommend that you read *Getting to Yes: Negotiating Agreement without Giving In*, by Roger Fisher, William Ury, and Bruce Patton.[22] The authors provide a proven, step-by-step strategy that can lead you and your business counterpart to mutually acceptable agreements in any situation. Following their advice is likely to lead to better outcomes for both parties and a more positive negotiating experience, which may very well result in a long-term business relationship that is highly beneficial to everyone involved.

19-4 Personal Time Management

19-4 Describe the problem of time pressure and suggest solutions.

A typical small business owner spends much of the workday on the front lines—meeting customers, solving problems, listening to employee complaints, talking with suppliers, and the like. That entrepreneur tackles such problems with the assistance of only a small staff. As a result, the owner-manager's energies and activities are diffused, and time becomes a scarce resource. This highlights the importance of *time management*. But when you think about it, time management isn't really about managing time. It's about managing activities within the limited time that you have available, and it's one of the challenges you are sure to face.

19-4a The Problem of Time Pressure

According to survey results reported by the Small Business & Entrepreneurship Council, small business owners work about twice as much as typical employees, with 33 percent saying they spend more than 50 hours a week running their companies and another 25 percent putting that figure at 60 or more hours.[23] The pace can be brutal. And such schedules can easily lead to inefficient work performance, especially when the entrepreneur has not made the effort necessary to set priorities in life and work. Owner-managers may be too busy to see sales representatives who could supply market information on new products and processes, too busy to read technical reports or trade publications that would tell them what others are doing and what improvements might be adapted to their own use, too busy to listen carefully to employees' opinions and grievances, and too busy to give employees the instructions they need to do their jobs correctly.

Getting away for a vacation seems impossible for some small business owners, which is why around two out of every five choose not to take one.[24] In extremely small firms, owners may find it necessary to close the business during their absence. Even in somewhat larger businesses, owners may fear that the firm will not function properly if they are not there. Unfortunately, keeping one's nose to the grindstone in this way may cost an entrepreneur dearly in terms of personal health, family relationships, and effectiveness in business leadership.

19-4b Time Savers for Busy Managers

Part of the solution to the problem of time pressure is the application of the managerial approaches discussed in the preceding section. For example, when possible, the manager should assign duties to subordinates who can work without close supervision. For such delegation to work, though, a manager must first select and train qualified employees.

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The greatest time saver is the effective use of time. Little will be achieved if an individual darts from one task to another and back again. On the other hand, using smartphones, email, the Internet, and other technologies can be very helpful in allowing a manager to make the most of their time. (A note of caution: Because these tools can become a distraction, they need to be used wisely. For example, checking and responding at length to incoming email messages throughout the day can distract from the tasks at hand and should be minimized.)

The first step in time management should be to analyze how much time is normally spent on various activities. Relying on general impressions is unlikely to be accurate. Instead, for a period of a few days or (preferably) weeks, the owner-manager should record the amounts of time spent on various activities during the day. An analysis of these figures will reveal a pattern, indicating which projects and tasks consume the most time and which activities are responsible for wasted time. It will also uncover chronic time wasting due to excessive socializing, working on trivial matters, coffee breaks, and so on.

If your habits are typical, you will probably find that the workplace "time wasters" in your life include such things as time lost from telephone interruptions, drop-in visitors, ineffective delegation, losing things in desk clutter, procrastination, and frequent or lengthy meetings. Knowing the distractions that others find to be time wasters may help you to pinpoint those that are creating a problem for you. Only by identifying these diversions can you take steps to deal with them.

After eliminating practices that waste time, a manager can carefully plan their use of available time. A planned approach to a day's or week's work is much more effective than a haphazard, do-whatever-comes-up-first style. This is true even for small firm managers, whose schedules are continually interrupted in unanticipated ways.

Many time management specialists recommend the use of a daily written plan of work activities, often called a "to-do" list, and most small business executives follow this advice. Many entrepreneurs turn to Microsoft Outlook or a day planner to create and manage these lists or use one of the countless to-do list mobile apps that are available online (search for "To-Do List Apps" to find the option that is right for you). Others prefer common alternatives, such as note cards or even sticky notes. Regardless of the medium selected, you should highlight priorities among listed items. By classifying duties as first-, second-, or third-level priorities, you can focus attention on the most crucial tasks.

To prioritize action items more precisely, you could adopt the approach used by Dwight D. Eisenhower, 34th president of the United States. He observed, "What is important is seldom urgent, and what is urgent is seldom important." In other words, many things that do not seem to be all that pressing actually deserve your immediate focus, and others that cry out for your attention are not all that important and should not be acted on first, though they often are. Your time and attention should be prioritized as follows:[25]

1. Give your attention first to critical activities (urgent and important). Leave enough slack time in your schedule to deal with unexpected issues and activities.
2. Next, deal with important concerns (not urgent, but important). These will not seem pressing, but they support the long-term goals of the company and should be given sufficient time.
3. Interruptions (urgent, but not important) can keep you from completing important work. Reschedule or delegate these tasks, if possible, and be prepared to respond to requests with a polite "no" when necessary.
4. Finally, avoid distractions (not urgent and not important) as much as possible. If they are not pressing and do not matter, attend to them only as you have spare time.

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Following these guidelines will help you to focus your time and attention in order to achieve the most productive outcomes. And that kind of focus apparently is sorely needed. A survey of 350,000 people worldwide found that those responding admitted to spending 40 percent of their time "on things that are unimportant or downright irrelevant."[26]

There are countless guides to time management, and they offer many valuable tips that may include recommendations such as the pointers you see below.

- Get a good time management system and use it.
- Try to make meetings more efficient.
- Schedule cellphone use at set times through the day to minimize constant checking.
- Unsubscribe from magazines and catalogs you never read.
- Turn off computer and cellphone push notifications to stay focused on tasks.
- Create a file folder for active projects.
- Keep your desk and office organized.
- Use deadlines to promote focus.
- Manage email effectively.

These are all good tips. However, the one bit of advice that seems to show up on just about every list of suggestions is to set aside time to work undisturbed. As the pace of business and the flow of information pick up speed, and new technologies and media channels increasingly compete for your attention, preserving time for focused work on important projects becomes more and more difficult—but it is critical that you do so. The health and future of your company may very well depend on it!

In the final analysis, effective time management requires firmly established priorities and self-discipline. An individual may begin with good intentions but then lapse into habitually attending to whatever they find to do at the moment. Procrastination is another common problem—many managers delay unpleasant and difficult tasks, retreating to trivial and less-threatening activities with the rationalization that they are getting those duties out of the way in order to better concentrate on the more important tasks. It is essential to identify such "time thieves" and correct them as soon as possible.

19-5 Outside Management Assistance

19-5 Discuss the various types of outside management assistance.

Because entrepreneurs tend to be better doers than they are managers, they should consider the use of outside management assistance. Such support can supplement the manager's personal knowledge and the expertise of the few staff specialists on the company's payroll.

19-5a The Need for Outside Assistance

Entrepreneurs often lack opportunities to share ideas with peers, given the small staff in most new enterprises. Consequently, they may experience a sense of loneliness. Some small business owners reduce their feelings of isolation by joining groups such as the Entrepreneurs' Organization (eonetwork.org) and the Young Presidents' Organization (ypo.org), which allow them to meet with peers from other firms and share problems and experiences.

Peer groups and other sources of outside managerial assistance can offer a detached, often objective point of view and new ideas. They may also possess knowledge of methods, approaches, and solutions beyond the experience of a particular entrepreneur.

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19-5b Sources of Management Assistance

Entrepreneurs seeking management assistance can turn to any number of sources, including SBA-funded programs, management consultants, and personal and business networks. Many colleges and universities also offer support that can help entrepreneurs navigate small business challenges.

U.S. Small Business Administration (SBA)

For many aspiring small business owners, the U.S. Small Business Administration (SBA) is an important gateway to information and support for start-ups and other small companies, and it is often the first place they go for assistance. The federal government specifically tasks the SBA with connecting entrepreneurs with the resources they need to start and/or grow their companies. In accord with its mandate, the agency helps small businesses across the country through a variety of support programs. For example, it offers the Service Corps of Retired Executives program and its Small Business Development Centers to provide consulting and other forms of assistance. But it also funds a much broader range of useful counseling programs, which you can find by visiting its main website at sba.gov.

Service Corps of Retired Executives (SCORE) By contacting any SBA field office, small business managers can obtain free management advice from the **Service Corps of Retired Executives**, or **SCORE** (score.org). SCORE has more than 10,000 working and retired business executives who offer business mentoring and workshops through its 250 local chapters across the United States.[27] As a resource partner of the SBA, SCORE provides an opportunity for retired executives to contribute to the business community and, in the process, help small business managers to solve their problems. The relationship is mutually beneficial.

Service Corps of Retired Executives (score)
An SBA-sponsored group of working and retired executives who give free advice to small business owners.

Small Business Development Centers (sbdcs)
SBA-sponsored centers offering consulting, education, and other support to small business owners.

Small Business Development Centers (SBDCs) Patterned after the Agricultural Extension Service, **Small Business Development Centers (SBDCs)** are required (since 1990) by Congress to be hosted by institutions of higher learning or Women's Development Centers as a part of the SBA's overall program of assistance to small businesses. Operating from more than 900 delivery points, SBDCs provide a wide range of services, including business plan consultation, export and import support, help with market research, and financial lending assistance. The staff typically includes faculty members, SCORE counselors, professional staff, and graduate student assistants.[28]

Educational Institutions and Foundations

Many colleges and universities have student consulting teams willing to assist small businesses. These teams of undergraduate and graduate students, under the direction of a faculty member, work with owners of small ventures in analyzing their business problems and proposing appropriate solutions to them.

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Living the Dream

When You're Doggin' It in the Game of Small Business, It's Important to SCORE

TenderCare Pet Salon & Day Spa

https://tendercarebymaria.com

Maria Conneway launched TenderCare Pet Salon & Day Spa in 2012 out of a rented garage in Fort Myers, Florida, "with the idea of helping dogs and owners who needed one-on-one care outside of the typical busy, caged salon atmosphere." The shop was uncomfortable because it was small and warm from inadequate air conditioning. But despite minimal creature comforts, Conneway invited all owners to stay with their dogs if they wanted to watch or assist as they were being groomed, and many did. This "owner stay" policy was so popular that soon the small business really started to pick up.

Conneway realized after a time that she would need to make some big changes to keep up with growth. So, four years after getting TenderCare off the ground, she relocated her business to a larger and nicer facility. She also hired other groomers and bought new and better equipment to help keep up with demand. Eventually she found it necessary to add a full-time office manager to her staff and expand the operation to five grooming stations and additional bathing areas.

The pet industry is booming, so it was not entirely surprising that things were going well for Conneway. Still, she believed she could do even better if she could only get some guidance from an experienced coach. That's what she was looking for when she signed on as a client with the Service Core of Retired Executives (SCORE). As a resource partner of the Small Business Administration, SCORE is "the nation's largest network of volunteer, expert business mentors [who are] dedicated to helping small businesses get off the ground, grow, and achieve their goals."

So, was SCORE able to help Conneway make improvements at TenderCare? In a word, yes! She explains some of the important lessons she learned by working with her SCORE mentor, Ben, whom she identifies only by first name:

> I have learned to do data analysis much more efficiently. I know where my finances are at any given moment and have learned how to do very accurate projections of the coming months and years. I have learned to work smarter and not so hard. I have learned how to manage people better and apply "golden handcuffs" when needed. I have also learned that no employee is irreplaceable, and that value often doesn't come from the quality of work, but rather, their quality as an employee overall. With Ben's help, I have turned my business toward me not being a working owner but more of a managing one.

Conneway goes on to list other benefits she gained from working with her SCORE mentor, but this provides a good idea of how useful the service can be. And since this assistance is offered free of charge in most cases, the price is definitely right for small businesses that so often are strapped for cash. And now you know from the results at TenderCare Pet Salon & Day Spa, at least, that the payoffs can be pretty doggone good.

Sources: "About SCORE," https://www.score.org/about-score, accessed July 15, 2021; Caroline Biggs, "The Pet Trends to Watch for in 2021," *Martha Stewart*, December 14, 2020, https://www.marthastewart.com/8034862/pet-trends-2021, accessed July 15, 2021; Maria Conneway, "From Mediocre to Booming," SCORE Success Stories, https://www.score.org/success-story/mediocre-booming, accessed July 15, 2021; and "TenderCare Pet Salon & Day Spa: Our Story," https://tendercarebymaria.com/about-us, accessed July 15, 2021.

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These programs offer mutual benefits. They provide students with a practical view of business management and supply small firms with answers to their problems. The students who participate are typically combined in teams that provide a diversity of academic backgrounds. An individual team, for example, may include students specializing in management, marketing, accounting, and finance.

Close to half a million entrepreneurs have gone through a business development program called FastTrac. This training, developed by the Ewing Marion Kauffman Foundation, is offered through a wide variety of affiliates, including colleges and universities, chambers of commerce, business development centers, and consulting firms. But participants now can also choose to learn through a self-paced online option. FastTrac is a practical, hands-on program designed to show entrepreneurs how to hone the practical skills they will need to start and grow a successful business. Participants don't just learn about business—they live it by working on their own business ideas.[29]

Management Consultants

Management consultants serve small businesses as well as large firms, and they do this with operations that can range from massive global corporations to one- and two-person ventures. The results they deliver can provide a substantial boost to small businesses, especially those in which the owner or management team struggles with day-to-day operational challenges so much that they are unable to "see the forest for the trees." But many small-firm managers are reluctant to use outside advisers, and for a host of reasons. Some believe that they can solve problems themselves, that an outsider could never truly understand the business, or that bringing in an outside adviser would simply cost too much. But some small businesses need the analysis that is best provided by consultants and find that the additional revenue resulting from improved performance can easily cover the cost of such services.

For small companies that decide to pursue the consulting option directly, the owner and the consultant should reach an understanding on the nature of the assistance to be provided before it begins. This can help to ensure satisfaction for both the provider and the client. Any consulting fees should be specified, and the particulars of the agreement should be put in writing. Fees are often quoted on a per-day basis and can easily range from $500 to $5,000, or more. Although the cost may seem high, it must be evaluated in terms of the expertise that it buys.

Directories are available to help entrepreneurs find the right management consultant. One such source is published by the Institute of Management Consultants USA (imcusa.org). The code of ethics to which institute members subscribe, as posted on the website, is an indication of their desire to foster professionalism in their work.

There are now some websites that provide access to expert advice by the minute, which can be very helpful if you have a focused problem that can be addressed over the phone. One of these services, Clarity, caters specifically to the needs of entrepreneurs. Getting the ear of most of the 30,000+ experts on the site will cost you around $1.50 per minute, but the price can go way up from there—for example, it will set you back a hefty $167 per minute if you feel that you just have to talk with Mark Cuban.[30] The service is very easy to use: Simply register on the site, search the community of available experts, select a few dates/times that will work for you, and then connect, talk, and pay.[31]

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Small Business Networks

Entrepreneurs can also gain management assistance from peers through **networking**, the process of developing and engaging in mutually beneficial informal relationships. When business owners meet, they can discover a commonality of interests leading to an exchange of ideas and experiences. The settings for such meetings may be trade associations, civic clubs, fraternal organizations, or any other situation that brings businesspeople into contact with one another.

However, if networking is going to be of benefit to both parties, then it needs to be about more than just showing up at an event and handing out a lot of business cards. You need to be prepared to create value for your counterpart on some level. Because people typically have a habit of looking first to see what they can get from others over what they can give, being the first to add value to the relationship will help you stand out from the crowd and perhaps ensure that you are appreciated and are easy to remember. This "pay it forward" approach to interactions can do wonders for you, personally, and for your business.

Harnessing a personal network, when managed wisely, can provide a tremendous boost to the launch of a new business. For example, fellow garden club members could serve as a focus group to assess start-up ideas or as a PR team to spread news of your new landscaping and water pond business. Or, alumni connections from your college days may lead you to professionals who can take care of your legal, banking, or other needs. They may even become loyal and effective business partners if the fit is right.

Other Business and Professional Services

A variety of other business and professional groups provide management assistance. In many cases, such assistance is part of the business relationship. Sources of management advice include bankers, certified public accountants (CPAs), attorneys, insurance agents, suppliers, trade associations, and chambers of commerce.

It takes initiative to draw on the management assistance available from such groups, so it is important to explore the possibilities. For example, rather than limiting a business relationship with a certified public accountant to audits and financial statements, many small business owners ask their CPAs to advise them on a much broader range of subjects.

A good accountant can offer advice on tax matters, and can recommend an appropriate severance package when it comes time to fire someone. If you are thinking about opening a new branch office, an accountant can tell you if your cash flow will support it. Considering the launch of an additional business? An accountant's insight will help you determine whether the margins will be adequate. Accountants can help you make informed assessments of your insurance needs, the impact of taking on a big account (as well as the downside of losing it), and the bottom-line effects of cutting expenses.

As you can see from these examples, potential management assistance often comes disguised as service from professionals and firms encountered in the normal course of business activity. By taking advantage of such opportunities, an entrepreneur can strengthen a small firm's management and improve its operations with little, if any, additional cost. But that doesn't mean it will be easy. Leading and overseeing the operations of a small business may eventually require a professional management approach, which can be developed only through great effort and attention to details. Reaching this state is a challenge, but the insights in this chapter can help guide you toward the competencies you will need to make it happen.

networking
The process of developing and engaging in mutually beneficial informal relationships.

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19-1. **Describe the entrepreneur's leadership role.**

- Entrepreneurs must establish and communicate a vision of the firm's future to all of the other participants in the business.
- Founding entrepreneurs need a tolerance for ambiguity and a capacity for adaptation.
- Leading a business to success requires a focus on reaching business goals more than a flashy personality.
- An entrepreneur exerts strong personal influence in a small firm, which can create a competitive advantage over corporate rivals.
- Progressive managers use various leadership styles, incorporating some participative management by employees and even empowerment.
- Entrepreneurs should deliberately shape the organizational culture, which can greatly influence how business is conducted in the company and how the company performs.

19-2. **Explain the small business management process and its unique features.**

- Many founders tend to manage more from gut instinct and are less analytical and systematic in their approach when compared to professional managers.
- A founder's less-sophisticated management style can adversely affect business growth, and many find it difficult to adopt more effective models.
- Small companies are particularly vulnerable to managerial inefficiency, which may even lead to a firm's failure.
- Small-firm managers face special financial and personnel constraints.
- As a new business grows, it adds layers of supervision and increases formality of management, a trend that moves through several stages of development.
- A firm's growth requires the entrepreneur to become more of a manager and less of a doer.

19-3. **Identify the managerial tasks of entrepreneurs.**

- Both long-range planning and short-range planning are required, but they are often postponed or neglected.
- An organizational structure must be created to provide for orderly direction of operations.
- Successful delegation of authority allows entrepreneurs to devote more time to important duties that drive the business forward.
- Managers exercise control by monitoring operations in order to detect and correct deviations from plans.
- Effective two-way communication is important in building a healthy organization.
- Entrepreneurs need to develop their public-speaking skills to meet the demands of being the leader of a growing business.
- Managers must be able to negotiate with both insiders and outsiders and should focus on win–win strategies, which will satisfy the basic interests of both parties.

19-4. **Describe the problem of time pressure and suggest solutions.**

- Time pressure creates inefficiencies in the management of a small firm because the entrepreneur's energies are scattered.
- The greatest time saver is the effective use of time, which requires firmly established priorities and self-discipline.
- A manager can reduce time pressure through such practices as eliminating unnecessary activities and planning work carefully by using tools like a "to-do" list and prioritizing activities according to their urgency and importance.

19-5. **Discuss the various types of outside management assistance.**

- Outside management assistance can be used to remedy staff limitations and reduce an entrepreneur's sense of isolation, among other things.
- The U.S. Small Business Administration (SBA) is an important source of information and support for small companies, and it is often the first place that small business owners turn to for help.

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- The SBA sponsors the Service Corps of Retired Executives (SCORE) and Small Business Development Centers (SBDCs), which provide management assistance to small companies.
- Another source of management assistance comes from educational institutions and foundations.
- Assistance may also be obtained by engaging management consultants and by networking with other small business owners.
- Professionals such as bankers and CPAs can also provide valuable management assistance.

Key Terms

budget p. 510
chain of command p. 511
delegation of authority p. 512
empowerment p. 504
line-and-staff organization p. 511
line organization p. 511
long-range plan (strategic plan) p. 510
negotiation p. 517
networking p. 525
professional managers p. 506
Service Corps of Retired Executives (SCORE) p. 522
short-range plans p. 510
Small Business Development Centers (SBDCs) p. 522
span of control p. 512

Chapter 19

Please see Appendix A for the Chapter 19 Case Study.

Discussion Questions

1. Would most employees of small firms welcome or resist a leadership approach that sought their ideas and involved them in meetings to let them know what was going on? Why might some employees resist such an approach?
2. Is the quality of management likely to be relatively uniform in all types of small businesses? If not, what might account for differences?
3. What are the four stages of small business growth, as outlined in this chapter? How do management requirements change as the firm moves through these stages?
4. What are the differences between a long-term plan and a short-term plan? In what ways does it pay for a small business owner to operate from these kinds of plans?
5. What type of small firm might effectively use a line organization? When might it be necessary to change the firm's structure? To what type of structure? Why?
6. How important is the practice of delegation to the effective operation of a small business? Why do many entrepreneurs find it hard to delegate responsibility to others?
7. What is the relationship between planning and control in a small business? How might these two features work together?
8. Why is effective communication important to a small business? What are some of the practical tools and techniques that can be used to promote communication between managers and employees?
9. What practices can a small business manager use to make the most of their time?
10. What sources of outside management assistance are available to small firms? Which of these is/are likely to provide the greatest support to the start-up of a new venture? Which would be more helpful to the continuing management of a small company?

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You Make the Call

Situation 1

John Smithers learned all about leadership from his time in the military, and he is hoping to apply those skills to running John's Deals to Go, his small automobile-leasing company. One interesting feature of life in the armed services is that considerable responsibilities are delegated to young military personnel who have very little work experience. Smithers was only 27 when he was assigned duties as a purchasing manager at Kandahar Airport, Afghanistan, in 2003. As a young Marine, he was directly responsible for nearly $50 million in purchasing contracts, which forced him to grow up—and really fast!

To parallel his military experience, Smithers and his small management team have decided to use various methods to delegate decision-making to employees at the operating level in his company. New employees are trained thoroughly after they are first hired, but supervisors will not monitor their work closely once they have learned their duties. Management is willing to jump in and help if truly needed, but they purposely leave workers alone when they take on their assigned duties. Managers will not look over employees' shoulders to be sure that they are doing their jobs as assigned, and they certainly do not monitor the work just to try to catch someone making a mistake. Smithers's managerial philosophy is that people work best when they sense that their superiors trust their abilities and their business integrity.

Smithers and his team sometimes leave for day-long meetings and allow the employees to run the business by themselves. Job assignments are defined rather loosely, but management expects employees to assume responsibility and to take necessary action whenever they see that something needs to be done. To reinforce the message of trust, employees who ask for direction are sometimes simply told to solve the problem in whatever way they think best.

Question 1 Is such a loosely organized firm likely to be as effective as a firm that defines jobs more precisely and monitors performance more closely? What are the advantages and the limitations of the managerial style described above?

Question 2 How might such managerial methods affect morale?

Question 3 Would you like to work for this company? Why or why not?

Situation 2

A few years after successfully launching a new outdoor advertising business, Sean Richeson found himself spending 16-hour days running from one appointment to another, negotiating with customers, drumming up new business, signing checks, and checking up as much as possible on his six employees. The founder realized that his own strength was in selling, but general managerial responsibilities were very time consuming and interfered with his sales efforts. Richeson even slept in the office one or two nights a week just to try to keep up with his work.

Despite his diligence, however, Richeson knew that his employees weren't organized and that many problems needed to be addressed. For example, he lacked the time to set personnel policies or to draw up specific job descriptions for his six employees. Just last week, he had been warned that one employee would sometimes take advantage of the lax supervision and skip work. Invoices often were sent out late to customers, and delivery schedules were not always kept. Fortunately, the business is profitable, in spite of the numerous problems.

Question 1 Is Richeson's problem one of time management or general managerial ability?

Question 2 If Richeson asked you to recommend some type of outside management assistance, would you recommend a SCORE counselor, a student consulting team, a CPA firm, a management consultant, or some other type of assistance? Why?

Question 3 If you were asked to improve this company's management system, what steps would you take first? What would be your initial goal?

Situation 3

Joan Hesper is founder of Hesper Corporate Success, in Memphis, Tennessee. Her results-oriented consulting company shows businesses of all sizes how to make the most of their resources. Hesper describes a simple technique that she uses for time management: "I like to build a significant buffer into my work plan for a given day. So, for example, when a task seems like it should take an hour to complete, I only allow myself 45 minutes. This mental adjustment causes me to stay on task and work faster." So, think less and get more.

Peter Deitrich, who is CEO of Arvada Solutions, a resource management company headquartered in the suburbs of Denver, Colorado, takes a very different approach. He leaves big blocks of his calendar open each day (usually 20 to 50 percent of his total time) so that he can be ready for the unanticipated. When the CEO of an important partner arrived at his office unexpectedly, Dietrich was able to find an open window of time to talk with him because of his scheduling habits. And it's a good thing he

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did—during an hour-long visit, the two identified new markets that would allow the company to expand globally. But notice that Deitrich squeezes more results from his hours by freeing up his schedule, whereas Hesper gets more done by allotting less time to her work. These clearly are very different approaches.

Question 1 Which of these two time-management methods is more likely to work best in a small business?

Question 2 What are the advantages and disadvantages of these two approaches? What personality characteristics or natural work habits might sync up best with each of them?

Question 3 Which of these two methods would help you, personally, to be most productive? Why?

Experimental Exercises

1. Interview a management consultant, SCORE member, university director of student consulting teams, or representative of a CPA firm to discuss small business management weaknesses and the willingness or reluctance of small firms to use consultants. Prepare a report on your findings.
2. Diagram the organizational relationships in a small business of your choice. Report on any organizational problems that are apparent to you or that are recognized by the owner-manager or others in the firm.
3. Prepare a report on your personal observations of leadership and delegation of authority by a supervisor in an organization where you have been an employee or volunteer. Include references to the type(s) of leadership exercised and the adequacy of authority delegation (if any), clarity of instructions, and any problems involved.
4. Select an unstructured time block of one to four hours in your schedule—that is, hours that are not regularly devoted to class attendance, sleeping, and so on. Carefully record your use of that time period for several days. Prepare a report summarizing your use of the time and outlining a plan to use it more effectively.

Endnotes

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Chapter 20

Managing Human Resources

Looking Ahead

Learning Objectives

This chapter introduces you to important facets of the human resource management function in the small business, which is critical to success. By studying this chapter, you should be able to . . .

20-1 **Explain the importance of employee recruitment, and list some useful sources for finding suitable applicants.**

20-2 **List the steps in evaluating job applicants.**

20-3 **Describe the roles of training and development for both managerial and nonmanagerial employees.**

20-4 **Explain the various types of compensation plans, including the use of incentive plans.**

20-5 **Discuss the human resource issues of co-employment, legal protection, labor unions, and the formalizing of employer–employee relationships.**

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Spotlight on Small Business

Kitu Life, Inc.

https://drinksupercoffee.com

Kitu Life Inc. was founded in 2016 by three brothers, Jim, Jake, and Jordan DeCicco, to create and sell a line of ready-to-drink coffees, espressos, and creamers that are healthier to consume.

The idea for the start-up first came to the youngest DeCicco brother, Jordan, while he was a college student. That's when he figured out that most available caffeinated beverages were loaded with sugar. The chance discovery led to the launch of Kitu Life—literally, out of his dorm room. His ambition was to create caffeinated drinks that would be healthier than other products on the market at the time.

Committed to improving life for coffee-drinkers everywhere, Jordan decided to get creative and tinker around with various caffeinated concoctions until he could find just the right recipe. His determined experimentation led to a product breakthrough, called Super Coffee, which is sweetened naturally with monk fruit. The sugar-free, lactose-free, organic Colombian coffee blend has been a big hit, especially with consumers who were looking for ways to reduce their calorie intake. But Super Coffee was only the beginning. Today, the brand also includes other ready-to-drink products, as well as flavored creamers, coffee pods, and packaged grounds.

In February 2019, the company was featured on an episode of ABC's *Shark Tank*. The DeCicco brothers' performance impressed would-be backers, including celebrities Jennifer Lopez and Alex Rodriguez, who eventually became major investors. Before long, Kitu Life Inc. was on a streak, racking up a number of noteworthy achievements, including recognition in 2021 as a Best Workplace in North America by *Inc*. magazine. The company's motto is, "We mass produce positive energy," a notion that seems to fit with its growth trajectory.

But starting a business is one thing. Managing it over time is another—especially during periods of rapid expansion. Like many start-ups, Kitu Life saw notable growth early on. During its first two years in business, the company grew to 18 employees in its New York City office, all of them hired through the brothers' personal networks and via social media. But the company was signing on new retail partners at a very brisk pace, which made it clear that hiring strategies of the past would simply come up short. At the time, the company needed 10 new salespeople on the West Coast, ASAP! As CEO Jim DeCicco conceded, "I would have liked to do the hires personally, but we simply didn't have enough time."

So how is a small but fast-growing entrepreneurial venture to find the employees it needs to support its expansion? One option is to do what Kitu Life ended up doing: Turn to a recruitment service.

The approach most recruiting services take to find viable job candidates is usually very different from the search processes employers typically follow. For example, most companies know their industries well and tend to search for new hires from the pool of prospects within it. Recruiting services are focused on the final results—that is, hiring the best employees for their clients—which means they can work through extended connections and cast their search nets over a much broader prospect space. Stated another way, they can search far beyond the personal network of the entrepreneur, or even the venture's industry, to find ideal hires.

When using a recruiting service, it is extremely important to be very specific about the needs of the company. This includes not only the skills required for the position, but also any other factors that can help ensure that hires are aligned with the company's shared values. Achieving a culture fit can be important to employer and employee satisfaction and long-term performance.

To be clear, recruitment services are not hiring services. "These firms provide you with candidates," warns Lisa Barrow, CEO of Kada Recruiting in Charleston, South Carolina. "But it is you who, in the end, choose to hire them or not." This is often important to small business owners who tend to be reluctant to give up control. But it also means that responsibility for results ultimately rests with the entrepreneur. They really can't pass the buck, then—though they will surely have to pass more than a few bucks to the recruitment company to pay for its services.

Long story short, small businesses need good people, especially if they want to grow. Then, once employees sign on with the company, the venture's leadership needs to think carefully about how to manage them effectively. Careless neglect of human resources has led to the demise of countless small firms.

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"I used to think it was so cheesy, hearing Bill Gates say, 'You need people to grow a successful business.' Now it's one of our biggest challenges—getting good people in the door." So says Sherman Standberry, co-founder and CEO of Atlanta-based start-up, LYFE Marketing, which handles digital marketing for more than 400 small businesses.[1]

But entrepreneurs have to find a way if they want to build a competitive enterprise. They need to think carefully about how to find and hire the best people available and then figure out how to hold on to them. This is one of the greatest drivers of business growth. It therefore stands to reason that employees need to be managed intelligently if they are to boost a venture's performance.

The term **human resource management (HRM)** refers to the management of employees, individually and collectively, in a way that enables them to help the business reach its strategic objectives. This can only be achieved if highly capable employees are recruited, trained, assessed, and given incentives to reach their greatest potential. To complicate things a bit, HRM looks very different in large firms than in small companies. A small entrepreneurial concern neither can nor should duplicate the personnel policies and procedures of a Google or a General Motors. Instead, it should carefully manage its employees in a way that is best suited for the 10, 50, or 100 employees on its payroll.

The HRM practices of small businesses should be well planned and professional, but unfortunately this often is not the case. If you are concerned that you may not know enough to hire suitable employees for your start-up or business expansion, this chapter will help you by presenting HRM practices that work best for entrepreneurial companies.

Before discussing the framework necessary to help you set up an effective human resource management program, we need to recognize that many aspiring business owners struggle mentally with hiring their very first employee. In fact, a recent study has shown that start-ups that do not hire in the first few years tend to remain single-person enterprises.[2] Just the thought of having to figure all of this out too often keeps new ventures from ever getting out of the starting block. The Small Business Administration (SBA) simplifies the process by outlining 10 easy-to-follow steps that will help to ensure your compliance with what can be a confusing array of federal and state regulations regarding hiring. These steps are provided at the Small Business Association's webpage, "Hire and Manage Employees."

human resource management (HRM) The management of employees in a way that enables them to help a company reach its strategic objectives.

20-1 Recruiting Personnel

20-1 Explain the importance of employee recruitment, and list some useful sources for finding suitable applicants.

Recruitment brings applicants to a business. The goal is to obtain a pool of potential employees large enough to contain a number of talented prospects. In a subsequent stage of the selection process, management decides which applicants are "keepers."

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But attracting and retaining good employees may be more difficult than you realize. In fact, 59 percent of the CEOs of Inc. 500 companies identified this as their greatest challenge.[3] Despite painstaking recruitment efforts, many small business owners indicate that they simply cannot find prospects with the skills and qualifications that they need, and the problem only gets worse when labor markets get tighter.

20-1a The Need for Quality Employees

If you want your venture to grow, then it is important to think of employees not as expenses but as revenue generators. Thus, it makes no sense to hire more employees unless the total costs involved will be more than offset by the additional profits from sales that their hiring yields. (It's important to keep cash flows in mind, since it will take some time for the revenue to come in.) According to the SBA, many small companies are finding ways to get by with very few employees or none at all, thereby simplifying their operations and avoiding payroll increases.[4] This is becoming increasingly possible because work that once required more employees can now be handled with low-cost or free software and tools that are user-friendly and readily accessible online. The limited availability of workers during the COVID-19 pandemic accelerated the trend even more; small businesses were left with no alternative.[5]

Despite these developments, many companies cannot forgo hiring without choking off their growth. When expansion is necessary, there is no substitute for having high-quality employees on board—and the more capable and motivated, the better. This can provide an enormous boost to the overall performance of a company. In fact, we know from research that the presence of one capable and motivated worker can raise the performance of others sitting nearby anywhere from 3 to 16 percent.[6] This suggests that interactions between two or more high-impact employees will often lead to outcomes significantly greater than the sum of their already excellent individual contributions.

Recruitment and selection of employees establish a foundation for the ongoing human interactions in a company. In a sense, beyond the entrepreneur's ability and vision, the quality of a company's employees determines its potential. A solid, effective organization can be built only with a talented, ambitious workforce. And since payroll is one of the largest expense categories for most businesses, wise employment decisions can have a direct impact on the company's bottom line. By recruiting the best personnel possible, an entrepreneurial firm can improve its return on each payroll dollar.

Most successful companies have moved ahead of their competition because they recognize that employees *are* the business, and vice versa. There is no getting around this, especially for entrepreneurial firms that are expanding. Hiring and holding on to the right people can easily make or break a small business.

20-1b The Lure of Entrepreneurial Firms

Competing for well-qualified business talent requires small firms to identify their distinctive advantages, especially when recruiting outstanding prospects for managerial and professional positions. Fortunately, there are many good reasons to work for an entrepreneurial business. This is especially true of growing enterprises led by individuals or teams with a compelling vision of a desirable and attainable future.

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Entrepreneurial firms can compete with recruiting juggernauts like Apple, Tesla, and Disney when it comes to attracting and hiring promising employees. The secret is coming up with a strategy that will convince the best and brightest to join a small company. Offering competitive salaries helps (more on that later in the chapter), but many recruits are even more interested in opportunities for high-level achievement, job variety, interesting experiences, personal recognition, and the potential to do work that they believe is important. Many small businesses are in an excellent position to offer such attractive opportunities to prospective employees. There are several reasons for this:

- Because of their small size and limited staff, entrepreneurial companies allow new managers to work more closely with the CEO (often the founder), which can lead to quicker action.
- A small business can also provide opportunities for the general high-level management or professional experience that achievement-oriented hires find attractive.
- Rather than toiling in obscure, low-level, specialized positions in a large firm while "paying their dues" and working their way up the corporate ladder, capable newcomers can quickly move into positions of responsibility in a well-managed small business, where they know that they are making a difference in the company's success.
- Small firms can also structure the work environment to offer professional, managerial, and technical personnel greater job variety and freedom than they would normally have in a larger business.
- Individual contributions are more likely to be recognized rather than hidden under numerous layers of bureaucracy.
- Compensation packages can be structured to create powerful incentives for outstanding performance.

These are just some of the "selling points" that small companies can use to attract candidates who would likely be moving toward a career in a large corporation. And it fits with the facts. When 1,000 employees were asked how they felt about working for a small business, 59 percent said they were very satisfied (36 percent more reported being somewhat satisfied) for the reasons just outlined.[7]

To be sure, though, there are drawbacks to working for a small company—for example, managerial blunders are harder to absorb and thus tend to be obvious to everyone, support systems from legal or human resource staff may not be readily available, and limited employee benefits can lead to high levels of turnover and constant changes in personnel. But many small employers can offset these disadvantages with appealing trade-offs, such as flexible work scheduling, job-sharing arrangements, less (or more) travel, and other potential advantages. With a little thought and some careful positioning, entrepreneurs can actually win the competitive challenge to lure the best talent available.


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Living the Dream

What to Do When a Bad-Fruit Start-Up Runs Out of Juice

Good Use

Employment in a small business can be complicated—even a little risky.

There is no question that signing on to work with a start-up or small venture has its upsides, like having direct access to the founder and other high-level leaders, getting to experience more of the business, and seeing the impact one's work has on the enterprise. These promising features allow budding companies to attract and hold onto the great talent they need to build an amazing business.

At the same time, though, honest entrepreneurs will also be upfront with prospective employees about the risks that come with the territory—the uncertain future of a new venture that lacks an established track record or a small company that could only dream of having the deep financial reserves and staying power of a corporate heavyweight. But even if the business fails, departing employees will not go away emptyhanded, as the experience can be invaluable if it can lead to deep self-understanding, acquired business knowledge, and potential new opportunities.

A start-up called Good Use shows how this can work. Launched in 2016 to sell delicious and nutritious juices that it processed from "cosmetically challenged and surplus fruits and vegetables," the company's products were made to order and delivered fresh. The goal was to find a productive use for what some analyses show to be nearly half of all produce that ultimately is wasted (this while some 820 million people around the world go hungry every day).

The Bay Area start-up was just hitting its stride when COVID-19 broke out. It was around that time that the bottom began to fall out of the business as lockdowns were mandated in response to the pandemic. Because the company catered mostly to tech firms in the San Francisco area, sales simply collapsed when their offices had to close. Good Use lost its juice-delivery client base almost overnight. The co-founders tried to adjust by converting their operations to producing hand sanitizer, but these Plan-B efforts didn't pan out. The death blow came when a supplier, which was also struggling financially, failed to deliver a paid-for order.

The handwriting was on the wall for the company's staff of around 20 people, and it was a punch to the gut. They would truly miss working for an exciting high-growth company that had a feel-good, anti-waste mission at its core, as this brought a deep sense of purpose to their work. But it was not to be. With the closure came an unavoidable need for reflection, renewal, and reinvention, forcing the entire group to work through major personal changes. Their "re-creation" in business and in life would be forged in the crucible of this very jarring moment.

But all was not lost. Below are some of the former team's stories and thoughts about new possibilities.

Grant Carlson (co-founder)

"It's hard to say goodbye to something that you built, [especially when] you worked with so many good people to build it," says Grant Carlson. After the collapse of Good Use, he moved to Seattle to manage a block of 58 apartment units for his mother's property management company. "I came from being the CEO of a company with a couple dozen employees to unclogging people's toilets, and I'm absolutely loving it," he says. Sometimes a plant just needs to be repotted.

Sabrina Corpus (chief financial officer)

After her position with the start-up came to an end, Sabrina Corpus acted on her love for pets and started working for a dog-walking service. The change meant that she would no longer have to spend all day in front of a computer, which is something that she didn't enjoy about her previous position. But she harbors no regrets about her time with the company and what she learned from it. "Entrepreneurship is real. I'm going to take that with me," she says. "If I hadn't had that job, I'd never understand that age doesn't really matter, as long as you put in a lot of effort."

Yemi Adelaiya (production manager)

As Yemi Adelaiya, a 44-year-old Nigerian, thinks back on his experience, he has come to realize that "Good Use gave [him] the opportunity to work in the kind of environment where everyone's input is valued no matter where they're from or who they are." But Adelaiya's professional setback was short-lived. Because of his production experience with Good Use, a small pudding maker called Petit Pot hired him to manage its nine-person crew. As good

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fortune would have it, his new employer operates from the same building. He sometimes uses the same parking spot!

Erin PonTell (chief marketing officer) and Kayla Castañeda (sales consultant)

Kayla Castañeda found a way to make peace with the loss of her position with Good Use: "When life gives you lemons, make agua frescas." It's more than just a clever response. After the start-up closed down, she and Erin PonTell decided to use what they had learned to launch their own venture, Agua Bonita, that offers a new canned (you guessed it) agua fresca product. PonTell has described the experience as "the most fun I've ever had working on something."

Castañeda says it was her time with Good Use that led her to take on the challenge of another start-up. "I felt more confident moving forward and launching my own product and project," she explained. And the experience helped her to realize that new venture failure is not the end of the world. As she puts it, "If it fails, OK, a lot of things are failing right now."

Cameron Drake (head of sales)

Cameron Drake took a very different direction after Good Use folded. He invested $40,000 of his own money to develop a new product called Cliffset, which is "portable, reusable cutlery designed for everyday use that comes with its own cleaning tool." He pursued crowdfunding on Kickstarter and sold more than 3,000 sets for $29 each. That was the proof of concept that he was looking for, so he is moving forward with the cutlery, which is now available for $45 a set.

Slava Chupryna (co-founder)

The collapse of Good Use took a heavy toll for a time on co-founder and chief operating officer Slava Chupryna. "I just felt powerless," the 29-year-old says. But his free-spirit mentality has helped him move on to other challenges. For example, he's helping Mexican companies find suppliers of protective gear for medical personnel, and he has joined forces with a Ukrainian maker of tiny homes that he hopes to bring to the U.S. "Some people stress so much," he says. "If you can live with yourself not having a plan, it's a lot more exciting."

As you can see, when a new venture door closes, somewhere a window of opportunity opens. Getting comfortable with the way this works is key to making life in the entrepreneurial fast lane work. Those who are thinking of being part of a new venture or small business need to keep in mind that the risk involved can be more than offset by the chance to do very well financially if the business succeeds. But even if it doesn't, there are payoffs that count for more than money. It's a win–win situation for those who have the courage to give it a try.

Sources: LinkedIn, "Good Use," https://www.linkedin.com/company/goodusefoods, accessed July 1, 2021; Pamela Okutoyi, "Make Room for Ugly Fruits, in Stomachs Not Landfills," *AgriBiz*, July 1, 2021, https://agribiz.kenyacic.org/2021/07/01/make-room-in-your-heart-for-ugly-fruits-fill-stomachs-not-landfills, accessed July 1, 2021; Laura Weber, "When Covid Sank This Small Business, Here's How Its Workers Rebounded," *The Wall Street Journal*, May 17, 2021, https://www.wsj.com/articles/job-search-small-business-pandemic-careers-good-use-11621014650, accessed July 4, 2021.

20-1c Sources of Employees

To recruit effectively, the small business manager must know where and how to find qualified applicants. Sources are numerous, and it is impossible to generalize about the best pool in view of the differences in companies' personnel needs and the quality of the applicants from one locality to another. Some of the more popular sources of employees among small firms are discussed in the following sections.

Internet Options

Small businesses are turning increasingly to the Internet to find the employees they need. A variety of websites, such as CareerBuilder, LinkedIn, Monster, and ZipRecruiter, allow applicants to submit their résumés online and permit potential employers to search those résumés for qualified applicants. Some of these services use artificial intelligence to match companies and prospective employees more precisely, which can make the process much more efficient for both parties. And because the

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Internet opens up a wealth of connections to potential applicants, many firms also post job openings on their own websites.

Using the Internet for recruiting is convenient, but it can also carry some significant limitations and unanticipated costs. For example, it would not be uncommon for a small business owner posting a job opening requiring a very specific online-advertising skill set to hear back from a slew of interested job seekers, none or few having the capabilities sought. Sorting through the responses can take up a great deal of an already-busy owner's time. The point is that the initial cost of posting a position online can be low—sometimes even free—but that doesn't mean the *overall process* will be inexpensive, and it may not even be useful in the end.

Beyond these options, social media tools can be indispensable to recruitment efforts, and their use for this purpose continues to grow. There is no question that these tools have radically changed how recruiting is done. In mere minutes and with a few quick clicks of a mouse, you can reach countless potential prospects—especially if you know what you're doing. According to the 2021 Future of Recruiting Study, 92 percent of organizations surveyed report using social media and professional networks in their recruitment efforts, with indications of plans for even greater use in the future. The 1,156 survey respondents involved in the study ranked the use of social media above other popular options, including employee referrals (87 percent), job boards (82 percent), and job ads (72 percent).[8]

Many companies are finding that social recruiting is very efficient and that it yields more applicants and higher-quality candidates. As with other online tools or channels for this, the process is not costless, but businesses are leaning toward these options because they are still more cost-effective than other available alternatives.

Schools

Secondary schools, trade schools, colleges, and universities are desirable sources of personnel for certain positions, particularly those requiring no specific work experience. Some secondary schools and colleges have internship programs that enable students to gain practical experience in firms, which can be very helpful. Applicants from trade schools often have useful educational backgrounds to offer a small business. Colleges and universities can supply candidates for positions in management and in various technical and professional fields. In addition, many students can work as part-time or temporary employees.

Some small businesses have decided that the best way to get the employees they need is to have input into the preparation provided at local trade schools and colleges. By working out partnerships with institutions that are interested in ensuring that the coursework they offer provides the skills for which companies will be hiring in the future, some small businesses have been given significant say in fine-tuning course content related to project management, engineering, architecture, and many other subjects. Some of the students may then be hired as interns, a strategy that gives the company access to inexpensive part-time help for the present and the inside track on hiring high performers as full-time employees after they graduate. The firm wins with this strategy, but so do the students and the training institutions.

Public Employment Offices

At no cost to small businesses, employment offices in each state administer the state's unemployment insurance program and offer information on applicants who are actively seeking employment. These offices, located in all major cities, are a useful source of clerical workers, unskilled laborers, production workers, and technicians. They do not

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actively recruit but only counsel and assist those who come to them for assistance. In any case, the role of such agencies will continue to be important to the employment needs of small businesses, especially during periods of economic instability.[9]

Private Employment Agencies

Numerous private firms offer their services as employment agencies. In some cases, employers receive these services without cost because the applicants pay a fee to the agency. More often, however, the hiring firms are responsible for the agency fee. Private employment agencies tend to specialize in people with specific skills, such as sales and marketing, computer programming, and human resource management.

Temporary Help Agencies

The temporary help industry, which is growing rapidly, supplies employees (or temps)—such as customer service representatives, accountants, home health aides, maintenance and repair workers, computer support specialists, and sales clerks—for short periods of time. By using an agency such as Kelly Services or Manpower Inc., small firms can deal with seasonal fluctuations and absences caused by vacation or illness. For example, a temporary replacement might fill the position of an employee who is taking leave following the birth of a child—a type of family leave mandated by law for some employees. In addition, the use of temporary employees provides management with an introduction to individuals whose performance may justify an offer of permanent employment. Staffing with temporary employees is less practical when extensive training is required or continuity is important.

Employee Referrals

Recommendations of suitable candidates from good employees may provide excellent prospects. Ordinarily, employees will hesitate to recommend applicants unless they believe in their ability to do the job. Also, the family and friends of current workers can be among the best and most loyal employees available, because these individuals are well known and trusted. One digital marketing manager explains why this approach works out so well, for both the recruiting company and the job candidate:[10]

> From an employer perspective, candidates referred by current employees tend to be the highest quality hires. A referral candidate often has greater job satisfaction and stays longer with the company. Referral candidates are three to five times more likely to be hired for a position than a candidate with no connection within the company. With the growing popularity of employee referral programs, 69 percent of companies say they have a program in place.

Because it works so well, some employers go so far as to offer a few hundred dollars for employee referrals that result in the hiring of new employees. Doing so can save money (costing much less than advertising or using employment agencies) and reduce turnover. But perhaps the most important advantage is that these new hires typically become productive in less time and tend to have superior skills.

Hiring based on referrals is really just a way of tapping into the personal networks of employees. However, network recruiting becomes more important as the responsibilities associated with the position increase, because it provides the best connections to individuals with the background, skills, and integrity that are essential to a position of great responsibility in the company.

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Executive Search Firms

When filling key positions, small companies sometimes turn to executive search firms, often called **headhunters**, to locate qualified candidates. The key positions for which such firms seek applicants are those paying a minimum of $50,000 to $70,000 per year. The cost to the employer typically runs from 20 to 35 percent of the first year's salary. Because of the high cost, the use of headhunters may seem unreasonable for small, entrepreneurial firms. At times, however, the need for a manager who can help a firm move to the next level justifies the use of an executive search firm. A headhunter is usually better able than the small business to conduct a wide-ranging search for individuals who possess the right combination of talents for the available position.

Walk-Ins and Help-Wanted Advertising

A firm may receive unsolicited applications from individuals who walk into the place of business to seek employment. Walk-ins are an inexpensive source of personnel, particularly for hourly work, but the quality of applicants varies. If qualified applicants cannot be hired immediately, their applications should be kept on file for future reference. In the interest of good community relations and ethical company behavior, all applicants should be treated courteously, whether or not they are offered jobs.

A "Help Wanted" sign in the window is one traditional form of recruiting used by some small firms (mostly retailers and fast-food restaurants). A similar but more aggressive form of recruiting consists of posting online newspaper job ads, which can be very effective as these are often discovered by job search engines like Indeed.com. For some technical, professional, and managerial positions, firms may advertise in trade and professional journals. Although the effectiveness of help-wanted advertising has been questioned by some, many small businesses still recruit in this way.

20-1d Diversity in the Workforce

Over time, the composition of the U.S. workforce has been changing. Economists with the U.S. Bureau of Labor Statistics project that the general trend will continue, but the change will come disproportionately from an increase in the number of available Hispanic workers:[11]

> The number of Hispanic workers in the labor force has grown from 10.7 million in 1990 to 29.0 million in 2020, and is projected to reach 35.9 million in 2030. Hispanics are projected to account for 78% of net new workers between 2020 and 2030. The U.S. labor force growth rate has slowed over the past couple of decades—and what growth has occurred is largely due to the increasing number of Hispanic workers. Non-Hispanic growth was negligible over the past 10 years, at just 0.5%. With Hispanic workers' growth factored in, the nation's overall growth rate clocked in at 4.5%.

The balance is shifting steadily toward greater **workforce diversity** (based on gender, age, ethnicity, and race), even as the labor force *participation rate* (which reflects the percentage of the population that is either working or actively looking for work, a figure that peaked at 67.1 percent in 2000) is expected to decrease from 63.1 percent in 2019 to 61.2 percent in 2029. While the overall size of the labor force will continue to grow, the *rate* of growth will increase slightly from 0.60 percent per year in the previous decade to 0.64 percent in the decade to come, despite the aging of the population.[12] As a result, the challenge for human resource management is to adapt to a pool of potential employees that is changing along a number of dimensions. To remain fully competitive,

headhunters
A search firm that identifies qualified candidates for executive positions.

workforce diversity
Differences among employees on such dimensions as gender, age, ethnicity, and race.

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business owners need to be open to innovative ways to access the available applicant pool. In many cases, hiring more workers from diverse groups can help a company maintain good relations with an increasingly heterogeneous customer base.

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While most of these employees are authorized to work, a certain portion of them are not, which can lead to challenges for business owners. Hiring undocumented workers is a punishable offense and can lead to fines or the suspension or revocation of a company's business license. To steer clear of such hiring violations, many small business owners find it helpful to consult the U.S. Department of Labor website at www.dol.gov/agencies/eta/foreign-labor for information on certifying foreign workers and other applicable laws. Your company may also be required to use the E-Verify system to confirm a potential new employee's eligibility. These limitations make it all the more important to cast the employment net as broadly as possible to find the best people available. By developing an awareness of the potential of various parts of the talent pool, small firms can improve the effectiveness of their recruitment methods.

The diversity of the American workforce is growing, but that is not the end of the story. As the largest economy in the world, the United States owes its size and dynamism, in significant measure, to the entrepreneurial drive and effort of immigrants. A recent analysis of businesses with fewer than 100 employees conducted by the Immigration Research Center of the non-partisan Fiscal Policy Institute found that 18 percent of small business owners in the United States are immigrants, even though they represent only 13 percent of the general population. Even more impressive, this group is responsible for 30 percent of the growth in the number of new small businesses in recent years.[13] This evidence, combined with other statistics, signals that the U.S. population is on course to become even more diverse as time goes on, and immigrants will continue to be overrepresented among small business owners.

20-1e Job Descriptions

A small business manager should analyze the activities or work to be performed to determine the number and types of jobs to be filled. Knowing the job requirements permits more intelligent selection of applicants for specific positions.

Certainly, an owner-manager should not select personnel simply to fit rigid specifications of education, experience, or personal background. Rather, they must concentrate on the overall ability of an individual to fill a particular position in the business. Making this determination requires an outline, or summary, of the work to be performed, which is often referred to as a **job description**. (If you need some ideas to get you started, sample descriptions for all kinds of jobs can easily be found by an Internet search using the term.)

Duties listed in a job description should not be defined too narrowly. It is important that such descriptions minimize overlap but also avoid creating a "that's not my job" mentality. Technical competence is as necessary in small businesses as it is in large firms, but versatility and flexibility may be even more important. Engineers may

job description
An outline, or summary, of the work to be performed for a particular position.

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occasionally need to make sales calls, and marketing people may need to pinch-hit in production.

Any analysis of a position should include a list of the knowledge, skills, abilities, and other characteristics that an individual must have to perform the job. This statement of requirements is called a **job specification** and may be a part of the job description. A job specification for the position of stock clerk, for example, might state that the individual must be able to lift 50 pounds and have completed 10 to 12 years of schooling.

Job descriptions are very important human resource management tools, but only if they are taken seriously. There are sound legal reasons for developing great—not just good—job descriptions. For example, if you do not specify important aspects of the job and how it is to be done *in detail*, the Americans with Disabilities Act presumes that an employee can go about the actual job duties in any way they want to, regardless of company policy or what you think is the best and proper way of doing them.[14] Getting the job description right can avert burdensome legal hassles, saving you money and giving you one less worry when you go to bed at night.

While job descriptions are primarily an aid in personnel recruitment, they also have other practical uses. For example, they can bring focus to the work of employees, provide direction in training, and supply a framework to guide performance reviews.

20-2 List the steps in evaluating job applicants.

20-2 Evaluating Prospects and Selecting Employees

Recruitment activities identify prospects for employment. Additional steps are needed to evaluate these candidates and extend job offers. To reduce the risk of taking an uninformed gamble on applicants of unknown quality, an employer can follow these steps:

STEP 1: Use application forms.
STEP 2: Interview the applicants.
STEP 3: Check references and other background information.
STEP 4: Test the applicants.
STEP 5: Require physical examinations.

20-2a Step 1: Use Application Forms

By using an application form, an employer can collect enough information to determine whether a prospect is minimally qualified and to provide a basis for further evaluation. Typically, an application asks for the applicant's name, current address, days/hours of work availability, educational background, employment history, and references.

Although an application form need not be lengthy or elaborate, it must be carefully written to avoid legal complications. In general, a prospective employer should not seek information about gender, age, marital status, race, color, national origin, disabilities, and religion. The information requested should be focused on helping the employer make a better job-related assessment. For example, an employer is permitted to ask whether an applicant has graduated from high school. However, a question regarding the year the applicant graduated would be considered inappropriate because the answer would reveal the applicant's age.

job specification
A list of the knowledge, skills, abilities, and other characteristics needed to perform a specific job.

20-2b Step 2: Interview the Applicants

An interview permits the employer to get some idea of an applicant's job knowledge, intelligence, and personality. Any of these factors may be significant to the job to be filled.

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Although the interview can be a useful step in the selection process, it should not be the only step. Some managers have the mistaken idea that they are infallible judges of human character and can choose good employees on the basis of interviews alone. Even when conducted with care, an interview can lead to false impressions. Recent research showing that candidates tell an average of two to three lies during a 10-to-15 minute interview only adds to the skepticism.[15] Those who have a talent for quick responses and smooth talk may, indeed, have an impressive skill set, but this might not be helpful when it comes to managing processes or technologies. The interview may reveal little about how well they work under pressure or when part of a team, what motivates them, and other important issues. In fact, research has shown that the typical job interview (unstructured and unfocused) is of limited value in predicting success on the job.[16]

In light of a growing concern regarding the value of interviews as they are typically used, many firms have adopted more effective approaches that are variations on the interview theme. For example, companies have found **behavioral interviews** to be 55 percent predictive of a candidate's future behavior on the job, representing a significant improvement over the results of traditional interviews.[17] This kind of interview doesn't focus on asking people about their accomplishments. Instead, it explores their reactions to specific employment-related situations, looks for patterns in how they use their time, gauges the core values that they embody, and more, all based on the notion that past behavior is a good predictor of future behavior.

Although it can be a taxing process that may come across to the applicant as a barrage of challenging questions, the behavioral interview is designed to get a sense of the applicant's past performance and likely responses in future situations. The nature of the method makes bluffing more difficult, and the focus on facts rather than feelings leads to a more accurate impression of what a person is *capable* of doing, as well as what they are *likely* to do on the job.


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Companies that use behavioral interviews must select a set of questions that will uncover the insights they need to make an informed hiring decision. To give you a sense of how such an interview can be structured, here are some questions that are often asked:[18]

- Can you share a specific example of a time when you used good judgment and logic when solving a problem?
- Tell me about a time when you set a goal and were able to achieve it.
- Can you recall a time when you had to conform to a company policy with which you did not agree? How did you handle that situation?
- How do you typically deal with workplace conflict? Describe an experience that required you to make such an adjustment.
- Give me an example of a time when your integrity was tested and yet prevailed in a workplace situation.

behavioral interviews An approach that assesses the suitability of job candidates based on how they have responded to specific employment-related situations and looks for patterns in past behaviors.

As you can see from these questions, the focus is on patterns of performance and behaviors in past situations similar to situations that are likely to come up in the job for which the applicant is being considered. Designing this emphasis into the interview process will lead to more effective hiring decisions.

Regardless of the interview method you choose, remember that serious legal consequences can result from a poorly conceived process. Just as in application forms,

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it is very important to avoid asking questions in an interview that conflict with the law (Exhibit 20.1 presents examples of topics that should be avoided). In a growing number of states, this even includes questions about salary figures from previous positions.[19] Some companies believe that applicants should be interviewed by two or more individuals in order to provide a witness to all interactions and to minimize bias and errors in judgment, but this is not always possible—and it certainly makes the process more expensive. In any case, careful planning up front can prevent serious trouble in the future from discrimination lawsuits and poor employee selection.

Time spent in interviews, as well as in other phases of the selection process, can save the company time and money in the long run. In today's litigious society, firing an employee can be quite difficult and expensive. A dismissed employee may bring suit even when an employer had justifiable reasons for the dismissal. Note, however, that released employees are much less likely to file a lawsuit if they conclude that their employer has been fair throughout the process and has provided ample opportunity for them to improve their work performance before termination.

It's important to remember that employment interviewing is actually a two-way process. The applicant is evaluating the employer while the employer is evaluating the applicant. In order for the applicant to make an informed decision, they need a clear idea of what the job entails and an opportunity to ask questions.

20-2c Step 3: Check References and Other Background Information

Careful checking with former employers, school authorities, and other references can help an employer avoid hiring mistakes. Suppose, for example, that you hired an appliance technician who later burglarized a customer's home. If you failed to check the applicant's background and they had a criminal record, it might be considered a

Exhibit 20.1 Topics to Avoid in an Interview

Children. Asking about children may indicate an employer's concern about child care needs, and it singles out women.

Age. The Age Discrimination in Employment Act prevents employers from asking applicants their age or even about life events that could indicate age, such as their year of high school graduation.

Disabilities. The Americans with Disabilities Act does not allow discussions regarding mental or physical disabilities until after a job offer has been made.

Physical Characteristics. Talking about height, weight, or other physical attributes can lead to discrimination based on those features.

Maiden Name. It is okay to ask an applicant's name, but asking for a maiden name can lead to discrimination based on marital status and, potentially, ethnic background.

Citizenship. The Immigration Reform and Control Act allows a company to ask if applicants have a legal right to work in the United States, but inquiring about citizenship can lead to claims of discrimination based on national origin.

Lawsuits. It is against federal and state laws to ask applicants if they have filed suit against a previous employer, a measure intended to protect whistleblowers from potential retaliation.

Arrest Records. Applicants can be asked if they have ever been convicted of a crime, but an arrest record does not necessarily reflect criminal activity (if the charges were later found to be groundless, for instance).

Smoking. Applicants can be asked if they know the company's policy on smoking at work, but they should not be asked if they smoke to avoid being seen as attempting to discriminate against those who may be more prone to absenteeism and higher medical claims.

Medical Conditions. It would violate the Americans with Disabilities Act as well as federal and state civil rights laws to ask if an applicant has any medical conditions, including AIDS or HIV.

Source: Adapted from Chuck Williams, *MGMT*, 8th edition (Boston, MA: South-Western Cengage Learning, 2022), p. 243.

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negligent hiring decision. Trying to prevent such scenarios from arising is becoming more important, since the number of negligent hiring lawsuits continues to rise, and the average settlement is nearly $1 million.[20]

It is becoming increasingly difficult to obtain more than the basic facts about a person's background from previous employers because of the potential for lawsuits brought by disappointed applicants. For this reason and others, firms have been turning increasingly to social media to evaluate job applicants, with LinkedIn, Facebook, and Twitter being used most often. Many are rejected because of what is revealed. Examples of potential turnoffs include posting inappropriate information or photos, exposing evidence of excessive drinking or illicit drug use, demonstrating poor communication skills, and badmouthing a previous employer.

The practice of using social media activity to evaluate job applicants is not without its problems, however. Some employers actually ask for passwords so that they can directly access Facebook accounts, but this is very controversial—even illegal in more than 20 U.S. states.[21] Beyond the privacy issues involved, demanding login details would force the applicant to violate their contract with Facebook, since the company's statement of rights and responsibilities specifically prohibits the sharing of this information. Access to a Facebook account may also expose details regarding age, religion, race, and other sensitive information, which could open up the evaluating company to charges of unlawful discrimination.[22] But despite the potential drawbacks, it is argued that using social media to evaluate job candidates can be very useful, as long as the company is searching for legitimate evidence to effectively assess a potential hire.[23]

Although standard reference checks on a prior employment record do not constitute infringements on privacy, third parties are often reluctant to divulge negative information, and this limits the practical usefulness of reference checking. To encourage former employers to be honest, ask for consent for a check from applicants first. Then, ask only for appropriate information, such as employment dates, duties, strengths and weaknesses, and whether the individual is eligible for rehire.

At the same time, gathering information online about an applicant's financial, criminal, and employment history has never been easier. While some employers conduct their own background checks by accessing databases that are readily available, most outsource this function to one of hundreds of vendors that specialize in performing this service. A number of companies advertise that they will provide *free* background checks over the Internet. This certainly sounds appealing. But given the importance of the task, we suggest that you check with the National Association of Professional Background Screeners (napbs.com) before selecting a company for this purpose.

A few final cautions about background checks are in order. First, keep in mind that if a prospective employer requests a credit report to establish an applicant's employment eligibility, the Fair Credit Reporting Act requires that the applicant be notified in writing that such a report is being requested. But this is good practice, in general, when it comes to background checks. Most experts suggest that you require applicants to sign a written consent (detailing how and what you plan to investigate) before you conduct a check, to ensure legal compliance and to give the applicant the opportunity to withdraw from further consideration. If an applicant refuses to sign the consent form, it is legal for the company to decide against hiring them based on that refusal.[24]

Getting access to data is critical to making an informed hiring decision. However, you may be legally prevented from using some of the insights revealed to reject an applicant. Be sure to make your selection based on recent information that is clearly related to job duties.

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20-2d Step 4: Test the Applicants

Many jobs lend themselves to performance testing. For example, an applicant for a clerical position may be given a standardized typing test. With a little ingenuity, employers can develop practical tests that are clearly related to the job in question, and these can provide extremely useful insights for selection decisions.

Psychological examinations may also be used by small businesses, but the results can be misleading because of difficulty in interpreting the tests or adapting them to a particular business. In addition, the U.S. Supreme Court has upheld the Equal Employment Opportunity Commission's requirement that any test used in making employment decisions must be job-related.

To be useful, tests of any kind must meet the criteria of **validity** and **reliability**. For a test to be *valid*, its results must correspond well with job performance—that is, the applicants with the best test scores must generally be the best employees. For a test to be *reliable*, it must provide consistent results when used at different times or by various individuals.

Ideally, testing should include consideration of an applicant's match with the work habits of the company and the team of employees already in place. For this reason, some small business owners conduct a work-style assessment test that provides a better sense of a potential hire's personality to see if they will fit in. This kind of assessment can lead to insights into what makes a person tick, or how they will respond to situations that are common in the business. This can also help predict how well they will interact with key personnel already in the company, which can be crucial. In the end, it's important to realize that you hire and work with a person, not a résumé.

Because turnover is so costly, even if all indications from testing are positive, it still pays to look deeper if it is practical to do so. Jason Fried, co-founder and CEO of the web applications company Basecamp, takes such measures in the hiring process he has designed for his small business. A job candidate who fares well in the company's very intentional interview process is still given a "test drive." That is, Fried hires prospective employees for a one-week project, or a month-long assignment in some cases, to see how they work, communicate, handle pressure, and so on. According to Fried, "These real-work tests have saved Basecamp a few mismatched hires and confirmed a bunch of great people."[25] Apparently, this approach is being adopted more widely as 34 percent of the CEOs responding to a recent *Inc*. magazine survey say they assess work samples when evaluating the job fit of prospects at their companies.[26]

20-2e Step 5: Require Physical Examinations

A primary purpose of physical examinations is to evaluate the ability of applicants to meet the physical demands of specific jobs. However, care must be taken to avoid discriminating against those who are physically disabled. The Americans with Disabilities Act requires companies with 15 or more employees to make "reasonable" adaptations to facilitate the employment of such individuals.

Although some small businesses require medical examinations before hiring an applicant, in most cases, the company must first have offered that individual a job.[27] As part of the physical examination process, the law permits drug screening of applicants. But most small business owners have concluded that drug testing is expensive and unnecessary, despite overwhelming evidence indicating that drug use is prevalent and creates unnecessary risks and costs for employers. The Society for Human Resource Management reports that nearly 8 percent of the U.S. population abuse substances, and 75 percent of those are in the workforce. The resulting financial burden to companies has reached an estimated $42 billion a year, which is a consequence of increased

validity
The extent to which a test assesses true job performance ability.

reliability
The consistency of a test in measuring job performance ability.

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healthcare costs, as well as workplace inefficiencies that result from lost productivity, absenteeism, and other related factors.[28] It follows that a drug screening program can be a bargain for small businesses, reducing problem hires and long-term costs.

As you can see, a sound program for evaluating and selecting employees involves a number of "moving pieces," but many small businesses have figured out how to pull all of the pieces together very skillfully. An increasing number are turning to software-based assessments that use the power of data to assess a very wide range of job-prospect attributes, including technical and communication skills and personality. In addition to emphasizing job-related expertise, some also believe that strength of character is just as important as skills, if not more so. Skills can be taught, but ethics, loyalty, and high standards are inherent qualities that are difficult to pass on in a business setting. Therefore, a well-designed hiring process should take all of this into account.

20-3 Training and Developing Employees

20-3 Describe the roles of training and development for both managerial and nonmanagerial employees.

Once an employee has been recruited and added to the payroll, the process of training and development must begin. The purpose of this process is to transform a new recruit into a well-prepared and effective technician, salesperson, manager, or other employee. Such programs can be well worth the cost. Beyond the benefits of the knowledge and skills conveyed, small businesses that provide good training and development programs tend to have employees who are more likely to show up for work, arrive on time, and give greater effort to their duties.[29] These outcomes offer obvious advantages to any firm.

20-3a Basic Components of Training and Development

Though the terms are often combined, a training and development program can be separated into its two basic components. **Employee training** refers to planned efforts to help employees master the knowledge, skills, and behaviors that they need to perform the duties for which they were hired. In contrast, **management development** is focused more on preparing employees for future roles in business and emphasizes the education, job experiences, network development, and performance assessment necessary to reach long-term career goals and fulfill managerial potential. While the two components are different, they are obviously related.

Most positions require at least some training. If an employer fails to provide such instruction, a new employee must learn by trial and error, which usually leads to a waste of time, materials, and money—and sometimes alienates customers. At the same time, training to improve basic capabilities should not be limited to new hires. The performance of existing employees can often be improved through additional preparation. Due to constant changes in products, technology, policies, and procedures in the world of business, continual training often is necessary to update knowledge and skills—in firms of all sizes. Only with such instruction can employees keep up with the changing demands being placed on them.

Preparation for advancement usually involves developmental efforts, which typically are quite different than the support needed to sharpen skills for current duties. Because most able employees are particularly concerned about their professional development and progress, a small business can profit from careful attention to this phase of the personnel program. Opportunities for growth in an organization not only attract potential applicants, but they also help to improve the morale of current employees and reduce turnover. Perhaps even more important, having a "bench" to turn to when a key manager chooses to move on or otherwise needs to be replaced can help keep the work of the firm on track and minimize disruption.[30]

employee training
Planned efforts to help employees master the knowledge, skills, and behaviors they need to perform their duties.

management development
Preparation of employees for career advancement through education, job experiences, network development, and performance assessment.

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20-3b Orientation for New Personnel

The training and development process often begins with an individual's first two or three days on the job. It is at this point that the new employee tends to feel lost and confused, confronted with a new physical layout, a different job title, unknown co-workers, a different type of supervision, changed hours or work schedule, and a unique set of personnel policies and procedures. Any events that conflict with the newcomer's expectations are interpreted in light of their previous work experience, and these interpretations can either foster a strong commitment to the new employer or lead to feelings of alienation.

Recognizing the new employee's sensitivity at this point, the employer can contribute to a positive outcome through proper orientation. Some phases of the orientation can be accomplished by informal methods. For example, a company might choose to introduce newcomers to the rest of the staff by strategically placing a tray of bagels and muffins near a new employee's desk on their first morning of work. This would encourage co-workers to come by and get acquainted.

Other phases of the orientation must be structured or formalized. In addition to explaining specific job duties, supervisors should outline the firm's policies and procedures in as much detail as possible. A clear explanation of performance expectations and the way in which an employee's work will be evaluated should be included in the discussion. The new employee should be encouraged to ask questions, and time should be taken to provide careful answers. Since new hires are faced with an information overload at first, it is a good idea to follow up with the employee after a week or two has passed.

One way to support the orientation process is by providing new hires with a written description of company practices and procedures, which is often referred to as an employee handbook. The handbook may include an expression of the company's philosophy—an overall view of what the firm considers important, such as standards of excellence or quality considerations. This document typically covers topics such as recruitment, selection, training, and compensation, as well as more immediately practical information about work hours, paydays, breaks, lunch hours, absences, holidays, overtime policy, and employee benefits. Such policies should be written carefully and clearly to avoid misunderstandings. Also, bear in mind that an employee handbook is considered part of the employment contract in some states.

20-3c Employee Training

Employee training is an integral part of comprehensive quality management programs. Although quality management is usually associated with machines, materials, processes, and measurements, it also concerns human performance. Training employees for quality performance is, to a considerable extent, part of the ongoing supervisory role of all managers.

A well-planned training program will begin on the first day on the job, and it will be multidimensional. For starters, you should clearly define what quality means in your company and explain how it is measured. But it will also help to describe some of the company's past problems, outline corrective actions that were taken, and summarize how it is currently reaching its quality goals. In addition, special classes and seminars can be used to teach employees about the importance of quality control and ways in which to produce high-quality work.

Job descriptions or job specifications can be used to identify abilities or skills required for particular jobs. To a large extent, such requirements determine the appropriate type of training. Instruction at the place of employment that is

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supervised by a professional trainer or an experienced employee is referred to as **on-the-job training**, or direct instruction. For some jobs, the law may actually *require* this form of preparation.

More training is accomplished on the job than through any other method. However, on-the-job training of nonmanagerial employees may be haphazard unless it follows a sound, systematic method of teaching, such as **Job Instruction Training**. The steps in this program, shown in Exhibit 20.2, are intended to help supervisors become more effective in training employees.

Exhibit 20.2 Steps in Job Instruction Training

PREPARE EMPLOYEES

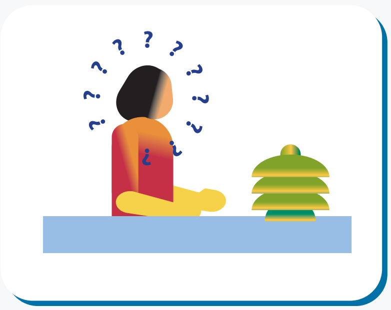
- Put employees at ease.
- Place them in appropriate jobs.
- Find out what they know.
- Get them interested in learning.

PRESENT THE OPERATIONS

- Tell, show, and illustrate the task.
- Stress key points.
- Instruct clearly and completely.

TRY OUT PERFORMANCE

- Have employees perform the task.
- Have them tell, show, and explain.
- Ask employees questions and correct any errors.



FOLLOW UP

- Check on employees frequently.
- Tell them how to obtain help.
- Encourage questions.

on-the-job training
Instruction at the place of employment, supervised by a professional trainer or experienced employee.

Job Instruction Training
A systematic, step-by-step method for on-the-job training of nonmanagerial employees.

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Effective training programs can take many forms. Some small businesses use more traditional in-person, instructor-led courses. Others lean more on longer-format online courses, which are less expensive. But an increasing number of companies are finding that some of their training needs are better met by using short digital learning sessions that employees can access at their convenience. This trend is being driven by realities that are impossible to avoid—mostly, busy work schedules and shrinking attention spans. Offered by e-learning companies like Grovo, LinkedIn Learning, and Udemy Inc., these training options can be accessed at the office, and often from any mobile device, and most take less than five minutes to complete. A quiz feature at the conclusion of the session provides assurance of learning quality.

Most companies adopting these microlearning options are mixing them in with other training formats, which are necessary for deeper instruction. But the abbreviated alternatives offer a more-focused tool to fill gaps in employee knowledge and skills, and they fit well with workplace and lifestyle conditions.[31] You should expect to see an increase in the use of microlearning in the future.

20-3d From Training to Implementation

Regardless of the level of the position involved, the goal of a training program is to teach employees new knowledge, skills, and behaviors that will lead to improved job performance. Spending on training by small U.S. companies has been rising steadily over time, including an increase from $1,511 per employee in 2019 to $1,678 in 2020.[32] Unfortunately, much of the training provided to employees each year is never actually applied on the job. As one business writer remarked, "Not only is the majority of training in today's companies ineffective, but the purpose, timing, and content of training is flawed."[33]

Many barriers to the implementation of training in the workplace are rooted in human nature. For starters, training suggests that change is necessary, but many people find that change provokes anxiety, so they often fall back on more familiar methods. Old habits and routines are hard to break, and workplace pressures or time demands can easily lead employees to turn to tried-and-true approaches. For example, an employee may find it easier to use an old software program that always worked in the past than to take the time to master an updated version offering new features that could improve performance and efficiency over the long run.

So, what should a small business owner do? To get a better return on training and development spending, the owner must create a workplace environment that encourages people to use that training on the job. Here are some ways to achieve that type of environment:[34]

- *Develop an implementation plan*. People are more likely to do what they write down, so employees should develop something like a personal business plan for implementing the training they receive. For example, a company could require training participants to spell out what they will do to apply the concepts they have learned and when. They could then ask them to describe the results they expect, how those results will be measured, and when they expect to see them. Finally, it would be helpful for training participants to identify the assistance they would need to implement their plan.
- *Measure results*. Employees will be more likely to put training to use if they know their performance will be evaluated in light of the new concepts

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learned. Companies can do this by measuring skills addressed in the training or by assessing the productivity improvement of work groups.

- *Get peers to help*. Peer support has the greatest impact on the effective translation of training to workplace application. When trainees get together to discuss the use of training concepts, they are more inspired to give them a try.
- *Involve supportive superiors*. Management involvement increases the odds that trainees will use what they learn. When supervisors meet with trainees, they can communicate expectations, promote focus on concepts, provide encouragement, and eliminate obstacles that can block success.
- *Provide access to experts*. Companies can assist employees with their action plans by helping to fill gaps in their understanding. Lingering questions can be answered by providing access to reference materials, additional information on training topics, and experts within the company or from outside sources. Employees who have follow-up meetings with instructors are more likely to apply their training.

Companies that make sure their employees apply the concepts they learn in training to their work are likely to outperform their competitors. In fact, an enterprise that bears the expense of an extensive training program but fails to enjoy any of the fruits of that investment is much more likely to fail in a competitive marketplace.

20-3e Development of Managerial and Professional Employees

A small business has a particularly strong need to develop managerial and professional employees. Whether the firm has only a few key positions or many, it must ensure that the individuals who hold these positions perform effectively. Ideally, other staff members should be trained as potential replacements in case key individuals retire or leave for other reasons. Although an owner-manager often postpones grooming a personal replacement, this step is crucial in ensuring a smooth transition in the firm's management.

Establishing a management development program requires serious consideration of the following factors:

- *The need for development*. What vacancies are expected? Who needs to be developed? What type of training and how much training are needed to meet the demands of the job description?
- *A plan for development*. How can the individuals be developed? Do their current responsibilities permit them to learn? Can they be assigned additional duties? Should they be given temporary assignments in other areas—for example, should they be shifted from production to sales? Would additional schooling be beneficial?
- *A timetable for development*. When should the development process begin? How much can be accomplished in the next six months or one year?
- *Employee counseling*. Do the individuals understand their need for development? Are they aware of their prospects within the firm? Has an understanding been reached as to the nature of the development program? Have the employees been consulted regularly about progress in their work and the problems confronting them? Have they been given the benefit of the owner's experience and insights without having decisions made for them?

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Management development strategies often work wonderfully, but they do have their limits. Indeed, the best development strategy may begin with making sure you do not promote an employee beyond the position they are best suited to perform, as a top player in one position can be a less-than-satisfactory player in another. And there are no guarantees that investing in a manager's development will make that manager more likely to stay with the company—in fact, it will only make them more capable and therefore more of a headhunting target for your competitors! But as Henry Ford is said to have declared, "The only thing worse than training your employees and having them leave is not training them and having them stay."[35] In other words, management development simply makes sound business sense, all possible outcomes considered.

20-4 Explain the various types of compensation plans, including the use of incentive plans.

20-4 Compensation and Incentives for Employees

Compensation is important to all employees, and small firms must acknowledge the role of the paycheck in attracting and motivating personnel. In addition, small firms can offer several nonfinancial incentives that appeal to both managerial and nonmanagerial employees.

20-4a Wage and Salary Levels

In general, small firms must be roughly competitive in wage and salary levels in order to attract well-qualified personnel. Payments to employees either are based on increments of time—such as an hour, a day, or a month—or vary with the output of the employees. Compensation based on time is most appropriate for jobs in which performance is not easily measured. Time-based compensation is also easier to understand and is used more widely than incentive systems that are based on specific dimensions of employee performance.

Many small businesses struggle to pay their lowest-level employees even the minimum wage required by law. However, an increasing number of employers are choosing to improve the lives of their employees and express their support by paying wages that exceed that legal minimum. For example, the In-N-Out Burger fast food chain has grown quickly over the years by following a few simple practices, including caring for its employees by paying above-minimum wages. According to the company's website, "We start all our new Associates at a competitive wage for one simple reason . . . you are important to us! And our commitment to a higher starting wage is just one of the ways in which we show it."[36] In the case of In-N-Out Burger, "a competitive wage" far exceed established minimum wage levels in the states where the company has restaurants.

Businesses that go out of their way to take care of their people often benefit along with the employees. Many see an improvement in recruiting and retention, particularly in hard-to-fill positions. These businesses may also enjoy an improved public image with customers and the community. In other words, they can earn a respectable return on their investment—on more than one front!

Small companies have reported that well-designed compensation plans can help to boost employee work performance and morale while reducing turnover. Offering pay raises, as appropriate, also motivates staff, with some evidence to show that splitting up raises (perhaps giving half as much of an increase, but twice as often) actually increases employee satisfaction and motivates them to work harder.[37] But one of the greatest advantages of being open-minded and reasonable about the compensation

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offered is that it helps to minimize discontent about one of the features of work that tends to generate a great deal of conflict. By keeping compensation from becoming a point of friction, you will help your employees stay focused on the work of the company.

20-4b Financial Incentives

Incentive plans are designed to motivate employees to increase their productivity. Incentive wages may constitute an employee's entire earnings or merely supplement regular wages or salary. The commission system for salespeople is one type of incentive compensation. (Chapter 17 provides an expanded discussion of this topic.) In manufacturing, employees are sometimes paid according to the number of units they produce, a practice called **piecework**. Although most incentive plans apply to employees as individuals, they may also involve the use of group incentives and team rewards.

General bonus or profit-sharing plans are especially important for managers and other key personnel, although they may also include lower-level employees. These plans provide employees with "a piece of the action" and may or may not involve assignment of shares of stock. Many profit-sharing plans simply entail distribution of a specified share of all profits or profits in excess of a target amount. Profit sharing serves more directly as a work-related incentive in small companies than in large corporations, because the connection between individual performance and success can be more easily appreciated in a small business.

Performance-based compensation plans must be designed carefully if they are to work successfully. Such plans should be devised with the aid of a consultant and/or an accountant's insight. Keys to developing effective bonus plans include the following:

- *Set attainable goals*. Performance-based compensation plans work best when workers believe that they can meet the targets. Complex financial measures or jargon-heavy benchmarks should be avoided—employees are motivated only by goals that they understand.
- *Include employees in planning*. Employees should have a voice in developing performance measures and changes to work systems. Incentive plans should be phased in gradually so that employees have a chance to get used to them.
- *Keep updating goals*. Performance-based plans must be continually adjusted to meet the changing needs of workers and customers. The life expectancy of such a plan may be no more than three or four years.

20-4c Stock Incentives

In young entrepreneurial ventures, stock options are sometimes used to attract, motivate, and hold onto key personnel. The option holders get the opportunity to share in the growing—perhaps even skyrocketing—value of the company's stock. If the business prospers sufficiently, such personnel can become millionaires.

But stock ownership need not be reserved only for executives or key personnel. Some small firms have created *employee stock ownership plans (ESOPs)*, which give employees a share of ownership in the business.[38] These plans may be structured in a variety of ways. For example, a share of annual profits may be designated for the purchase of company stock, which is then placed in a trust for employees. When

piecework
Financial incentive based on number of units produced.

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coupled with a commitment to employee participation in business operations, ESOPs can motivate employees, resulting in improvements in productivity.

ESOPs also can provide a way for owners to cash out and withdraw from a business without selling the firm to outsiders. Chapter 13 offers an expanded discussion of this topic.

20-4d Employee Benefits

Employee benefits include payments by the employer for such items as Social Security, vacation time, holidays, health insurance, and retirement compensation. All told, these benefits are expensive. According to the Bureau of Labor Statistics, their cost to the average firm is equal to about 31 percent of salary and wage payments.[39] And while increases in the cost of some benefits have slowed in recent years, the burden of these cost increases have been borne far more by employers than by employees.[40] In general, small companies are less generous than large firms when it comes to providing benefits for employees.[41] Even so, the cost of such benefits is a substantial part of total labor costs for these businesses.

Though employee benefits are expensive, a small company cannot ignore them if it is to compete effectively for good workers. In fact, job seekers have been choosing between employment opportunities based much more on the health-insurance benefits offered since the COVID-19 pandemic hit in 2020. This trend has highlighted even more the importance of providing access to high-quality healthcare. As further support of this idea, surveys have found that offering well-designed benefit packages—that is, plans that are tailored to the unique needs and preferences of workers—can result in higher levels of employee satisfaction, productivity, and retention.[42] But this is where small companies can really shine, because they are closer to their employees and typically have greater flexibility when it comes to accommodating different preferences.

To ensure fit, a limited but growing number of small businesses now use **flexible benefit programs** (or **cafeteria plans**), which allow employees to select the types of benefits they wish to receive. All employees receive a core level of coverage, such as basic health insurance, and then are allowed to choose how an employer-specified amount is to be divided among additional options—for example, dependent care assistance, group term life insurance, and additional health insurance.[43]

For small companies that wish to avoid the detailed paperwork associated with administering cafeteria plans, outside help is available. Many small firms—some with fewer than 25 employees—turn over the administration of their flexible benefit plans to outside consulting, payroll accounting, or insurance companies that provide such services for a monthly fee.

A number of firms have devised relatively affordable but meaningful "perks" that are customized to their particular situation but still signal appreciation for workers. Buying pizza for everyone on Fridays and giving each employee a paid day off for their birthday are just two examples. These small benefits make employment more attractive for employees and are motivating because they are often thoughtful and sometimes even personalized. Indeed, studies have shown that employees respond more positively to such rewards than to cash, especially when these gestures communicate that they are recognized and appreciated.[44] With a little creativity, these perks can be used to build morale, promote loyalty, and encourage healthy behaviors.

employee benefits
Supplements to compensation, designed to be attractive and useful to employees.

flexible benefit programs (cafeteria plans)
Benefit programs that allow employees to select the types of benefits they wish to receive.

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Living the Dream

Sorry Charlie, Your Unlimited Vacation Plans Have Been Canceled

CharlieHR

https://www.charliehr.com

Offer unlimited paid time off? Do you really expect me to pay my employees to sit around and do nothing? That's what some small business owners ask. Others are more open to the idea and have been willing to give it a try. But what does evidence and experience tell us about the practice?

Gene Marks is a business consultant and writer who makes a strong case for the value of using unlimited PTO (shorthand for the practice). For starters, he says this approach would give small companies an edge in the competitive race for talent—especially when it comes to millennials and others who "crave greater work-life balance, flexibility, and independence" and want to "feel more in control of their lives."

Most small business owners figure offering unlimited PTO to their employees will simply run up a big tab as workers spend more time vacationing and less time taking care of the work they were hired to do. But the evidence doesn't seem to support this conclusion. Research on the topic shows that employees with unlimited vacation plans actually took fewer days off, not more. The explanation for this phenomenon is based in psychology. "People, by nature, don't want to be missing out or they're concerned that [it will look like] they're taking advantage," Marks suggests. And many employees assume that taking too many days off would put at risk their bonuses and opportunities for promotion—perhaps even their jobs.

As icing on the cake for employers, if the company has a policy stating that it will pay for unused vacation time, then offering an unlimited PTO program eliminates all of that on the premise that there is no way to pay for an unlimited number of available vacation days. In fact, the courts have already heard a number of cases challenging the policy and have sided with the employers.

But does the policy work? Consider the experience of CharlieHR. Launched in 2015, this young software development company provides an easy-to-use "people platform" for small businesses. Its programs support these companies by pulling all parts of the HR process together, making them simpler and easier to manage. In a nutshell, the venture was created to help its clients improve their workplace culture by showing them how to onboard new hires seamlessly, make performance reviews engaging and effective, track time off and sick leave for easy planning and reporting, and improve other HR functions. In other words, the company really knows how to manage people. But three years after giving unlimited PTO a try, CharlieHR determined that it was time to pull the plug on the arrangement.

So, what went wrong?

Ben Gateley, CEO and co-founder of the company, offers a number of explanations for the policy's failure—at least at CharlieHR:

1. Taking away the limit on vacation days removes the cue suggesting that they should be taken. As this played out, the company's hard-working staff ended up taking too few days off, not too many.
2. It can create a sense of unfairness. When work shifts from an employee who is taking more time off to those who are still at work, it is easy for the office-faithful to feel cheated.
3. Not having a limit leads to anxiety because it takes away a clear definition of acceptable behavior that everyone can understand and follow.
4. The reality of running a business means that there will be times when employees simply can't be away, and that can create disagreements about which days should be off limits.

Though the policy didn't work at CharlieHR, that doesn't mean it can't work elsewhere, because it has! And it can offer advantages, to be sure. For example, firms allowing unlimited PTO find that it can enhance new staff recruitment, improve work-life balance, and boost employee morale. At the same time, though, this practice seems to work best for certain kinds of companies—mostly those that are very results-focused, have high-performing teams that are largely self-managing, and can offer the scheduling flexibility it takes to make the policy work.

Would unlimited PTO be right for your small business? That decision may have greater consequences than you are

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thinking, for good or bad. Therefore, you probably should take some time off to think about it. Just don't take forever.

Sources: CharlieHR, "The HR Software for Forward-Thinking Teams, https://www.charliehr.com, accessed July 23, 2021; Ben Gateley, "We Tried Unlimited Holiday for Three Years. Here's Everything that Went Wrong," https://www.charliehr.com/blog/we-tried-unlimited-holiday-heres-everything-that-went-wrong, accessed July 23, 2021; Elizabeth Gonzales, "Is Unlimited PTO Right for Your Small Business," *The Blueprint,* August 21, 2020, https://www.fool.com/the-blueprint/unlimited-pto, accessed July 23, 2021; Gene Marks, "An Unlimited PTO Plan Is Vital to Attract the Best Talent—and Saves Small Businesses Money," *The Guardian*, March 21, 2021.

20-5 Discuss the human resource issues of co-employment, legal protection, labor unions, and the formalizing of employer–employee relationships.

20-5 Special Issues in Human Resource Management

So far, this chapter has dealt with the recruitment, selection, training, and compensation of employees. Several related issues—co-employment agreements, legal protection of employees, labor unions, the formalizing of employer-employee relationships, and the need for a human resource manager—are the focus of this final section.

20-5a Co-Employment Agreements

Entrepreneurs can choose to outsource part of the burden of managing employees through an arrangement known as **co-employment**. Today, nearly 500 co-employment companies, also known as **professional employer organizations (PEOs)**, operate in all 50 states and assist small businesses with their human resource management needs. For a fee of 2 to 6 percent of payroll, a PEO will manage a company's increasingly complex employee-related matters, such as overseeing health benefit programs, handling workers' compensation claims, ensuring payroll tax compliance, processing unemployment insurance claims, and filing reports required by government agencies. Although small companies using this service avoid a certain amount of paperwork, they do not escape the tasks of recruitment and selection. In most cases, the entrepreneur or the venture's management still determines who works, who gets promoted, and who gets time off.

Many employees like the co-employment arrangement. It may allow small employers to provide better benefit packages, since PEOs generally cover hundreds or thousands of employees and thus qualify for better rates. Of course, the small business must bear the cost of insurance and other benefits obtained through a co-employment partner, in addition to paying a basic service fee. However, this may be the only way the company can afford to offer the benefits necessary to attract and keep high-quality employees, and the savings often will more than offset the cost of using a PEO. The fact that the co-employment partner also assumes the burden of managing payroll and other administrative processes makes this arrangement even more attractive.

When a company decides to use the services of a PEO, both parties share legal obligations as a result. That is, the law holds both companies responsible for payment of payroll taxes and workers' compensation insurance and compliance with government regulations—the client company cannot simply offload these obligations to the PEO. This highlights the importance of selecting a PEO carefully to ensure that you will be dealing with a responsible firm. It is wise to follow the guidelines offered by the National Association of Professional Employer Organizations (napeo.org) to be sure you are contracting with a service provider that is honest, dependable, and right for your company.

co-employment
An arrangement to outsource part of personnel management to an organization that handles paperwork and administers benefits for those employees.

professional employer organization (PEO)
A company that sets up co-employment agreements.

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Using a PEO can also change the application of government regulations to small businesses. Very small ventures are often excluded from specific rules. For example, companies with fewer than 15 employees are exempt from the Americans with Disabilities Act (with some exceptions, such as where state law holds even small ventures to a high standard). However, when these employees officially become part of a large PEO, the small company using the co-employed workers becomes subject to this law. It always pays to treat your employees with care and respect, of course, but taking on added legal obligations by working with a PEO can in some ways make managing a small company more complicated. Clearly, there are upsides, though, and that is why the use of co-employment has been growing. It also helps that research has shown that companies using PEOs "grow 7 to 9 percent faster, have 10 to 14 percent less employee turnover, and are 50 percent less likely to go out of business."[45]

20-5b Legal Protection of Employees

Employees are afforded protection by a number of federal and state laws. The U.S. Department of Labor (DOL) provides a summary of the principal labor statutes that it administers and enforces,[46] but it can be difficult to sort out which of these will apply to your particular business. For that reason, the DOL has created the "*FirstStep* Employment Law Advisor," and we strongly recommend that you use it. By answering a few brief questions about your business, this interactive e-tool will direct you to summaries of the statutes that will affect ventures such as yours. It also provides guidance on recordkeeping, reporting, and notification requirements that you must follow.

This information still does not cover everything that you need to know, including state laws that may apply. To fill any gaps, we recommend that you gather as much information as you can from the DOL's "Employment Law Guide" and the same agency's "State Labor Laws" webpages. But even with these facts in hand, it is best to consult with an attorney to be sure that you are in compliance. It is also advisable to be familiar with some of the broader statutes that shape and influence the wide scope of labor law in the United States.

One of the most far-reaching statutes is the **Civil Rights Act**, originally enacted in 1964, and its amendments. This law, which applies to any employer with 15 or more people, prohibits employment discrimination on the basis of race, color, religion, sex, or national origin. Other laws, such as the Americans with Disabilities Act and the Age Discrimination in Employment Act, extend similar protection to disabled and older employees. Every employment condition is covered, including hiring, firing, promotion, transfer, and compensation.

The Civil Rights Act includes protection against sexual harassment, an issue that must be addressed by small businesses as well as large corporations. Education and prompt responses to complaints are the best tools for avoiding sexual harassment and the possibility of liability claims. The following practical action steps can help a small company prevent sexual harassment from occurring in its workplace and avoid liability if a claim should arise:[47]

1. Establish clear policies and procedures regarding sexual harassment in the workplace, and publish this information in an employee handbook.
2. Define *sexual harassment* in the handbook, and state in no uncertain terms that it will not be tolerated and that wrongdoers will be disciplined or fired.
3. Communicate a clear procedure for filing sexual harassment claims, and require employees to report incidents of harassment to management immediately.

Civil Rights Act
Legislation prohibiting discrimination based on race, color, religion, sex, or national origin.

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4. Explain that any and all complaints of sexual harassment will be investigated fairly and fully (while assuring claimant confidentiality) and that retaliation against anyone who complains about sexual harassment will not be tolerated.
5. Conduct sessions at least once a year to teach employees and managers (separately) about sexual harassment and the company's complaint procedure and encourage them to use the procedure if harassment should occur.

Of course, even a well-designed and carefully implemented action plan cannot guarantee that a sexual harassment claim will never be filed. And if that should happen, it would be wise to contact an attorney and proceed according to their counsel.

Employees' health and safety are protected by the **Occupational Safety and Health Act** of 1970. This law, which applies in general to firms of any size doing business in the United States and/or its territories, created the Occupational Safety and Health Administration (OSHA) to establish and enforce necessary safety and health standards. But when it comes to determining the requirements that will be applied to your small company, keep in mind that your state might apply even more demanding workplace safety rules than those mandated under federal law. To learn more about how OSHA requirements apply to start-ups and small companies, consult the administration's *Small Business Safety and Health Handbook,* which is easy to access online for free.

Compensation of employees is regulated by the minimum wage and overtime provisions of the **Fair Labor Standards Act (FLSA)**, as well as by other federal and state laws. The FLSA applies to employers involved in interstate or foreign commerce or those with annual sales of $500,000 or more. In reality, though, the law covers nearly all businesses because of the way the courts have interpreted it.[48] The act sets the minimum wage (which is periodically increased by Congress) and specifies no less than time-and-a-half pay for most employees if they work more than 40 hours per week. Penalties for noncompliance can be severe, so it is advisable to review the details of the law as posted on the U.S. Department of Labor's website.

The **Family and Medical Leave Act** was passed and signed into law in 1993. The law requires firms with 50 or more employees to allow workers as much as 12 weeks of unpaid leave under any of the following conditions:

- Birth and care of a newborn child of the employee.
- Placement of a child for adoption or foster care with the employee.
- Care of an immediate family member with a serious health condition.
- An employee who cannot work due to a serious health condition.
- A qualified need resulting from military deployment in the family.

Up to 26 weeks of leave is to be granted in circumstances involving the care of a military servicemember with a serious injury or illness—that is, if the caregiver is the spouse, child, parent, or next of kin of that servicemember.

Occupational Safety and Health Act
Legislation that regulates the safety of workplaces and work practices.

Fair Labor Standards Act (FLSA)
Federal law that establishes a minimum wage and provides for overtime pay.

Family and Medical Leave Act
Legislation that assures employees of unpaid leave for childbirth or other family needs.

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To be eligible for leave, the worker must have been employed by the firm for at least 12 months and have worked at least 1,250 hours over the previous 12 months. Furthermore, the employer must continue healthcare coverage during the leave and guarantee that the employee can return to the same job or one that is comparable.[49]

20-5c Labor Unions

As a general rule, entrepreneurs prefer to operate independently and to avoid using union laborers. Indeed, most small businesses are not unionized. To some extent, this results from the predominance of small business in services, where unionization is less common than in manufacturing. Also, unions typically focus their attention on large corporations.

Though uncommon, labor unions are not unknown in small firms. Many types of small businesses—building and electrical contractors, for example—negotiate labor contracts and employ unionized personnel. The need to work with a union formalizes and, to some extent, complicates the relationship between a small company and its employees.

If employees wish to bargain collectively—that is, to be represented in negotiations by a union—the law in many states requires the employer to participate in such bargaining. The demand for labor union representation may arise from employees' dissatisfaction with their pay, work environment, or employment relationships. By following constructive human resource policies, a small company can minimize the likelihood of labor organization and improve the relationship between management and employees.

20-5d Formalizing Employer–Employee Relationships

As explained earlier in this chapter, the management systems of small companies are typically less formal than those of larger firms. A degree of informality can be a virtue in small organizations. As personnel are added, however, the benefits of informality decline and its costs increase. Large numbers of employees cannot be managed effectively without some system for regulating employer–employee relationships. This situation can be best understood in terms of a family relationship. House rules are generally unnecessary when only two people are living in the home. But when several children are added to the mix, parents soon start sounding like a government regulatory agency.

Growth, then, creates pressure to formalize personnel policies and procedures. Determining how much formality to introduce and how soon involves managerial judgment. Some employee issues should be formalized from the very beginning. On the other hand, excessive regulation can become paralyzing.

Personnel management procedures are standardized in many companies, using performance assessment systems that follow a set timetable for reviews—often on an annual basis. But effective performance review programs tend to bear certain hallmarks. For example, they are guided by clearly established benchmarks that are based on goals that are SMART—that is, *S*pecific, *M*easurable, *A*chievable, *R*ealistic, and *T*ime-bound. They also tend to follow a well-planned process that highlights the connection between individual goals and the priorities of the business and emphasizes continual communication between managers and employees to ensure effective ongoing performance tracking. Effective review meetings require sufficient time (which will depend on how often assessments are conducted) and undivided attention, and they should begin with positive feedback before summarizing objective judgments of attitudes and behaviors in need of improvement. Used correctly, employee reviews can be a powerful tool for building a small business.

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Many firms are modifying their performance review processes to accommodate rapidly changing work conditions and shifting employee needs and attitudes. Some of these adjustments include more frequent setting and resetting of goals (which studies show leads to better performance than annual goals) and addressing performance problems immediately rather than waiting for a scheduled formal review. The availability of abundant data and the means to analyze them make this more than manageable today.

A growing number of these firms are also asking their employees to assess their own performance (to determine expectations) and are adopting (mostly) online tools, such as Achievers and Globoforce, to create a setting in which employees feel comfortable providing feedback to one another on a continuous basis. To compete successfully these days, companies are realizing that they need to become more agile and work harder to attract and retain top talent, and that calls for improved performance review strategies.[50]

20-5e The Need for a Human Resource Manager

A venture with only a few employees cannot afford a full-time specialist to deal with personnel problems. And some of the human resource management techniques used in large corporations may be far too complicated for small businesses. As a small company grows in size, however, its personnel problems will increase in both number and complexity.

The point at which it becomes logical to hire a human resource manager cannot be precisely identified. In view of the increased overhead cost, the owner-manager of a growing business must decide whether circumstances make it profitable to employ a personnel specialist. Hiring a part-time human resource manager—a retired personnel manager, for example—is a possible first step in some instances. Conditions such as the following favor the appointment of a human resource manager in a small business:

- There are a substantial number of employees (100 or more is often suggested as a guideline).
- Employees are represented by a union.
- The labor turnover rate is high.
- The need for skilled or professional personnel creates problems in recruitment or selection.
- Supervisors or operations employees require considerable training.
- Employee morale is unsatisfactory.
- Industry competition for personnel is keen.

Until a human resource manager is hired, the owner-manager typically functions in that capacity. Their decisions regarding employee selection and compensation, as well as other personnel issues, will have a direct impact on the operating success of the firm.

As this chapter points out, the human resource management function is simple in concept, but it can be challenging to put into practice. From recruitment to prospect evaluation and selection to training and development programs to the administration of compensation and benefit plans—there is so much to do! And these activities must be conducted within the constraints of some very specific laws. While this may seem overwhelming, keep in mind that working with the people who join your enterprise is likely to be the most fulfilling feature of being in business. If they are managed carefully and motivated to do their best, capable employees can take your business to new heights. There is no limit to what can be done with the right people in the right enterprise with the right care and handling.

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20-1. Explain the importance of employee recruitment, and list some useful sources for finding suitable applicants.

- Start-ups have been launching with fewer employees in recent years, but recruiting good employees can boost the overall performance of a small business.
- Small companies can attract applicants by stressing their unique work features and opportunities.
- Recruitment sources include the Internet, schools, public and private employment agencies, temporary help agencies, employee referrals, executive search firms, and walk-ins and help-wanted advertising.
- The composition of the U.S. workforce is becoming more diverse over time with respect to race, ethnicity, gender, and age. The varied perspectives of a diverse workforce can offer advantages, such as improved decision-making.
- Well-developed job descriptions can help with employee recruitment, but they can also be useful in other ways, such as bringing focus to work performed, providing direction to training, and serving as a guide for performance reviews.

20-2. List the steps in evaluating job applicants.

- In the first step, application forms help the employer obtain preliminary information from applicants. (Employers must avoid questions about sex, race, religion, color, national origin, age, and disabilities.)
- Additional evaluation steps are interviewing the applicant (with behavioral interviews offering the best insights), checking references and other background information, and testing the applicant.
- The final evaluation step is often a physical examination, which may include screening for drug use.

20-3. Describe the roles of training and development for both managerial and nonmanagerial employees.

- Employee training enables nonmanagerial employees to perform their current jobs effectively. Management development prepares them for career advancement.
- An orientation program helps introduce new employees to the firm and its work environment.
- Training is an integral component of a comprehensive quality management program.
- More training is accomplished on the job than through any other method. Following the steps in Job Instruction Training should make training more effective.
- Training is more likely to be put to use if it is written down, measured for results, structured for peer support, encouraged by management, and supported with ongoing advice from experts.
- A management development program should be guided by an understanding of the need for development, a plan for development, and a timetable for development. It should also provide appropriate employee counseling.

20-4. Explain the various types of compensation plans, including the use of incentive plans.

- Small companies must be roughly competitive in salary and wage levels in order to attract well-qualified personnel.
- Payments to employees either are based on increments of time or vary with employee output.
- Incentive systems relate compensation to various measures of performance.
- Employee stock ownership plans enable employees to own a share of the business and provide motivation for improved productivity.
- Employee benefit costs often equal 31 percent of payroll costs and can include flexible benefit programs, which allow employees to select the types of benefits they wish to receive.

20-5. Discuss the human resource issues of co-employment, legal protection, labor unions, and the formalizing of employer–employee relationships.

- Small businesses can reduce paperwork by transferring personnel to the payroll of a professional employer organization (PEO) through a co-employment arrangement, but legal obligations remain and may actually increase.

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- Depending on their size, small businesses may have to observe laws that prohibit discrimination and sexual harassment, protect employee health and safety, establish a minimum wage, and provide for family and medical leave.
- Some small businesses must work with labor unions, which may involve collective bargaining.
- As small firms grow, they must adopt more formal human resource management methods, including regular performance reviews.
- Employment of a human resource manager usually becomes necessary as a company grows in size.

Key Terms

behavioral interviews p. 543
Civil Rights Act p. 557
co-employment p. 556
employee benefits p. 554
employee training p. 547
Fair Labor Standards Act (FLSA) p. 558
Family and Medical Leave Act p. 558
flexible benefit programs (cafeteria plans) p. 554
headhunters p. 540
human resource management (HRM) p. 533
job description p. 541
Job Instruction Training p. 549
job specification p. 542
management development p. 547
Occupational Safety and Health Act p. 558
on-the-job training p. 549
piecework p. 553
professional employer organizations (PEOs) p. 556
reliability p. 546
validity p. 546
workforce diversity p. 540

Chapter 20 Case

Please see Appendix A for the Chapter 20 Case Study.

Discussion Questions

1. Why is it so important for a small business to have high-quality employees?
2. What factor or factors would make you cautious about going to work for a small business? Could these reasons for hesitation be overcome? How?
3. In what ways is the workforce becoming more diverse, and how do these changes affect recruitment by small companies?
4. What do you think are the most serious weaknesses in the interviewing process of many small businesses? How could these be remedied?
5. What are the positive and negative features of background checks? How important are these checks to the selection of high-quality employees?
6. What steps and/or topics should be included in an orientation program if it is to be effective? What outcomes can reasonably be expected from running new employees through such a program?
7. What problems are involved in using incentive plans in a small company? How would the nature of the work affect management's decision concerning the use of such a plan?
8. Is the use of an employee stock ownership plan desirable in a small business? What might lessen such a plan's effectiveness in motivating employees?
9. How does a professional employer organization (PEO) differ from a temporary help agency? What are the greatest benefits of co-employment?
10. What impact do the Civil Rights Act and the Fair Labor Standards Act have on human resource management in a small business?

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You Make the Call

Situation 1

While trying to find a new accounts receivable employee for his Chicago-based postcard printing business, Javier Gomez decided that he had surely found the perfect applicant. On paper, this applicant had the right background and was asking for less money than Gomez was willing to pay. The interview went well, the reference check was positive, and the drug test came back clear. A few odd twists in the applicant's story, though, have created some questions for Gomez. First, during the hiring process, the applicant failed to show a driver's license, producing only an Illinois state I.D. card. (A driver's license is needed to operate a motor vehicle legally, but the state also issues I.D. cards to help Illinois residents prove their identity when banking, traveling, and in other situations.) Second, under work experience, the applicant indicated 12 years with a previous company and thus could provide only one appropriate reference. Gomez always asks for three references so he can contact them all and look for patterns of behavior. Finally, the applicant mentioned in passing that if hired, it would be a pleasure to perform tasks beyond those listed in the job description for the position, such as dropping the company's mail off at the post office as needed. Gomez has had plenty of employees ask if they could take on new responsibilities, but doing post office runs was never one of them.

As Gomez pondered his hiring decision, he kept coming back to the fact that if the perfect applicant were hired, the accounts receivable job would provide access to cash, blank checks, and financially sensitive information. And if allowed to take the company's mail to the post office, the applicant would have access to that, too. In so many ways, the perfect applicant seemed to be exactly what Gomez was looking for, but the strange details left Gomez wondering if hiring this person would be wise.

Question 1 With the information available at this point, do you think Gomez should hire this applicant? How much weight should be given to the fact that the applicant doesn't, for example, have a driver's license?

Question 2 How important are reference checks in the hiring process? Should having only one reference cause any concern? Why or why not? What potential problems can you see in this?

Question 3 The applicant seems to be just the person for the job in so many ways. Does it make sense to think about restructuring the job (for example, limiting access to cash and blank checks as much as possible) to minimize the concerns that have surfaced in the hiring process? Should a job ever be structured for a specific employee?

Situation 2

Madison Keller is the hiring manager at an advertising agency, and she must choose between two final candidates, Terry Ellis and Sarah Renfro, for a senior media specialist position in the firm. Both applicants are equally qualified. However, Ellis had the edge at first because of the reports Keller was getting about his very impressive leadership and analytical skills and the strong work ethic he has exhibited in the past. But when she Googled both candidates, a different impression emerged. The search on Renfro revealed only work-related sites that seemed solid. Entries on Ellis were more noteworthy, including references to nonprofit work and an award for exemplary community service. Unfortunately for Ellis, though, one of his friends failed to enable the privacy settings on his Facebook page, opening a back door that led Keller to pictures of Ellis drinking and partying with friends from his college days. The reference to "smokin' blunts" was particularly damaging, and the overall profile convinced Keller that it would be best to hire Renfro, which is exactly what she did.

It is very efficient to conduct online searches. This is why Keller has come to prefer them to the laborious task of checking references, especially since previous employers have become very reluctant to reveal anything negative about a past employee out of concern for legal complications later. However, she is very much aware that there may be problems with this method, and that is causing her to wonder if she should really be using it. For example, Ellis is only one of many job candidates in recent years on whom she has taken a pass because of the reputational damage caused by the online behavior of friends—damage that could have been prevented if they had been more careful with their privacy settings. And there is a question of fairness as well. Ellis was prudent enough to select appropriate privacy settings on his own Facebook page, but it was his friend who let the cat out of the misbehavior bag. The photos seemed to provide evidence of wild conduct, but what if the friend's posts were exaggerated and misleading? Ellis will never know that this was the reason that he was passed over for the job, so he won't have an opportunity to explain. Such are the drawbacks to using social media in the hiring process.

Question 1 What are the major advantages and disadvantages for employers that choose to use social media to screen job candidates? What are the major benefits and drawbacks for job candidates who are evaluated in this way?

Question 2 What are the most important ethical questions that should be addressed if a small company should decide to use social media tools in its assessment of prospective employees? Can all of these questions be addressed to your satisfaction? Why or why not?

Question 3 The use of social media in employee recruitment and evaluation continues to increase as time goes on. Since there is little question that these tools are going to be even more widely used in the future, what guidelines would you recommend to any small business that chooses to take this path?

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Situation 3

John Abelson had a promising idea for a new business. Sizing up the situation at the time, he concluded that the few retailers that specialized in the sale of men's ties had it all wrong. They were always behind when it came to keeping up with the latest fabrics, patterns, and style trends. He wanted to come up with a concept that would become the go-to website for men's ties, mixing style news, social networking, and personalized neckwear recommendations with e-commerce. So he and a partner started TiesInStyle.com to fill the void. But given their limited start-up capital, they had to come up with a creative way to staff their new venture on a shoestring.

How were they going to get people to work for a new company for free—especially when they would have to live in New York, one of the most expensive cities in the United States? Simple—they would "hire" interns. As it turns out, they found that there are plenty of young graduates with diplomas from excellent universities or fashion institutes and dreams of a career amidst the glitz and glamour of the men's fashion world, but with scant job prospects because there are so few openings available for the horde of interested applicants. Many of them have accepted Abelson's offer, seeing it as a chance to get a foot in the door of a competitive industry and to make contacts for future opportunities. At last count, TiesInStyle.com had 21 unpaid part-time interns signed up to assist the firm's 7 regular employees.

Question 1 Do you think interns make the best employees for a small business like TiesInStyle.com? Does the fact that the company is a start-up create any potential complications that you can think of?

Question 2 What adjustments would a small company need to make to its selection practices if it decided to take on unpaid interns in place of hiring regular, paid employees?

Question 3 Do you see any ethical issues that should be considered when hiring unpaid interns? Read the U.S. Department of Labor's Fact Sheet #71, "Internship Programs under the Fair Labor Standards Act" that can be found at https://www.dol.gov/agencies/whd/fact-sheets/71-flsa-internships. Do you think Abelson's use of interns is in compliance with these regulations?

Experiential Exercises

1. Invite the director of the placement office at your college or university to speak to your class. Ask about the extent to which small companies use the office's services, and obtain the director's recommendations for improving college recruiting by small firms. Prepare a one-page summary of your findings.
2. Examine and evaluate the positions in your state that are listed on a popular job board. Summarize your conclusions and formulate some generalizations about small business advertising for personnel.
3. With another student, form an interviewer–interviewee team. Take turns posing as job applicants for a selected type of job vacancy. Critique each other's performance, using the interviewing principles outlined in this chapter.
4. With another student, take turns playing the roles of trainer and trainee. The student-trainer should select a simple task and teach it to the student-trainee, using the Job Instruction Training method outlined in Exhibit 20.2. Jointly critique the teaching performance after each turn.

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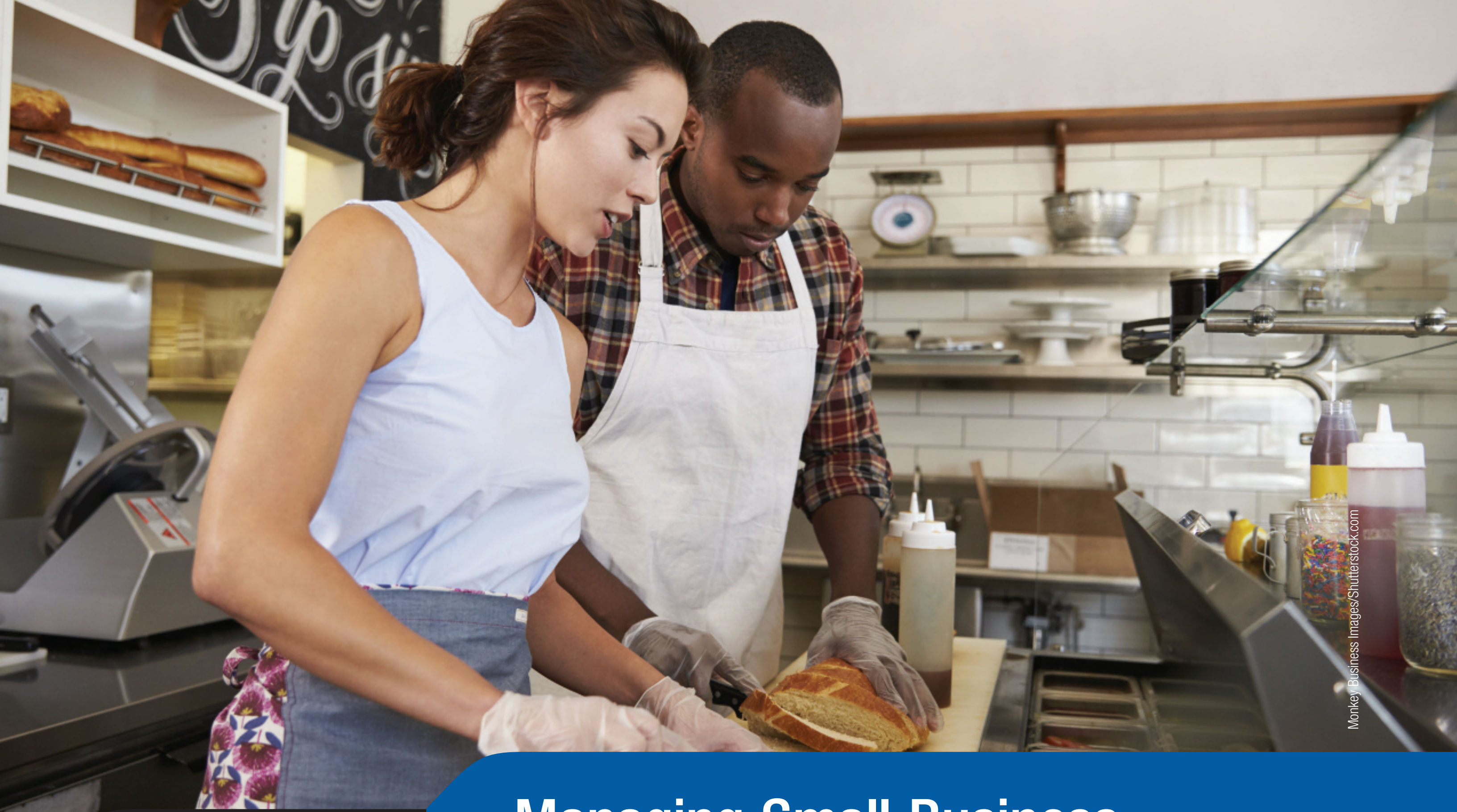

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Chapter 21

Managing Small Business Operations

Looking Ahead

Learning Objectives

In this chapter, we will help you to grasp the importance of managing a small business from an operational point of view. By studying this chapter, you should be able to . . .

21-1 Describe how operations enhance a small company's competitiveness.

21-2 Discuss the nature of the operations process for both products and services.

21-3 Identify ways to control inventory and minimize inventory costs.

21-4 Summarize the contributions of operations management to product and service quality.

21-5 Explain the importance of purchasing and the nature of key purchasing policies.

21-6 Describe lean production, synchronous management, and the value these approaches provide to the overall operations management of a small business.

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Spotlight on Small Business

Roscoe Village Bikes

https://roscoevillagebikes.com

The COVID-19 pandemic disrupted the lives of tens of millions of Americans—and with dreadful consequences for so many. But the devastation it wreaked on countless small businesses was also severe. At the top of the list of problems was the widespread dislocation of supply chains, which forced companies to radically transform the way they do business.

Roscoe Village Bikes is a good example of a small business that was impacted. Opened by Alex and Lesley Tweedie in March of 2007, this Chicago-based shop sells a wide range of bicycles, cycling-related products, and repair services. But by the time the summer of 2021 had rolled around, the store's sales were down 10 percent from the same time the year before. However, the cause of the decline was not a drop off in demand; it was a decrease in supply. No matter how much the Tweedies wanted to provide every customer who came through their doors with the bike or part of their choice, that was out of the question for many because of stock shortages that had resulted from pandemic-caused supply chain hang-ups.

Many bikes and bike parts were ready and waiting to be shipped but were delayed because ports were backed up. To complicate matters, businesses also were experiencing shortages of workers. It was a double-whammy, and then some. One of the most frustrating challenges for small businesses that saw a rise in demand during the pandemic, including Roscoe Village Bikes, was to figure out how to match supply with order increases.

These developments turned the focus to the great importance of smooth-running and reliable supply chains. In response, small business owners like the Tweedies determined to pay closer attention to this feature of their operations. Part of the answer was to simplify the system so it would be more stable and reliable. Brady Maller, executive vice president of strategy and sales at outdoor furniture maker POLYWOOD, explains why this change is so important.

> It only takes one missing component to put an entire production line and workforce at a standstill. Try selling coffee without a cup, building furniture without fasteners or constructing a house when windows are backordered. The unusual disruption [during the pandemic] has been the shortage in items that just a year ago seemed limitless.

Many companies were working to solve these supply chain problems by using technology to capture a detailed view of stock levels and predict when they would need to reorder product. This can help ensure that the company isn't holding so little inventory that it suffers stockouts—or so much that it racks up unnecessary carrying costs. Developing more coordinated relationships with suppliers and seeking advice from industry specialists can also help a small business anticipate future purchasing trends and be certain that they have sufficient inventory to match them. Most of all, it pays greatly to have a clear plan and the flexibility to adjust as needed.

Looking forward, many small companies need to adjust the way they manage their supply chains. For a venture like Roscoe Village Bikes, you might say that shifting gears has never been more important. But heads-up entrepreneurs are used to paying close attention to current conditions so they can fine tune their business operations to meet whatever challenges life sends their way.

Sources: Joe Barrett, "Small businesses on One Chicago Street Struggle to Meet Demand as Covid-19 Restrictions End," *The Wall Street Journal*, June 21, 2021, https://www.wsj.com/articles/small-businesses-on-one-chicago-street-struggle-to-meet-demand-as-covid-19-restrictions-end-11624267802, accessed on June 29, 2021; Nicole Fallon, "5 Ways to Simplify Your Inventory Management," *U.S. Chamber of Commerce*, https://www.uschamber.com/co/run/technology/simplify-inventory-management, accessed June 29, 2021; and Roscoe Village Bikes, "About Roscoe Village Bikes," https://roscoevillagebikes.com/about, accessed June 29, 2021.

Managing operations almost sounds like something that happens in a hospital, but you don't have to be a doctor to manage the kind of operations we discuss in this chapter. Effective operations management is all about understanding the individual activities involved in a company's creation of goods and services and the way they fit together in an orderly sequence—and then managing these activities with efficiency in mind.

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The name of the game is coordination, but entrepreneurs tend to underestimate the amount of effort required to keep the people and processes in a business functioning and working smoothly together. If one link fails, the work of the entire team comes up short.

Many of the concepts presented in this chapter were pioneered and perfected by large corporations. However, this does not mean that they have no place in the world of small business. In some cases, the concepts can be applied directly; in others, they must be adapted before they can meet the needs of small companies.

Entrepreneurs who work to improve their operations will find that their companies are better able to withstand the escalating pressures of the competitive marketplace—including those coming from the Amazons, AT&Ts, and Ford Motor Companies of the world. Understanding and adopting the best practices of industry giants may also give your small company a pattern to follow as it grows to become a market leader of the future. Whether they are used in a manufacturing business or a service-based company, these principles can drive profits.

21-1 Competing with Operations

21-1 Describe how operations enhance a small company's competitiveness.

In very simple terms, **operations** refers to the processes used to create and deliver a product or service. By now, it should be clear that companies vary considerably in how they compete for customers, and the planning and management of operations almost always play a major role in this. You are probably familiar with high-profile examples, such as Apple's superior design efforts, Walgreens's emphasis on convenient locations, and Walmart's highly efficient supply chain and distribution capabilities. These companies are truly world-class players. In the end, however, the formula for gaining competitive strength is surprisingly similar for all firms: Companies gain power to the degree that they excel in satisfying customer needs and wants more precisely and/or efficiently than their competitors.

To be successful, a company's operations must involve all of the activities required to create value for customers and earn their dollars. A bakery, for example, purchases ingredients, combines and bakes them, and makes its products available to customers at some appropriate location. For a service business like a hair salon, activities include the purchase of supplies and shampooing, haircutting, and other tasks and processes involved in serving its clients. A bakery cannot offer its products without operating its ovens, and a hair salon cannot serve its clients without actually styling hair. (Outsourcing these activities presents one possible, but highly practical exception to this view.) In the end, *all* necessary activities must be handled in some form if the company's operations are to function.

Operations management refers to the planning and control of a conversion process that includes bringing together inputs (such as raw materials, equipment, and labor) and turning them into outputs (products and services) that customers want. An operations process is required whether a firm produces a tangible product, such as a cupcake from a bakery, or provides an intangible service, such as dry cleaning.

Operations are at the heart of any business. Indeed, a company would not be able to exist without them. It should come as no surprise, then, that their design and effectiveness can determine the success of an enterprise. The following questions can help you to identify operations factors that will impact firm performance and to recognize adjustments that need to be made:

- How much flexibility is required to satisfy your customers over time?
- What is customer demand today? What is the demand trend for the future? Are existing facilities and equipment adequate to keep up with current and future demand?

operations
The processes used to create and deliver a product or service.

operations management
The planning and control of a conversion process that includes turning inputs into outputs that customers desire.

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- What options are available for satisfying your customers? For example, should you set up in-house fabrication, outsource production, or enter a joint venture for manufacturing or service delivery?
- What operations-related skills or capabilities set your firm apart from its competitors? How can you best take advantage of these distinctive features in the marketplace?
- Does the competitive environment require certain capabilities that your enterprise lacks?

Our focus in this chapter is on examining the ways a business can function economically and profitably, providing a high-quality product or service that keeps customers coming back for more. But even more significantly, we discuss how operations management is an important means of building competitive strength in the marketplace. For this, there is no substitute.

21-2 Discuss the nature of the operations process for both products and services.

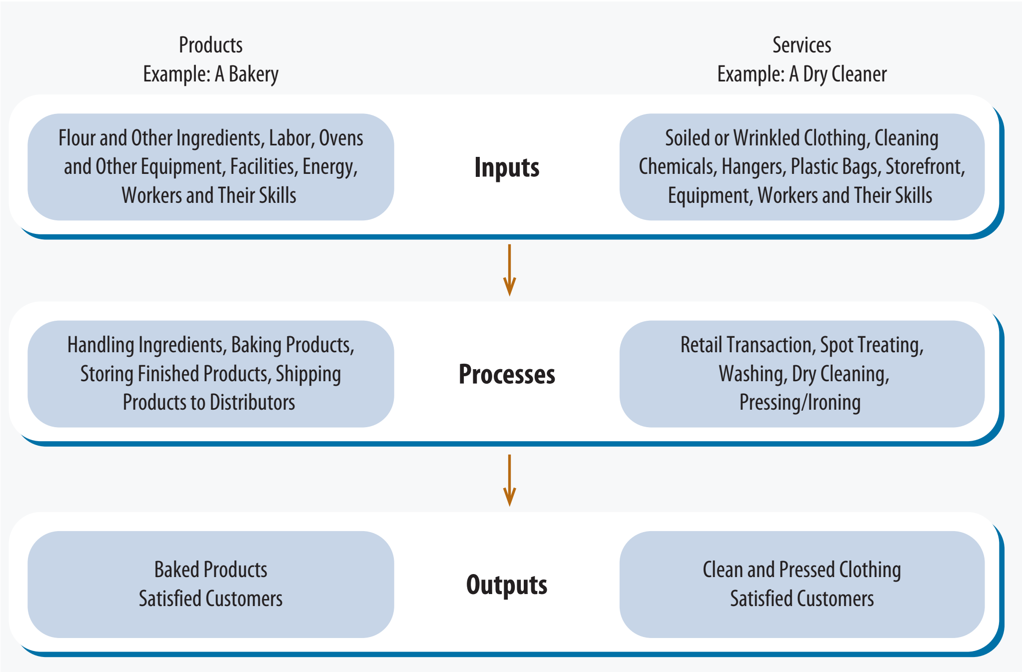
21-2 The Operations Process

Product-oriented and service-oriented operations are similar in that they change inputs into outputs. Inputs can include money, raw materials, labor, equipment, information, and energy—all of which are combined in varying proportions, depending on the nature of the finished product or service. Outputs are the products and/or services that a business provides to its customers. Thus, the operations process may be described as a conversion process, as shown in Exhibit 21.1.

21-2a The Operations Process in a Service Business

The operations of firms that provide services differ from those of firms that provide products in a number of ways. One of the most obvious is the intangible nature of

Exhibit 21.1 The Operations Process



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services—that is, the fact that you cannot easily see or measure them. Managers of businesses such as auto repair shops and hotels face special challenges in ensuring and controlling the quality of their services, given the difficulty inherent in measuring and controlling intangibles.

Another distinctive feature of most service businesses is the extensive personal interactions of employees with customers. In a physical fitness facility, for example, the customer is directly involved in the process and relates personally to trainers and other service personnel. In a small movie theater operation, it only makes sense to show a film when patrons are present to watch it. This naturally allows for customer input and feedback into creation and delivery processes. In addition, services are created and delivered on demand. That is, neither a workout nor a movie viewing experience can be entered into finished products inventory.


Monkey Business Images/Shutterstock.com

Managing the operations of a service business will be very different from managing the operations of a product-based venture, mostly because of the intangible nature of services and the extensive employee–customer interactions they require.

Some service companies have taken unique steps to understand the service provider–customer connection. Firms like Southwest Airlines, for example, want their managers to get close enough to customers to hear what they have to say about various facets of the operation. To that end, they are sent into the field periodically to fill customer-contact positions, which allows them to return to their normal responsibilities with much greater insights into the strengths and weaknesses of services offered. Closer interactions with customers enable employees to understand and report customer sentiments more accurately.

For a service business, the critical importance of its relationship with customers carries implications for managing personnel. An open position that involves a great deal of sensitive interaction with clients requires that those making hiring decisions select individuals with strong interpersonal skills for that vacancy. Employee training must emphasize the skills needed to serve customers well and encourage employees to find ways to improve customer satisfaction.

Various technologies have enabled customers of many businesses to provide more of their own services. More and more hotels are offering their guests self-check-out options, and many telephone systems allow or even encourage customers to obtain information without speaking to a salesperson or other staff. The extent to which such systems are satisfactory from a customer's point of view depends on whether they are more convenient than traditional systems and whether they function efficiently and accurately in meeting customer needs.

In some cases, technology can provide even better service than the traditional model. Consider traditional bookstores and their online counterparts. When browsing an e-commerce website, for example, a shopper could be provided with customer-driven information, such as the following:

- Customer reviews.
- Other items customers bought after viewing this item.
- Products you may also like.

The insights provided by these options can help visitors find services that interest them, and that leads to increased customer satisfaction. The most well-informed employee of a traditional bookstore would have trouble providing similar data.

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21-2b The Operations Process in a Manufacturing Business

Manufacturing operations can take many forms, depending on the degree to which they are repetitive. For example, a master craftsman furniture maker who makes customized pieces follows a very different process than do auto workers who assemble hundreds of cars on a production line each day. The former deals with great variety and must maintain flexible operations, whereas the latter follow a set routine that allows them to build cars more efficiently. Most manufacturing operations can be classified as one of three types—job shops, project manufacturing, and repetitive manufacturing.

Job shops are designed for short production runs. Skill sets are grouped, and work moves in batches from location to location. Only a few products are produced before the general-purpose machines are shifted to a different production setup. Machine shops represent this type of operation.

When most people think about manufacturing, they often picture a factory operation, but this is not always the case. **Project manufacturing** is used to create unique but similar products, such as site-built homes and grandstands for sporting facilities. In some cases, these operations may not even seem to belong to the manufacturing family. Creative work, such as composing music or painting portraits, can fall into this category, as can professional work, such as processing tax returns or drafting specific legal documents. Because each project is unique, this type of operation has to be highly flexible to meet the requirements of the job and the demands of customers. However, because of the similarity involved, a company can achieve operational efficiencies by using manufacturing methods that, in some ways, resemble those of repetitive manufacturing, or mass production.

Firms that produce one or relatively few standardized products use **repetitive manufacturing**. This is considered mass production because it requires long production runs. Repetitive manufacturing is associated with the assembly-line production of high-volume products, such as smartphones and apparel items. Highly specialized equipment can be employed because it is used over and over again in making the same item. When the output created more closely resembles a stream of product (such as water from a purification plant or power generated by a hydroelectric dam) than individual goods, this form of repetitive manufacturing is sometimes referred to as **continuous manufacturing**.

Most businesses do not implement a pure version of any of these process types, but rather mix and match them in order to gain the benefits of each. For instance, home builders will frequently blend job shop operations (building several houses using specialized subcontractors for plumbing, painting, and electrical work) with project manufacturing features (being unique, individualized, and customized). To meet the increasing market demand for unique products that are low in price, many companies have turned to **flexible manufacturing systems**, which usually involve computer-controlled equipment that can turn out a variety of products in smaller or more flexible quantities. In other words, machine automation, while expensive, can help cut manufacturing costs while giving customers exactly what they want.

Flexible manufacturing is being pushed to the extreme as entrepreneurs learn that buyers will pay much more for products that are highly customized. They have taken the process to a whole new level by using do-it-yourself platforms that allow customers to actually design and create what they buy. Using fast-emerging technologies like 3-D modeling and printing, entrepreneurial companies are now offering customers the ability to express themselves in their clothing (Picture This), footwear (Wiivv Wearables), smartphone cases (Zazzle), and a wide range of other products (Shapeways)—and new ventures are launched all the time to provide even more options.[1] A company called Carbon is using 3-D printing to

job shops
Manufacturing operations designed for short production runs of small quantities of items.

project manufacturing
Manufacturing operations used to create unique but similar products.

repetitive manufacturing
Manufacturing operations designed for long production runs of high-volume, standardized products.

continuous manufacturing
A form of repetitive manufacturing with output that more closely resembles a product stream than individual products.

flexible manufacturing systems
Manufacturing operations that usually involve computer-controlled equipment that can turn out products in smaller or more flexible quantities.

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create built-to-size and highly durable sneakers for Adidas,[2] and Los Angeles-based Divergent Technologies has impressed automotive enthusiasts by using 3D printing technologies to manufacture a customizable supercar called the Blade that is powered by a 700-horsepower engine that can catapult the vehicle from 0 to 60 miles per hour in a blinding 2.2 seconds.[3] It appears that there is no limit to what can be created using these new design and production platforms, and that means endless customization is now possible and sure to grow in use as time goes on.

21-2c Capacity Considerations

A small company's capacity to offer products or services is a critical factor. It puts a ceiling on the firm's ability to meet demand and match competitors, but it may also determine start-up costs and usually represents a long-term commitment.

To understand how this would work, consider the case of a small manufacturer of high-performance snow skis, which obviously would need to plan for seasonal demand. Customers buy most of the skis purchased each year just before the season starts (late fall and early winter), with the greatest surge of sales taking place just before Christmas as gift purchases. Sales continue but slow dramatically toward the end of ski season (February to March) and then drop off almost entirely for the rest of the year.[4] In order to handle peak seasonal demand, the equipment manufacturer in this scenario would have to set its production capacity to meet the average level of this demand, manufacture extra product during the slow months, and store these units in inventory to smooth out production for the year and satisfy orders when they come in. This works well for manufacturers. However, service companies cannot hold inventory in the same way, so a competitor such as Starbucks must have the capacity to meet peak demand throughout the day.

Capacity for a snow ski manufacturer is determined by factory space, machinery, worker availability, and other such factors. Although capacity at Starbucks is similarly determined by store space, equipment, and employees, adjusting capacity to meet market changes looks very different for these two firms.

21-2d Planning and Scheduling

In manufacturing, production planning and scheduling procedures are designed to achieve the orderly, sequential flow of products through a plant at a rate that matches deliveries to customers. To reach this objective, the manufacturer must avoid production disruptions and utilize machines and personnel efficiently. Simple, informal control procedures are often used in small plants. If a procedure is straightforward and the output is very limited, a manager can keep things moving smoothly with a minimum of paperwork. However, any manufacturing venture that experiences growth will eventually have to establish formal procedures to ensure production efficiency.

Because service firms are closely tied to their customers, they are limited in their ability to produce services and hold them in inventory. An automobile repair shop must wait until a car arrives before starting its operations, and a community bank cannot function until a client is available. A retail store can perform some of its services, such as transporting and storing inventory, but it, too, must wait until the customer arrives to perform other services.

Part of the scheduling task for service firms relates to planning employees' working hours. For example, restaurants schedule the work of servers to coincide with variations in diner traffic, and stores and medical clinics increase their staff to handle the crush of customers or patients during periods of peak demand.

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Living the Dream

Some Employees Always Have a Chip on Their Shoulders—Or in Their Bellies

CaliBurger, LLC

Small business owners have long complained that they cannot find the employees that they very desperately need, which limits the productive capacity of their operations. But when the COVID-19 pandemic started to take hold in 2020, the problem definitely went from bad to worse!

One indication of the seriousness of the problem surfaced in a report from the National Restaurant Association. It showed that by mid-2021, there had been an 8 percent drop in employment in the food and beverage service industry when compared to pre-pandemic levels. Struggling to find or hire back employees, restaurant owners had to get inventive to fill the gap. Many, including small independent operators, turned to a new class of employees: Robots.

Robots are used in the workplace mostly to *complement* the work of employees, not *replace* them. These machines are able to take over mindless, routine, and menial tasks, which then frees up time for people to focus on more productive, high-value functions that robots cannot handle. For example, they make it possible for employees to set aside more time to analyze the moves of competitors or carry out product development efforts.

Despite widespread (and understandable) concerns, robots will not be able to replace humans entirely anytime soon because they lack the cognitive skills and critical thinking that are necessary to execute subtle and complex actions. This will be true even as the performance of robots is increasingly enhanced by means of artificial intelligence (AI). In a sense, AI can serve as the "brain" for a robot, which then can carry out actions as the "body" as guided by its sensors and mechanical parts. But even there, AI comes up short compared to people in many ways since it cannot emulate critical traits and abilities that are uniquely human, such as the capacity for social intelligence and creativity. Still, robots offer great potential, and small business owners are finding ways to tap into it.

When it comes to jobs with repetitive activities that can more easily be automated, companies of all sizes are beginning to turn to robots to stand in for the workers they can't seem to hire. Take privately owned Caliburger, for example. The "21st century revival of the classic California burger joint" that employs 80 people decided its operations would best be served by "hiring" a robot, named Flippy, to prepare burgers in its restaurants. Flippy is a $60,000 machine that can take food orders digitally. Then, after hamburger patties are added to the grill by a human attendant (a step the robot cannot handle), the machine flips them when the time is right and determines precisely when they are "done" (by means of thermal cameras). It even removes the cooked patties from the grill and places them onto buns.

Flippy can also perform other kitchen tasks (including scraping the surface of the grill to keep it clean), which allows employees more time to work the front lines and interact with customers. Beyond addressing critical labor shortages, these robots prevent diners from getting sick by ensuring that meat products are fully cooked and safe to eat. This became another major selling point during the pandemic as health came to be a front-of-mind concern.

Robot use has become far more common in recent years. This is largely because they are more affordable than ever, putting them within the financial reach of small businesses. Today, robots can be purchased for as little as $25,000 to help employees with everyday tasks. And given the assorted tools with which they can be equipped, robots can tackle a wide range of applications in very cost-effective ways. Sweetening the deal even more, they also are able to operate 24/7, stocking shelves and performing other menial tasks when stores and warehouses are closed. This allows employees to work hours that better suit their lifestyles and family needs.

The use of robots has direct application to different forms of production, including repetitive manufacturing and flexible manufacturing systems. But it also can boost product and service quality and yield efficiencies that are the cornerstone of lean production processes (introduced later in this chapter). On top of that, robots are always happy with their work, do not require benefits, and never ask for a pay raise—even when employees are hard to find. Given these and other advantages, it is only reasonable to expect this form of automation to become even more common in the future.

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Other strategies of service firms focus on scheduling customers. For example, appointment systems are used by many automobile repair centers and beauty shops. Some service firms, such as dry cleaners and plumbers, take requests for service and delay delivery until the work can be scheduled. Still other firms, including banks and movie theaters, maintain a fixed schedule of services and tolerate some idle capacity.

To smooth out and delay investment in additional capacity, companies are turning increasingly to **demand management strategies**. These strategies are used to stimulate customer demand when it is normally low, and the options are limited only by the entrepreneur's imagination. Some businesses attempt to spread out customer demand by offering incentives for customers to use services during off-peak hours—examples of this would include early-bird dinner specials at restaurants and lower-price tickets for the afternoon showing of a movie.

Other approaches are sometimes more sophisticated. Six Flags theme parks have implemented the FLASH Pass rider reservation system, where a pager-like device holds a visitor's place in line so that they can be waiting for a seat on a popular ride while enjoying other activities in the park. When a place on the ride becomes available, the pager indicates that the visitor can go to the attraction to claim it. Gold and platinum levels of the service have been added in recent years, which also hold a spot in line but reduce wait time by an additional 50 and 90 percent, respectively. Of course, Six Flags charges an extra fee for this privilege—even more for the premium options—but the net result is both a smoothing and a prioritization of demand. Those customers willing to pay more also get more value from their time in the park.[5]

21-3 Inventory Management and Operations

21-3 Identify ways to control inventory and minimize inventory costs.

It may not be glamorous, but inventory management can make the difference between success and failure for a small firm. When examined carefully, inventory management can help an entrepreneur understand the vital balance between two competing pressures in the business. As shown in Exhibit 21.2, the company may need *more* inventory to satisfy customers (meeting customer demand and providing high-quality service), but it will want to maintain *less* inventory to keep the company's balance sheet healthy. Inventory management is particularly important in small retail or wholesale companies because inventory typically represents a major financial investment by these businesses.

demand management strategies
Operational strategies used to stimulate customer demand when it is normally low.

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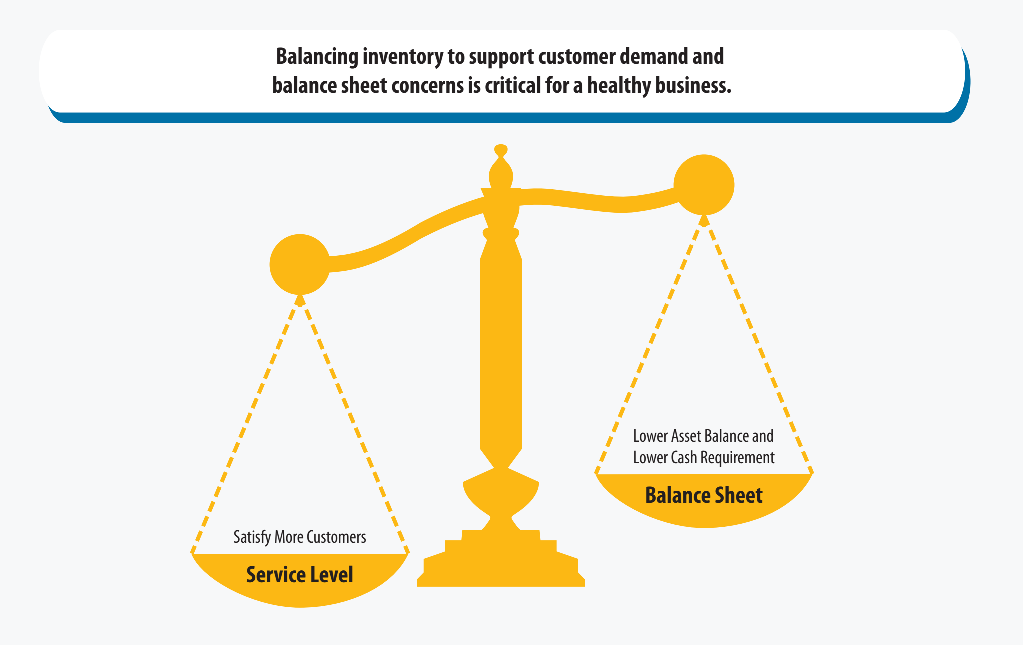
Exhibit 21.2 Service Level and Balance Sheet Considerations



21-3a Objectives of Inventory Management

The reasons for carrying inventory are numerous. A kitchen pantry analogy can help you to see why this is the case. Why do you keep more boxes of your favorite cereal in the pantry than you need today?

- To eat (to meet customer demand).
- To avoid going to the grocery store for each breakfast meal (to be less dependent on the source).
- To have breakfast supplies for guests to eat (to protect against stockouts).
- To benefit from price discounts (to gain from sales or quantity-based cost reductions).
- To have them in stock before prices go up (to protect against price increases).

This exercise shows that you probably store extra cereal boxes for a number of reasons. Having something to eat for breakfast is likely only one of your objectives for keeping the pantry well stocked.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Ensuring continuous operations is particularly important in manufacturing because delays caused by lack of materials or parts can be costly. Furthermore, sales can be maximized by completing production in a timely manner and by stocking an appropriate assortment of merchandise for distribution to wholesale establishments and retail stores. Protecting inventory from theft, misplacement, and deterioration likewise contributes to operational efficiency and business profits.

You may conclude that carrying more stock is the key to maintaining high-quality service. However,

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most of the root causes of running out of stock can be found in the store—that is, they derive from varied problems such as incorrect forecasting, lost or misplaced inventory, poor shelving or storage systems, and inadequate stock measurements. Having more inventory on hand would increase costs but would not improve service quality in these cases because customers would still be prevented from accessing that stock efficiently due to these other fundamental problems.

21-3b Inventory Cost Control

Maintaining optimal inventory—the level that minimizes stockouts and eliminates excess inventory—saves money and contributes to operating profits. Traditional methods of determining ideal inventory levels may be sufficient for your business. One such method is calculating the **economic order quantity**, a relatively simple index that determines the purchase quantity of an item (some of which will be carried in inventory) that will minimize total inventory costs.[6]

Preferring more advanced methods, many small companies have turned to **statistical inventory control**, which accommodates the variability of supply and demand using a targeted service level. This method allows you to determine statistically the appropriate amount of inventory to carry, and it is easier to use than you might imagine. In fact, the tools required for this computation are built into many inexpensive, off-the-shelf business software packages that are well suited for small businesses, such as Microsoft Dynamics 365 or SAP Business One.

If a firm could order merchandise or raw materials and carry inventory with no expenses other than the cost of the items, there would be little concern about order quantity at any given time. However, this is not the case. Inventory comes with many other related costs, which are easy to overlook. At a minimum, you should consider the following:

- Storage (land and buildings, as well as shelving and organization systems).
- Theft, weathering, spoilage, and obsolescence.
- Cost of capital (from tying up cash in inventory that could be better used elsewhere).
- Transaction costs (from ordering, receiving, inspecting, transporting, and distributing inventory).
- Insurance and security.
- Disposal costs (of inventory that cannot be sold).

Your business may have to bear these costs and others. While some are fixed costs, others will rise and fall based on the quantity of inventory held. Inventory cost management can be a complex challenge, but there are approaches that can help you to minimize these costs, including the ABC method and the just-in-time inventory system.

ABC Inventory Classification

Some inventory items are more valuable or critical to a firm's operations than others. That is, some items have a greater effect on the costs and profits of a business. As a general rule, managers will be most attentive to those inventory items requiring the largest investment. Managing inventory according to its priority can help boost a company's performance.

One approach to inventory analysis, the **ABC method**, classifies items into three categories based on *dollar velocity* (purchase price × annual quantity consumed). Its purpose is to focus managerial attention on the most important items. The number of

economic order quantity
An index that determines the quantity to purchase in order to minimize total inventory costs.

statistical inventory control
A method of controlling inventory that uses a targeted service level, allowing statistical determination of the appropriate amount of inventory to carry.

ABC method
A system of classifying items in inventory by dollar velocity (purchase price × annual quantity consumed).

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categories could easily be expanded to four or more, if that seemed more appropriate for a particular firm.

Category A holds a few high-value inventory items that account for the largest percentage of total dollars or are otherwise critical in the production process and, therefore, deserve close control. These might be monitored using an inventory system that keeps a running record of receipts, withdrawals, and balances of each item. In this way, a company can avoid an unnecessarily heavy investment in costly inventory items.

Category B items are less costly but deserve moderate managerial attention because they still make up a significant share of the firm's total inventory investment. Category C contains low-cost or noncritical items, such as paper clips in an office or nuts and bolts in a repair shop. The carrying costs of such items are not large enough to justify close control. These items might simply be checked periodically to ensure that a sufficient supply is available.

Just-in-Time Inventory Systems

The **just-in-time inventory system** is designed to cut inventory carrying costs by making or buying what is needed just as it is needed. First popularized by the Japanese, the just-in-time approach has led to cost reductions in many countries. New items are received, presumably, just as the last item of that type from existing inventory is placed into service. The just-in-time concept rests on a few basic principles, but chief among these is emphasis on the *pull* of inventory over the *push* of the same. That is, inventory items are made or bought in response to demand (pull), rather than in response to what is planned or anticipated (push). This method prevents the buildup of unnecessary inventory.

Many large firms have adopted some form of the just-in-time system for inventory management, but small businesses can also benefit from its use. It's important to note that this approach requires careful coordination with suppliers. Supplier locations, production schedules, and transportation timetables must be carefully considered, as they all affect a firm's ability to obtain materials quickly and in a predictable manner—a necessary condition for using this approach. The just-in-time method also requires a flexible production system, with short set-up and turnaround times.

The benefits of just-in-time management go beyond reducing in-house inventory and creating a healthier balance sheet. Quality problems become evident sooner, which reduces waste. Storage space, insurance costs, and revolving credit are freed up for other purposes. The ultimate objective of this method is a smooth and balanced system that responds nimbly to market demand.

The just-in-time inventory system has been used by businesses of all sizes, and with good results. You may be familiar with McAlister's Deli, a franchised chain of more than 400 restaurants in 28 states.[7] The operation of each franchise is carefully dictated by the firm's operations manual. Its prescribed approach specifies that each restaurant is to set up four sandwich-making workstations or production cells and to use as many of these as needed, based on the hour of the day and the flow of customers. Each station has a single operator who receives sandwich orders in batches. So, if a party of eight comes in, one workstation would prepare sandwiches for all eight diners.[8]

A McAlister's restaurant in central Texas is one of the higher-volume outlets, and it was granted permission to experiment with the production system by making two changes. First, to accommodate the high volume, the four cells were changed to two assembly lines with specialized workers. Only one of the lines is used most of the time, but it is operated by four to six workers. The second modification, and one that is consistent with the spirit of the just-in-time approach, is that the batch size has been changed to *one sandwich*, regardless of the order size. That is, even when both assembly

just-in-time inventory system
A method of cutting inventory carrying costs by making or buying what is needed just as it is needed.

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lines are operating, the sandwiches in a large order will be split, based on available capacity. The result has been reduced order lead time and variability, fewer mistakes, and higher efficiency. Because this new arrangement worked so well, the local owner was happy with the change, and so was the franchisor.[9]


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21-3c Inventory Recordkeeping Systems

The larger the company, the greater the need for recordkeeping, but even a very small business needs a system for keeping tabs on its inventory. Because manufacturers are concerned with three broad categories of inventory (raw materials and supplies, work in process, and finished goods), their inventory records are more complex than those of wholesalers and retailers. Small firms should emphasize simplicity in their control methods. Too much control can be as wasteful as it is unnecessary.

In most small businesses, inventory records are computerized. Many different software programs are available for this purpose. The owner or manager, in consultation with the company's accounting advisers, can select the software best suited for the particular needs of the business.

Inventory checks can be carried out in different ways. A **physical inventory system** depends on an actual count of items on hand. The counting is done in physical units, such as pieces, gallons, or boxes. By using this method, a firm can create an accurate record of its inventory level at a given point in time. Some businesses have an annual shutdown to count everything—a complete physical inventory. Others use **cycle counting**, scheduling different segments of the inventory for counting at different times during the year. This simplifies the process and makes it less of an ordeal for the business as a whole.

A **perpetual inventory system** provides an ongoing, current record of inventory items. It does not require a physical count. However, a physical count of inventory should be made periodically to ensure the accuracy of the system and to make adjustments for such factors as loss or theft.

The simplest method is called a **two-bin inventory system**. For each item in inventory, the business sets up two containers, each holding enough to cover lead time. When one is emptied, it is replaced with the second and a new container is ordered. In fact, you may already be using this approach at home. For example, you use sugar out of one bag, but you keep a second bag in the pantry. When the first is empty, you open the second and buy a new one at the grocery store. As a result, your "sweet tooth" is always taken care of.

physical inventory system
A method that provides for periodic counting of items in inventory.

cycle counting
A method for counting different segments of the physical inventory at different times during the year.

perpetual inventory system
A method for keeping an ongoing current record of inventory.

two-bin inventory system
A method of using two containers for each item in inventory, one to meet current demand and the other to meet future demand.

21-4 Quality and Operations Management

21-4 Summarize the contributions of operations management to product and service quality.

Owners of successful small firms realize that quality management is serious business and that a strong commitment to the achievement of quality goals is essential. However, quality can be achieved only to the extent that operations lead to the outcomes that customers want. Following this logic, companies that fail to produce quality in their operations will not have the buyers they need to stay in business for long.

21-4a Quality as a Competitive Tool

Quality may be defined as the characteristics of a product or service that determine its ability to satisfy customers' stated and implied needs. Quality obviously has

quality
The features of a product or service that enable it to satisfy customers' stated and implied needs.

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many dimensions. For example, a restaurant's customers base their perceptions of its quality on the taste of the food, the attractiveness of the décor, the friendliness and promptness of servers, the cleanliness of silverware, the appropriateness of background music, and many other factors. The operations process establishes the level of quality as a product is being produced or as a service is being provided. Although costs and other considerations cannot be ignored, quality must remain a primary focus of a firm's operations.

International competition is increasingly turning on quality differences. Automobile manufacturers, for example, have had to step up their focus on quality in order to compete effectively with foreign producers. In examining the operations process, small business managers also must direct special attention to achieving superior product or service quality.

The American Society for Quality (ASQ) has been the leading quality improvement organization in the United States for more than 75 years and has introduced many quality improvement methods throughout the world. Among these is an approach known as **total quality management (TQM)**, an aggressive effort by a company to achieve superior quality. According to the ASQ, total quality management is an all-encompassing, quality-focused management approach that bears the following eight hallmarks:[10]

1. It is *customer-focused*: Customer needs and wants are at the core of organizational efforts.
2. It stresses *total employee involvement*: Management leads, but the entire organization participates.
3. It is *process-centered*: Steps involved in transforming inputs into outputs are defined and monitored continuously to detect deviations and improve process performance.
4. It is an *integrated system*: All involved micro-processes are understood in the context of the overall system and are monitored and communicated continuously.
5. It follows a *strategic and systematic approach*: All process stages are guided by a strategic plan that integrates quality as a core component.
6. It focuses on a *culture of continuous improvement*: The organization emphasizes analysis and creativity to find ways to become more effective and competitive.
7. It involves *fact-based decision making*: TQM requires continual collection and analysis of data to improve accuracy, achieve consensus, and improve projections.
8. It emphasizes *communication*: Effective and timely communications help maintain employee morale and motivation.

The most successful quality management efforts will incorporate these important features.

Companies that are particularly serious about meeting the highest standards of quality can apply to receive the Malcolm Baldrige National Quality Award, which has a category that is exclusively for small businesses (refer to www.nist.gov/baldrige/baldrige-award for details). The award's prestige factor is a great incentive; in fact, this is the only award for organizational excellence that is granted by the President of the United States.[11]

Many firms choose not to apply but still use the award's criteria and questions to run a check on their operations. For those companies that decide to apply, it is important to know that the process is nothing short of grueling. So, is the outcome

total quality management (TQM)
An all-encompassing management approach to providing high-quality products and services.

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worth the effort involved? One executive has no doubt that it is, declaring that winning the award "has paid off more than we could have imagined." He offers the following expanded explanation:[12]

> You may be worried about the commitment of time and resources to take such a long journey. Make no mistake, the commitment is substantial, and it will take a while—it took [us] ten years! But I can assure you that it will pay off, in the short term and the long term. We saw improvement in our first year and the improvements have never stopped.

Perhaps this is a little beyond your reach for now. But, at some point, you may want to go through the process with your small business in order to chart a clear path toward outstanding quality performance.

21-4b The Customer Focus of Quality Management

A firm's quality management efforts should begin with a focus on the customers who purchase its products or services. Without this focus, the quest for quality can easily degenerate into an aimless search for some abstract, elusive ideal. To get started, the entrepreneur should determine the products and services that will satisfy customers' needs and expectations.

Customers have expectations regarding the quality of products (such as durability and attractiveness) and services (such as speed and accuracy). A customer is concerned with *product* quality when purchasing a camera or a loaf of bread, but their primary concern is *service* quality when having an automobile repaired or a suit tailor-made. Frequently, a customer expects some combination of product *and* service quality—for example, the buyer of a flat-screen TV may be concerned with the performance of the model selected, knowledge and courtesy of the salesperson, credit terms offered, and warranty coverage.

At times, it can be easy to misread what customers want, but what they desire is usually very simple. For example, a car owner who takes his automobile to a repair shop hopes to receive competent service (that is, a successful repair), to get a reasonable explanation of what had to be done, and to be treated with respect. Similarly, a hotel patron anticipates being provided with a clean room, having reasonable security, and being treated like a valued guest. Such uncomplicated expectations open up avenues of opportunity. Exceeding these basic expectations can leave a lasting, favorable impression on customers, which often results in repeat business and free promotion through positive word of mouth. As a bonus, a genuine concern for customer needs and satisfaction can be a powerful force that energizes the total quality management effort of a company.

Retail Is Detail

Perhaps you've heard the saying "Retail is detail." This means that operating details are crucial to the success of a business, especially in retail industries. Consider Shake Shack, the gourmet hamburger chain that was started by experienced restaurateur Danny Meyer as part of an effort to revitalize Madison Square Park in New York City. It wasn't long before the startup had earned a cult following, which only continues to grow as time goes on. They may love the food, but few of Shake Shack's faithful customers recognize the meticulous attention to detail that makes the eatery the phenomenal success that it is today. The motivation starts from a carefully considered business philosophy:[13]

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> We are on an endless pursuit to create uplifting experiences. Our products are elevated, modern, and fun versions of the classics, and our mission is to Stand for Something Good in all aspects of our business. This prioritizes taking care of our team, sourcing premium ingredients from like-minded supply partners, well-crafted design of our Shacks, and community support through donations, events and volunteering.

For Meyer, making high-quality burgers, chicken sandwiches, hotdogs, shakes, and fries is nothing short of an obsession. Consider some of the painstaking detail that has been planned into the chain's operations:[14]

- The chain uses only a proprietary blend of freshly ground (never frozen!), 100 percent all-natural Angus beef for its burgers, and it must be verified as pasture-fed and humanely raised.
- The restaurant sources its beef from specific, high-quality butchers, like Meyer Natural Angus, Creekstone Farms, and Aspen Ridge that provide only premium cuts certified to be untainted by hormones or antibiotics.
- Shake Shack's 'Shroom Burgers are made only from premium real ingredients that include "crisp-fried portobello mushrooms filled with muenster and cheddar cheeses."
- Products like the Smoke Shack are topped with bacon that is 100 percent nitrite, nitrate, and antibiotic free, having come from Niman Ranch–affiliated family farms, that raise pork in humane conditions—not in crates or cages, ever!
- The company maintains a comprehensive recycling program, including an industry-leading switch to the use of straws made of carbon-negative biomaterial that is fully compostable, reusable aluminum water bottles that are BPA-free, and regenerative bioplastic alternatives for eating utensils.
- To minimize the environmental impact of each restaurant, all physical facilities are planned with energy and water usage, air purity, and transportation footprint in mind.

Its "retail is detail" emphasis has definitely paid off, with Shake Shack expanding from a single, modest kiosk-style fast-food restaurant in 2004 to 247 U.S. locations today that are spread from coast to coast. In addition, it now has international locations in Bahrain, China, Japan, Kuwait, Oman, the Philippines, Qatar, South Korea, Saudi Arabia, Singapore, Turkey, the United Arab Emirates, and the United Kingdom.[15]

Customer Feedback

Listening attentively to customers' opinions can provide information about their level of satisfaction. Employees who interact directly with customers can serve as the eyes and ears of the business in evaluating existing quality levels and customer needs. Unfortunately, many managers are oblivious to the often-subtle feedback from customers. Preoccupied with operating details, they may not listen carefully to, let alone solicit, customers' opinions. Adding to the problem, employees who work closely with customers—such as servers in a restaurant—are seldom shown how to, and often are not encouraged to, obtain information about customers' quality expectations. Careful training and management of servers could make them more alert to diners' tastes and attitudes, and provide a mechanism for reporting these reactions to management.

Experts now recommend that firms work hard to involve and empower customers in efforts to improve quality. The importance of customer involvement is described

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in Chapter 7, which points out that input from customers can help to determine if the product or service a company offers will solve their problems or improve the conditions they are facing. Some businesses, for example, provide comment cards for their customers to use in evaluating service or product quality.

Another approach to gathering customer-based information is to "mine" company sales data, statistically analyzing it in search of useful insights into customer behavior. Consider operations superstar Walmart and its response to severe weather events. From carefully studying its own sales data, the firm is well aware of customer buying patterns preceding storms. Before a serious weather event strikes, customers stock up on the expected: water, flashlights, and generators. But in the aftermath of such a storm, customers buy yard and home cleanup items, such as mops and trash bags. Some items that are commonly purchased are less predictable, such as Strawberry Pop-Tarts (a quirk in buying behavior).[16] By recognizing past trends and adjusting operations to match them (including having an ample supply of Pop-Tarts available before and after a storm), Walmart can help those most in need and make a profit by serving its customers' known, and perhaps unknown, needs with great precision.

The use of predictive analytics seems to be transforming every facet of business, not just anticipating customer trends and buying behavior. You need a business intelligence tool to make this work, and fortunately many are available. Free open-source tools like Microsoft R Open offer some possibilities, but these can be difficult to program. Systems offered by SAS and SAP may be too complex and expensive for many small businesses. More suitable are inexpensive dashboard tools like Geckoboard and IBM Cognos Analytics, which allow you to visualize your data. These tools can help you make sense of your numbers at a subscription price that won't break the bank—some cost as little as $5 a month for startups and small businesses.[17] In any case, data-mining techniques that provide powerful insights to guide small business operations should not be overlooked.

21-4c "The Basic Seven" Quality Tools

Another important element in effective quality management consists of the various tools, techniques, and procedures needed to ensure high-quality products and services. Once the focus is shifted to the customer and the entire organization is committed to continuous improvement, operating methods become critical concerns. Kaoru Ishikawa, the father of "quality circles," contended that 95 percent of a typical company's quality problems can be solved by using the following seven tools (sometimes called "The Basic Seven"):[18]

1. A *cause-and-effect diagram* (also known as an *Ishikawa chart*, or a *fishbone chart*) identifies potential causes for an effect or problem while sorting them into categories.
2. A *check sheet* provides a structured, prepared form for collecting and analyzing data.
3. A *control chart* transforms data into graphs that can be used to determine if a process errs in some predictable, and correctable, way.
4. A *histogram* is the most commonly used graph for showing how often each different value in a set of data occurs.
5. A *Pareto chart* is a bar graph that reveals which causes are significant, separating the "vital few" from the "useful many."

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6. A *scatter diagram* (or *scattergram*) graphs pairs of different sets of variables, allowing a search for quality relationships or patterns.
7. A *flow chart* (or *run chart*) visually represents the series of steps required to complete an operation.

While this list may seem overwhelming, most of these tools are straightforward and require almost no training, except for control charts, which are discussed in more detail later in this section. You can learn more about how to use all seven of these tools through online resources.

21-4d Quality Inspection Versus Poka-Yoke

Management's traditional method of maintaining product quality has been **inspection**, which consists of examining a part or a product to determine whether or not it is acceptable. An inspector often uses gauges to evaluate important quality variables. For effective quality control, the inspector must be honest, objective, and capable of resisting pressure from shop personnel to pass borderline cases.

Denis Selivanov/Shutterstock.com

Although the inspection process is usually discussed with reference to product quality, comparable steps can be taken to evaluate service quality. Follow-up calls to customers of an auto repair shop, for example, might be used to measure the quality of the firm's repair services. Customers can be asked whether recent repairs were performed in a timely and satisfactory manner.

The problem with inspection is that it occurs after the fact—that is, after faulty goods or inadequate services have been created or offered for sale. At that point, considerable resources have already been consumed in a company's operations, but with nothing of quality to show for it. This can lead to both internal costs (those related to repair, inspection, prevention, and training) and external costs (from the loss of reputation and repeat customers). Knowing this inspired quality guru Philip Crosby to declare, "Quality is free!" In other words, the *savings* associated with getting quality right more than offset the *cost* of a total quality management program.

Quality inspection processes are helpful, but **poka-yoke** (the Japanese concept of designing business processes to prevent defects) is a more proactive approach that seeks to mistake-proof a firm's operations. For example, a microwave oven may be designed so that it will not work with the door open, thereby preventing radiation leakage. And fryers at many fast-food restaurants now raise the product out of the hot grease using a timed machine, rather than relying on a vigilant employee and an audible alarm. This innovation prevents food waste (from over- or under-cooked foods) and eliminates the risk of grease-burn injuries.

inspection
The examination of a part or a product to determine whether it meets quality standards.

poka-yoke
A proactive approach to quality management that seeks to mistake-proof a firm's operations.

acceptance sampling
The measurement of random samples of products against predetermined standards to determine the acceptability of an entire lot.

21-4e Statistical Methods of Quality Control

The use of statistical methods and control charts often can make controlling product and service quality easier, less expensive, and more effective. Because some knowledge of quantitative methods is necessary to develop a quality control method using statistical analysis, a properly qualified employee should be available to lead this part of the process. The savings made possible by use of an efficient statistical method usually will more than justify the cost of setting it up and managing it.

Acceptance sampling involves taking random samples of products and measuring them against predetermined standards to determine the acceptability of an entire lot. Suppose that a small business receives a shipment of 10,000 parts from a supplier.

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Rather than evaluate all 10,000 parts, the purchaser might check the acceptability of a small sample of the parts and then accept or reject the entire order based on the results. The smaller the sample, the greater the risk of either accepting a defective lot or rejecting a good lot due to *sampling error*. A larger sample reduces this risk but increases the cost of inspection. A well-designed plan strikes a balance, simultaneously avoiding excessive inspection costs and minimizing the acceptance/rejection risk.

The use of statistical analysis makes it possible to establish tolerance limits that allow for inherent variation due to chance. When measurements fall outside these tolerance limits, however, the quality controller knows that a problem exists and must search for the cause. A control chart graphically shows the limits for the process being controlled. As current data are entered, it is possible to tell whether a process is under control or out of control (random or non-random).

Control charts may be used for either attribute or variable inspections. **Attributes** are product or service parameters that can be counted as being either present or absent. A light bulb either lights or doesn't light; similarly, a water hose either leaks or doesn't leak. **Variables** are measured parameters that fall on a continuum, such as weight or length. If a large can of cashews is to be sold as containing a minimum of two pounds of nuts, an inspector may judge the product acceptable if its weight falls within the range of 32 to 33 ounces.

A problem might be caused by variations in raw materials, machine wear, or changes in employees' work practices. Consider, for example, a candy maker that is producing one-pound boxes of chocolates. Although the weight may vary slightly, each box must weigh at least 16 ounces. A study of the operations process has determined that the actual target weight must be 16.5 ounces, to allow for normal variation between 16 and 17 ounces. During the production process, a set of boxes is weighed every 15 or 20 minutes. If the average weight of a box falls outside the tolerance limits—below 16 or above 17 ounces—the quality controller must immediately try to find the problem and correct it.

Continuing improvements in computer-based technology have advanced the use of statistical control processes in small enterprises. In fact, many off-the-shelf enterprise resource planning systems (computer software that coordinates all major facets of a firm's operations) for smaller businesses now include statistical quality control tools. A few of the systems best suited to the needs of small companies include SAP Business One, ECount, NetSuite, Prodsmart, and SigmaXL, though some packages on the market carry hefty price tags. And since selecting the package that is right for a specific venture can be a complex decision, the choice should be made with great care and the help of a knowledgeable adviser.

21-4f International Certification for Quality Management

A firm can obtain international recognition of its quality management program by meeting a series of standards, known as **ISO 9000**, developed by the International Organization for Standardization (ISO) in Geneva, Switzerland. The certification process requires full documentation of a firm's quality management procedures, as well as an audit to ensure that the firm is operating in accordance with those procedures. In other words, the firm must show that it does what it says it does.

ISO 9000 certification is particularly valuable for small firms because they usually lack a global image as producers of high-quality products. Buyers in other countries, especially in Europe, view this certification as an indicator of supplier reliability. Some large U.S. corporations, such as the major automobile makers, require their domestic suppliers to conform to these standards. Small firms, therefore, may need ISO 9000 certification either to sell more easily in international markets or to meet the demands of their domestic customers.

attributes
Product or service parameters that can be counted as being present or absent.

variables
Measured parameters that fall on a continuum, such as weight or length.

ISO 9000
The standards governing international certification of a firm's quality management procedures.

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Environmental concerns and a focus on social responsibility have created new opportunities and challenges for entrepreneurs. Although no general certifications have been offered, the International Organization for Standardization also offers an ISO 14001 certification. This certification reflects how efficiently companies have set up and improved their operations processes in order to control the impact of vehicle and smokestack emissions, noise, and other fallout on air, water, and soil.

ISO certification is challenging to earn, but the payoff from achieving it can make it all worthwhile. Small companies that take up the ISO 9000 challenge will find that the certification process can be demanding, taking from six months to a year to complete and costing anywhere from $10,000 to $20,000 or more. But having this designation can lead to significant advantages, including preferential selection by customers, better access to public-sector contracts, lower insurance premiums—even fewer lawsuits. These improvements then can translate directly to the firm's bottom line.

21-4g Quality Management in Service Businesses

For many types of service firms, quality control constitutes management's most important responsibility. When all that a firm sells is service, its success depends on customers' perceptions of the quality of that service.

While customer satisfaction with service businesses overall has been greater in recent years, there is still plenty of room for improvement. For example, some large corporations adjust the quality of the services they provide to the profitability of the customer—with better customers getting better service—and this can easily lead to general dissatisfaction. However, poor service from larger businesses (automated telephone answering systems that do not allow callers to speak to a live representative, long lines, reluctance to respond to customer problems, and so forth) opens the door for small service-oriented companies. Although some services are too costly to be used as powerful competitive weapons, providing high-quality service may sometimes involve nothing more than simple attention to detail.

Gathering relevant and useful measurements can be problematic when assessing the quality of a service. It is easier to measure the length of a section of pipe than the quality of motel accommodations. However, methods can be devised for measuring service quality. For example, a motel manager might maintain a record of the number of problems with travelers' reservations, complaints about the cleanliness of rooms, and so on. Frequently, the "easy to measure" becomes the only measure. It is critical that assessment measures are chosen carefully to find parameters most relevant to customers' perspectives on quality.

21-5 Explain the importance of purchasing and the nature of key purchasing policies.

21-5 Purchasing Policies and Practices

Although its role varies with the type of business, purchasing constitutes a key part of operations management for most small businesses. Through purchasing, firms obtain materials, merchandise, equipment, and services to meet production and marketing goals. For example, manufacturing firms buy raw materials or components, merchandising firms purchase products to be sold, and all types of firms obtain supplies.

21-5a The Importance of Purchasing

The quality of a finished product depends on the quality of the raw materials used. If a product must be made with great precision and close tolerances, the manufacturer

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must acquire high-quality materials and component parts. Then, if a well-managed production process is used, excellent products will result. Similarly, the acquisition of high-quality merchandise makes a retailer's sales to customers easier and reduces the number of necessary markdowns and merchandise returns.

Purchasing also contributes to profitable operations by ensuring that goods are delivered when they are needed. Failure to receive materials, parts, or equipment on schedule can cause costly interruptions in production operations. In a retail business, failure to receive merchandise on schedule may mean a loss of sales and, possibly, a permanent loss of customers.

Another aspect of effective purchasing is securing the best possible price. Cost savings go directly to the bottom line, so purchasing practices that seek out the best prices can have a major impact on the financial health of a business.

Note, however, that the importance of the purchasing function varies according to the type of business. In a small, labor-intensive service business—such as an accounting firm—purchases of supplies are responsible for a very small part of the total operating costs. Such businesses are more concerned with labor costs than with the cost of supplies or other materials that they may require in their operations process.

Make or Buy?

Many firms face **make-or-buy decisions**. Such choices are especially important for small manufacturing companies that have the option of making or buying component parts for products they produce. A less obvious make-or-buy choice exists with respect to certain services—for example, purchasing janitorial or car rental services versus providing for those needs internally. Some reasons for making component parts, rather than buying them, follow:

- More complete utilization of plant capacity permits more economical production.
- Supplies are assured, with fewer delays caused by design changes or difficulties with outside suppliers.
- A secret design may be protected.
- Expenses are reduced by an amount equivalent to transportation costs and the outside supplier's selling expense and profit.
- Closer coordination and control of the total production process may facilitate operations scheduling and control.
- Parts produced internally may be of higher quality than those available from outside suppliers.

Reasons for buying component parts, rather than making them, include the following:

- An outside supplier's part may be cheaper because the supplier specializes in the production of that particular part.
- Additional space, equipment, personnel skills, and working capital are not needed.
- Less-diversified managerial experience and skills are required.
- Greater flexibility is provided, especially in the manufacture of a seasonal item.
- In-plant operations can concentrate on the firm's specialty—finished products and services.
- The risk of equipment obsolescence is transferred to outsiders.

make-or-buy decisions
A choice that companies must make when they have the option of making or buying component parts for products they produce, or the option of purchasing necessary services or providing them in-house.

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The decision to make or buy should be based on long-run cost and profit optimization because it can be expensive to reverse. Underlying cost differences need to be analyzed carefully, as small savings from either buying or making may greatly affect profit margins.

Outsourcing

Sometimes it makes sense for a business to contract with an external provider (that is, an independent party with its own employees) to take on and manage one or more of its functions. This is called **outsourcing**. (You may recall that international outsourcing was discussed in Chapter 18.) As mentioned earlier, firms can sometimes save money by working with outside suppliers specializing in a particular type of work, especially tasks such as accounting, payroll, janitorial, and equipment repair services. The expertise of these outside suppliers may enable them to provide better-quality services by virtue of their specialization.

Chapter 20 explained the practice of co-employment, through which a small company can transfer its employees to a professional employer organization, which then leases them back to the firm. In that case, the small business is outsourcing the payroll preparation process. But the explosive growth in outsourcing among smaller companies may be mostly due to their taking advantage of the broad reach of the Internet to tap the services of hungry freelancers. Online crowdsourcing platforms like Guru, 99designs, Freelancer, and Upwork connect businesses with a global market of freelancers and receive a small cut of the final transaction for the services they provide. In the end, everyone comes out ahead.

According to a survey conducted by KPMG's Shared Services and Outsourcing Advisory, nearly all U.S. companies engage in outsourcing in some form. The amount of work that these firms are handing off had been growing for decades, but these plans, in general, had slowed more recently.[19] However, the trend reversed significantly starting in 2020 because of the COVID-19 pandemic as firms of all sizes realized that they had to become more digital to adapt to pressing conditions and lacked the skills to make the transition. And that growth in outsourcing is forecast to continue, mostly because of the sustained increase in information technology-related needs. But it is worth noting that work with outside providers is already widespread as nearly half of the companies surveyed recently by Boston Consulting Group outsourced more work than they performed internally.[20]

There clearly can be drawbacks to outsourcing—for example, no one knows a small business as well as its owner or works as hard for its success. It is never advisable for a company to outsource its unique skill or core product, but everything else could logically be considered. The advantage in turning these tasks over to others is that it frees up the entrepreneur to focus on their greatest strengths. However, to protect against the risks inherent in outsourcing, it would be wise to have a backup plan in case a supplier fails to deliver, and you should also monitor the progress of those companies with which you choose to work. These steps require time, effort, and expense but can help to ensure that your firm is spared the operational disasters that can easily arise from turning over processes to others.

outsourcing
Contracting with a third party to take on and manage one or more of a firm's functions.

cooperative purchasing organizations (coops)
An organization in which small businesses combine their demand for products or services in order to negotiate as a group with suppliers.

Coops and the Internet

Some small companies find that they can increase their buying power if they join **cooperative purchasing organizations** (often called **coops**). In this type of arrangement, several smaller businesses combine their demand for products and services with the goal of negotiating, as a group, for lower prices and better service

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from suppliers. Coops, which have been around for a long time, usually focus on a specific industry to maximize the benefits to participating businesses, and they can be very effective.

The Internet, however, has leveled the playing field for many small companies. Today's connected small business owners can line up hundreds of suppliers, large and small, to solicit bids—with just a few mouse clicks. They can also outsource a variety of tasks, from business planning and product design to sales presentations and warranty service. Technology has opened the door to a world of outsourcing alternatives that was unimaginable just a few decades ago.

Diversification of Supply

Small businesses often must decide whether it is better to use more than one supplier when purchasing a given item. The somewhat frustrating answer is "It all depends." A small company might concentrate purchases with one supplier for any of the following reasons:

- A particular supplier may be superior in its product quality.
- Larger orders may qualify for quantity discounts.
- Orders may be so small that it is impractical to divide them among multiple suppliers.
- The purchasing business may, as a good customer, qualify for prompt treatment of rush orders and receive management advice, market information, and flexible financial terms in times of crisis.
- The franchise contract might require purchasing from the franchisor.

The following reasons favor diversifying rather than concentrating sources of supply:

- Shopping among suppliers allows a company to locate the best source in terms of price, quality, and service.
- A supplier, knowing that competitors are getting some of its business, may provide better prices and service.
- Diversifying supply sources provides insurance against interruptions caused by strikes, fires, or similar problems with individual suppliers.

Some companies compromise by following a purchasing policy of concentrating enough purchases with a single supplier to justify special treatment and, at the same time, diversifying purchases sufficiently to maintain alternative sources of supply. A small business can adopt any of a number of different approaches in order to diversify its sourcing strategy.

21-5b Measuring Supplier Performance

What measures of a supplier's performance matter most? The Supply Chain Council has an answer to that question. It has developed the **Supply Chain Operations Reference (SCOR) model**, a list of critical factors that provides a helpful starting place when assessing a supplier's performance. Five attributes stand out:[21]

- *Reliability:* Does the supplier provide what you need and fill orders accurately?
- *Responsiveness:* Does the supplier deliver inputs when they are needed?
- *Agility:* Does the supplier respond quickly to changes in your order?

Supply Chain Operations Reference (SCOR) model
A list of critical factors that help in assessing a supplier's performance.

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- *Costs:* Does the supplier help you to control your cost of goods sold, your total supply chain management costs, and your warranty/returns costs?
- *Assets:* Does the supplier help you to improve efficiencies by shortening the cash cycle, inventory holding time, and demand on assets?

These factors can also prove helpful when first selecting a supplier. Since they are commonly used performance measures, some suppliers have data to show potential new customers how they stack up (along with references to verify their claims). Just remember that an outstanding rating on a measure that is not important to your business does not provide an advantage—in fact, it can be a form of waste.

When choosing a supplier, also consider the services it offers. The extension of credit by suppliers provides a major portion of the working capital of many small businesses. Some also plan sales promotions, provide merchandising aids, and offer management advice.

Clearly, it is vitally important to choose suppliers carefully. If a supplier fails to deliver what you need when you need it and with the quality you require, the entire operation breaks down—and so may your business.

21-5c Building Good Relationships with Suppliers

Good relationships with suppliers are essential for firms of any size, but they are particularly important for small businesses. A small company may be only one among dozens, hundreds, or perhaps thousands buying from that supplier. And the small company's purchases are often very limited in volume and, therefore, of less concern to the supplier.

To implement a policy of fair play and to cultivate good relations with suppliers, a small business should try to observe the following purchasing practices:

- Pay bills promptly.
- Give sales representatives a timely and courteous hearing.
- Minimize abrupt cancellation of orders merely to gain a temporary advantage.
- Avoid attempts to browbeat a supplier into special concessions or unusual discounts.
- Cooperate with the supplier by making suggestions for product improvements and/or cost reductions, whenever possible.
- Provide courteous, reasonable explanations when rejecting bids, and make fair adjustments in the case of disputes.

Some large corporations, such as UPS, Dell, FedEx, and Office Depot, have made special efforts to reach out to small business purchasers. By offering various kinds of assistance, such suppliers can strengthen small companies, which then continue as customers. Of course, it still makes sense to shop around, but low prices can sometimes be misleading. If a low bid looks too good to be true, perhaps it is. Low bids often exclude crucial items. Nonetheless, building strong relationships with the right large suppliers can clearly help small businesses become more competitive.

21-5d Forming Strategic Alliances

Some small firms have found it advantageous to develop strategic alliances with suppliers. This form of partnering enables the buying and selling firms to work much more closely together than is customary in a simple contractual arrangement. But the

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choice of partner can quickly determine whether the arrangement succeeds or fails—so choose carefully. Look first at companies with which you already have a relationship, such as a faithful supplier or distributor. Then, make sure that they offer the right fit, are trustworthy, and have track records of true performance. If a strategic alliance is well planned and executed, everyone involved comes out ahead.

Some potential alliance partners design their businesses specifically to help small firms. In 2005, Michael Prete started a venture called Gotham Cycles to sell parts online for Italian-made Ducati motorcycles. But it wasn't long before he was selling to a loyal worldwide customer base. How did he get off to such a fast start? He hired a very important employee: eBay.[22] Of course, the online auction site isn't exactly an employee—it's more like an army of employees (more than 12,700 strong, in fact[23]) that can help a small company with many of its needs. Sellers who lean on eBay's rich stable of resources to automate their operations are able to focus on building their businesses. A powerful partner for a small company, eBay offers sophisticated tools that can help with shipping, handling e-mail messages and feedback for buyers, and managing listings. It can even help you decide which tools are right for your business (click on "How to Sell" at the bottom of eBay's homepage and follow provided links for details).

21-5e Forecasting Supply Needs

How much cash is needed for the next quarter? How much inventory must be carried to support the next season? How much lead time is needed to fill orders? Forecasting can help with understanding where the business is going and the level of resources—from personnel to capital funding—that will be required. Forecasting techniques can be as simple as projecting what will happen based on what happened last year, last week, or an average of several previous periods. Some businesses may require greater accuracy and thus need a more complex model for forecasting.

Associative forecasting takes a variety of driving variables into account when determining expected sales. The amount of sales expected at a local ice cream parlor, for example, is a product of many underlying predictors, such as the day of the week or season of the year, weather (rain versus sunshine, hot versus cool), local events (such as the timing of sporting events or movie premieres), and promotions (which could include sales or coupons). Each of these factors has a different impact on expected sales. Using forecasting tools such as regression, a small business owner can determine the impact of each variable on sales in the past and then use that association to predict future demand.

21-5f Using Information Systems

For years now, small firms have been improving their operational efficiency through the use of computers, new business software, and Internet links with suppliers and customers. Tedious, paper-based processes for tracking orders, work in process, and inventory have been replaced by simplified and accelerated computer-based processes.

The use of electronic invoicing and billing is growing worldwide—and with good reason. A study conducted by *CFO* magazine found that 25 percent of 1,485 companies using paper invoices were spending more than $10 per invoice to process them. The average amount spent was $5.83.[24] Companies using one of the many available accounts payable automation services find that they can reduce that cost to less than $1 per invoice.[25] For a company that handles thousands of invoices per month, such savings

associative forecasting
Forecasting that considers a variety of variables to determine expected sales.

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can have a substantial impact on costs. The software can be purchased off the shelf, so changing how things are done and training personnel on a new system may actually be more challenging than the installation of the new software itself.

Management information systems are continually being reinvented and improved. Microsoft alone spends exceedingly large sums of money to build software that will automate practically every aspect of a small company's business (including order processing and inventory management) and create a base layer of technology upon which smaller software makers can build applications. This software is also designed to work for a variety of businesses, from retail to manufacturing and distribution.[26] The information systems options and other tech-based tools available to small companies just keep getting better, more powerful, and less expensive.

21-6 Describe lean production, synchronous management, and the value these approaches provide to the overall operations management of a small business.

21-6 Lean Production and Synchronous Management

A revolution in operations management practices is changing the way business is done in many firms. With a focus on eliminating waste, lean production and synchronous management have made their mark on both large and small companies.

21-6a Lean Production

Companies are widely adopting principles of lean production, an influential model that is fundamentally reshaping the way operations are planned and managed. **Lean production** is more than a simple set of practices—it is a guiding philosophy and management approach that emphasizes efficiency through the elimination of all forms of waste in a company's operations.

The ideas at the center of lean production certainly are not new. In fact, the seeds of the concept were sown more than a century ago by Henry Ford, a leading visionary in the automobile industry and an outspoken advocate of efficiency in manufacturing. Later, Shoichiro Toyoda, former president of Toyota Motors, built on Ford's concepts and focused on eliminating waste, in all of its many forms, from his production system. He defined *waste* as "anything other than the minimum amount of equipment, materials, parts, space, and workers' time, which are absolutely essential for adding value to the product."[27] In other words, the goal of lean production is to use the minimum amount of resources necessary to achieve a total bundle of satisfaction for the customer.

The lean production mindset that has been integrated into the operations of most major corporations, including the Toyota Production System (TPS), makes the elimination of waste a top priority by emphasizing the following principles:[28]

- *Defects* are costly because they have to be repaired or scrapped.
- *Overproduction* can lead to waste because it must be stored and may never be sold.
- *Transportation* costs can be minimized by locating close to suppliers and customers.
- *Waiting* can be wasteful because resources are idle.
- *Inventory* in excess of the minimum required is unproductive and costly.
- *Motion*, whether by people or machinery, is wasted when it's unnecessary.
- *Processing* itself is wasteful if it is not productive.

lean production
An approach that emphasizes efficiency through elimination of all forms of waste in a company's operations.

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As companies of all sizes around the world have subscribed to the principles of lean production, the supply chain (introduced in Chapter 15) has become susceptible to disruption, and this can be a problem. Toyota, for example, keeps only two hours of inventory in their assembly plants, so there is little margin for error on the supply side of the equation. When the COVID-19 pandemic began to disrupt supply chains, the downside of this practice became very evident, leading some to conclude that production cost-cutting strategies may have gone too far.[29] At the same time, though, maintaining minimal inventory can also lead to a variety of benefits, ranging from capital efficiency to a smooth production process. So, it is likely to become the norm once the pandemic subsides and global supply chains stabilize.

Businesses choosing to adopt lean production approaches obviously have to wrestle with the difficult challenges that may come with them. However, new solutions continue to emerge that can help to make them more manageable. One of these is the use of robots. There was a time when using robots in manufacturing was something that only huge corporations could consider. But now that high-potential machines with much lower prices have hit the market, that is no longer the case.

As mentioned earlier in the chapter, small companies have been recognizing the value of using robots to help with their work. These machines can handle a wide range of unbearably tedious and unpleasant tasks, and with greater precision and fewer errors than human beings. The new breed of collaborative robots, often called "cobots," are able to work closely with people and can be programmed with flexibility to handle various tasks. And they ultimately promote lean production and waste reduction by increasing efficiencies, minimizing scrap and rework, and replacing more expensive human labor. Though small businesses are still struggling to integrate robots into their workflow, this is quickly becoming a game-changer for companies of all sizes, especially those for which efficiency and waste control are primary concerns.[30]

21-6b Synchronous Management

Going a step beyond lean production, **synchronous management** views the assets and activities of an organization as interdependent and suggests that they be managed in a way that optimizes the performance of the entire company. This approach presumes that the goal of the organization, and the definition of performance that flows from it, is known and influences all decision-making. It requires an understanding of how a shift in one area of operations can affect the rest of the organization—that is, it provides insight regarding interrelationships between assets, changes in activities, and achievement of the firm's goals.

Although these ideas are not original, they are finally being understood and implemented, in many cases for the first time. Henry Ford concluded early on that the key to manufacturing efficiency lies in a synchronized flow of materials and products into, through, and out of the plant in concert with market demand. It's clear to see that companies that understand crucial interactions between their assets and activities are likely to produce greater profits.

Identifying bottlenecks is imperative to making synchronous management work. A **bottleneck** is any point in an operations system where limited capacity reduces the production capability of an entire chain of activities so that it cannot satisfy market demand for products or services. For example, a bottleneck can be created by a machine that cannot operate fast enough to keep up with the rest of the equipment on an assembly line. In a more complex production system, it is possible to have more than

synchronous management
An approach that recognizes the interdependence of assets and activities and manages them to optimize the entire company's performance.

bottleneck
Any point in the operations process where limited capacity reduces the production capability of an entire chain of activities.

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Living the Dream

Some Small Business Problems Can Be Cutting!

David Allen, Puremco, Inc.

David Allen is adjunct professor of entrepreneurship and past Director of the John F. Baugh Center for Entrepreneurship and Free Enterprise at Baylor University. But he also owned a manufacturing business in Central Texas for several years and learned a thing or two about production bottlenecks from that experience. What follows is an account of how he tackled a serious production problem while running his business, presented in his own words.

From my years as an owner/operator of a manufacturing company, I found that managing operations was one of my favorite aspects of small business management. The venture, Puremco Manufacturing Company, produced dominoes. You may know that there are 28 individual tiles in a regular double-six set of dominoes. Our process involved pouring a liquid plastic solution into molds after adding a catalyst that would cause the plastic to heat up to a fairly high temperature. When the solution cooled, it would then harden and become a solid bar of plastic approximately 12 inches long. These bars would then be cut into individual tiles that were either 3/8 inch or 1/2 inch in thickness, depending on the size of the dominoes we were producing.

After the cutting operation, the pieces were tumbled in a barrel containing the domino tiles, a rough volcanic rock called pumice, and water to smooth out any cut marks and to round off the edges. They were then tumbled again in hardwood pegs and a polish which would give them a glossy finish before they were fed through semi-automated production machinery that would drill the shallow holes and insert a drop of paint into the holes. The dominoes came out the end of the production line in complete sets and were ready for inspection and packaging.

In order to maintain a coordinated operation, each step in the process had to be constantly monitored. Staying on top of all of this was like solving a puzzle with many different parts, and on a daily basis. I found it interesting and challenging to keep all operating stations running smoothly and in sync with one another. The goal was to prevent bottlenecks from interrupting the operation, which naturally would happen if any one station could not keep up with the others. The cutting operation, in particular, had to be watched carefully at all times because it could not run fast enough to maintain pace with the other operating stations over an ordinary eight-hour shift. How to solve this bottleneck problem? I came up with a few possible solutions. One option would be to build an additional cutting machine. Or, as an alternative, we could run the current cutter for more than eight hours every day.

Since the cutters were unique, they had to be specially made in a machine shop and therefore were very expensive. And since adding a new cutter would leave us with excess capacity for that stage of the process, we would have costly equipment sitting idle for much of the day. Taking these factors into account, I concluded that solution didn't make sense financially. That's when I determined that the best answer was simply to monitor the cutting operation closely so we would know immediately when it started to fall behind. Whenever we noticed that a bottleneck was forming, we ran the machine extra hours to build up a backlog of stock ahead of the next step in the operation. After that, we continually monitored the station to make sure further bottlenecks did not develop.

This simple solution worked well and was far less expensive than investing in additional equipment which could not be fully utilized. My experience at Puremco was par for the course for small businesses, which almost always have ambitions that outpace their resources. Since they often cannot come up with solutions out of the wallet, entrepreneurs have to think very creatively to solve everyday problems. But as I see it, that's all part of the adventure of being a small business owner.

constraint
The most restrictive of bottlenecks, determining the capacity of the entire system.

one bottleneck (that is, more than one resource whose capacity is lower than the market demand for what is being produced). In this case, the most restrictive of the bottlenecks is called a **constraint**. Since the constraint determines the capacity of the entire system, it is imperative that it be synchronized with all other organizational activities.

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Exhibit 21.3 Avoiding Bottlenecks and Constraints

Add Capacity	• Expand resources. • Subdivide the work. • Outsource production to a company with more capacity.
Increase Efficiency	• Arrange schedules so that the resources take no breaks (for example, have employees take breaks during setup, teardown, or maintenance activities). • Schedule maintenance on nights, weekends, and holidays rather than during productive time. • Increase productivity through employee training, upgraded tools, or automation.
Filter Production	• Inspect quality prior to a constraint. • Allow only work that achieves firm goals and contributes to performance (that is, a finished goods inventory would be unnecessary).

Finding the bottlenecks in an organization can be a challenging exercise. Sometimes, setting up a simple suggestion box can provide valuable information from employees who are able to identify and address bottlenecks and constraints and other operations-centered problems. You might be surprised by the quality of the ideas that your staff can come up with if you offer a small incentive (like a cash prize for the best suggestion). Or, you could use an idea-management system like Ideawake, Spigit, or Brightidea to collect and rank employee recommendations.

High-tech solutions are also available to help keep production moving efficiently, but the high cost can be prohibitive for many small businesses. For example, manufacturing analytics systems like Sight Machine use artificial intelligence, machine learning, and advanced analytics to address critical quality and productivity challenges across a company's full range of operations. The platform can trace a problem back to the plant, production line, machine—even a specific part—that is causing it. It can determine when and why production is lagging and can help to identify ways to reduce scrap.[31] But no matter how you go about this, once a bottleneck or constraint is found, you need to figure out what can be done to address it. The three basic options shown in Exhibit 21.3 provide common ways to deal with bottlenecks and constraints.

Any loss of throughput at a bottleneck or constraint translates to lower production for the entire line or organization. It follows that these points in an operations system deserve special attention, for the sake of the company and its performance. For resources that do not contribute to a bottleneck or constraint in a production line or service firm, it is far less important to make investments to improve their functioning and increase their efficiency.

Hopefully, it is apparent to you by now that operations management is very important to the functioning and performance of all types of businesses, whether large or small. Best practices typically are perfected in large corporations, but the principles and approaches they refine can usually be adapted to the management of smaller enterprises, at least at some level. In a competitive marketplace, effective and efficient operations are necessary to survival. And where this is not the case, best practices can still add to customer benefits, firm performance, and the satisfaction of the company's owners. Practices such as managing inventory wisely, treating suppliers well, and ensuring the quality of products made or services offered protect and enhance the reputation of the company. This is only possible when sound operations management practices are used. The commitment of time and energy required to reach excellence certainly pays off over the long run.

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21-1. Describe how operations enhance a small company's competitiveness.

- The term *operations* refers to the processes used to create and deliver a product or service.
- Companies gain power to the degree that they excel in satisfying customer needs and wants more precisely and/or efficiently than their competitors.
- To be successful, a company's operations must involve all of the activities required to create value for customers and earn their dollars.
- *Operations management* refers to the planning and control of a conversion process that includes bringing together inputs and turning them into outputs (products and services) that customers want.

21-2. Discuss the nature of the operations process for both products and services.

- Product-oriented and service-oriented operations are similar in that they change inputs into outputs.
- Managers of service businesses face special challenges in ensuring and controlling quality, given the difficulty inherent in measuring and controlling intangibles.
- In service businesses, employees interact extensively with customers.
- The adoption of various technologies has enabled customers of many businesses to provide more of their own services.
- Most manufacturing operations can be classified as one of three types—job shops, project manufacturing, and repetitive manufacturing.
- Flexible manufacturing systems can help cut manufacturing costs while giving customers exactly what they want.
- A small company's capacity to offer products or services is a critical factor.
- Production planning and scheduling procedures are designed to achieve the orderly sequential flow of manufactured products through a plant at a rate that matches deliveries to customers.
- Demand management strategies are used to stimulate customer demand when it is normally low.

21-3. Identify ways to control inventory and minimize inventory costs.

- Inventory management can help an entrepreneur understand the vital balance between two competing pressures in the business—increasing inventory to satisfy customer demand and reducing inventory to maintain a healthy balance sheet.
- The reasons for carrying inventory include the following: to meet customer demand, to be less dependent on a supplier, to protect against stockouts, to benefit from sales or quantity-based discounts, and to protect against price increases.
- One method of determining an ideal inventory level is to calculate the economic order quantity, an index that establishes the purchase quantity of an item that will minimize total inventory costs.
- Statistical inventory control accommodates the variability of supply and demand using a targeted service level.
- The ABC method of inventory analysis classifies items into three categories based on dollar velocity.
- Just-in-time inventory systems are designed to cut inventory carrying costs by making or buying what is needed just as it is needed.
- Types of inventory recordkeeping systems include physical inventory systems, perpetual inventory systems, and two-bin inventory systems.

21-4. Summarize the contributions of operations management to product and service quality.

- *Quality* can be defined as the characteristics of a product or service that determine its ability to satisfy customers' stated and implied needs.
- Total quality management is an all-encompassing, quality-focused management approach that is customer driven, stresses total employee involvement, is process-centered, calls for overall system integration, follows a strategic and systematic approach, focuses on

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a culture of continuous improvement, involves fact-based decision making, and emphasizes effective and timely communication.

- A company's quality management efforts should begin with a focus on meeting the expectations of customers who purchase its products or services.
- Paying careful attention to the details of a firm's operations and correcting any weaknesses, as well as listening to customer feedback, help ensure that customers get the quality they expect.
- One useful approach to gathering customer-based information is to "mine" company sales data to learn more about customer behavior.
- An important element in effective quality management consists of the various tools, techniques, and procedures needed to ensure high-quality products and services.
- Product quality can be maintained by inspection or by using the poka-yoke approach, which seeks to mistake-proof a firm's operations.
- Acceptance sampling is one statistical method of quality control.
- ISO 9000 certification requires full documentation of a firm's quality management procedures and is particularly valuable for small firms.
- Although it is easier to measure the quality of products, effective methods for measuring the quality of services can also be devised.

21-5. Explain the importance of purchasing and the nature of key purchasing policies.

- The quality of a finished product depends on the quality of the raw materials used.
- Purchasing contributes to profitable operations by ensuring that goods are delivered when they are needed.
- Purchasing practices that seek out the best prices can have major impact on the financial health of a business.
- The decision to make or buy should be based on long-run cost and profit optimization because it can be expensive to reverse.
- Companies can sometimes save money by outsourcing to suppliers specializing in a particular type of work.
- Cooperative purchasing organizations help smaller firms negotiate as a group for lower prices and better service from suppliers.
- The Internet provides small business owners with connections to hundreds of suppliers.
- Diversifying purchases from suppliers can help a small business maintain alternative sources of supply.
- Critical factors in assessing supplier performance are reliability, responsiveness, agility, costs, and assets.
- Good relationships with suppliers are essential for small businesses.
- Developing strategic alliances, forecasting supply needs, and using information systems are elements of other purchasing policies used by small companies.

21-6. Describe lean production, synchronous management, and the value these approaches provide to the overall operations management of a small business.

- Lean production emphasizes efficiency through the elimination of all forms of waste in a company's operations.
- Maintaining a very low amount of inventory can lead to a variety of benefits, ranging from capital efficiency to a smooth production process.
- Synchronous management suggests that the assets and activities of an organization are interdependent and should be managed in a way that optimizes the performance of the entire company.
- Understanding how a shift in one area of operations can affect the rest of the organization underlies synchronous management and is likely to produce the greatest profits.
- Bottlenecks and constraints must be managed carefully because these determine the capacity of the entire production system.

Key Terms

ABC method p. 577
acceptance sampling p. 584
associative forecasting p. 591
attributes p. 585
bottleneck p. 593
constraint p. 594
continuous manufacturing p. 572
cooperative purchasing organization (coop) p. 588
cycle counting p. 579
demand management strategies p. 575
economic order quantity p. 577
flexible manufacturing systems p. 572
inspection p. 584
ISO 9000 p. 585

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job shops p. 572
just-in-time inventory system p. 578
lean production p. 592
make-or-buy decision p. 587
operations p. 569
operations management p. 569
outsourcing p. 588
perpetual inventory system p. 579
physical inventory system p. 579
poka-yoke p. 584
project manufacturing p. 572
quality p. 579
repetitive manufacturing p. 572
statistical inventory control p. 577
Supply Chain Operations Reference (SCOR) model p. 589
synchronous management p. 593
total quality management (TQM) p. 580
two-bin inventory system p. 579
variables p. 585

Chapter 21 Case

Please see Appendix A for the Chapter 21 Case Study.

Discussion Questions

1. How important is managing operations to the competitiveness of a small business? Why?
2. What are some distinctive features of the operations process in service firms?
3. Customer demand for services is generally not uniform during a day, week, or other period of time. What strategies can be used by service businesses to better match the company's capacity to perform services to customers' demand for those services?
4. What are the major features of the just-in-time inventory system? Is it applicable to small companies? Be prepared to defend your answer.
5. Why is the customer focus of quality management so important in a small firm? What can be done to ensure that the quality of a small venture's products or services remains high?
6. How important is effective purchasing to a small business? Can the owner-manager of a small firm safely delegate purchasing authority to a subordinate? Explain.
7. Under what conditions should a small manufacturer either make component parts or buy them from others?
8. What are the relative merits of inspection approaches and poka-yoke to quality assurance in a small company?
9. What steps can a company take to build good relationships with suppliers? Can you think of any ethical issues that should be taken into account when deciding how to interact with suppliers?
10. Explain the meaning of the terms *lean production* and *synchronous management*. How are these relevant to operations in a small company?

You Make the Call

Situation 1

Christina Poole owns two pizza restaurants in a city with a population of 150,000 and is studying her company's operations to be sure they are functioning as efficiently as possible. About 70 percent of the venture's sales represents dine-in business, and 30 percent comes from deliveries. Poole has always attempted to produce a high-quality product and to minimize the waiting time of customers both on- and off-premises.

Poole recently read a magazine article suggesting that quality is now generally abundant and that quality differences between businesses are narrowing. The writer advocated placing emphasis on saving time for customers rather than producing a high-quality product. Poole is contemplating the implications of this article for her pizza business. Realizing that her attention should be focused, she wonders whether to concentrate primary managerial emphasis on delivery time.

Question 1 Is the writer of the article correct in believing that quality levels now are generally high and that quality differences among businesses are minimal?

Question 2 What are the benefits and drawbacks of placing the firm's primary emphasis on minimizing customer wait time?

Question 3 If you were advising Poole, what would you recommend?

Question 4 How would your answers to the previous questions be different if Poole sold a $6 pizza? What if the pizza cost $25?

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Situation 2

Jonathan Tandy, owner of a small furniture manufacturing firm, is trying to deal with the firm's thin working capital situation by carefully managing payments to the company's major suppliers. These suppliers extend credit for 30 days, and customers are expected to pay within that time period. However, the suppliers do not automatically refuse subsequent orders when a payment is a few days late. Tandy's strategy is to delay payment of most invoices for 10 to 15 days beyond the due date. He believes that the suppliers will go along with him rather than risk losing future sales. This practice enables Tandy's firm to operate with sufficient inventory, avoid costly interruptions in production, and reduce the likelihood of an overdraft at the bank.

Question 1 What are the ethical issues raised by Tandy's payment practices?

Question 2 What impact, if any, might these practices have on the firm's supplier relationships? How serious would this impact be?

Question 3 What changes in company culture, employee behavior, or relationships with other business partners may result from Tandy's practices?

Situation 3

Tyler Smithson owns Joe on the Run, a local chain of three coffee shops in the Denver area, all of which are facing a challenge that is common to most service businesses: They have to deal with highly variable demand, with two or three very busy times each day. If a waiting line develops, we can assume that a constraint exists somewhere in the product or service delivery. Typical workstations behind the counter include the barista station (where specialty drinks are made), the drive-thru station, and the cashier station. Because the goal of the company is to satisfy the most customers possible (and thus increase profits), a constraint at one of these workstations must be addressed quickly.

Question 1 What can be done to improve capacity?

Question 2 What can be done to improve efficiency?

Question 3 What could be done at a store level to improve the performance of the business?

Experiential Exercises

1. Outline the operations process in your present educational program. Be sure to identify inputs, processes, and outputs.
2. Describe, in detail, your customary practices in studying for a specific course. Evaluate the methods you use and specify changes that might improve your productivity.
3. Using the ABC inventory analysis method, classify some of your personal possessions into the three categories. Include at least two items in each category. Does this practice change the way you think about managing your "personal inventory"?
4. Interview the manager of a bookstore about the type of inventory control system used in the store. Write a report in which you explain the methods used to avoid buildup of excessive inventory.

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Chapter 22

Managing the Firm's Assets

Looking Ahead

Learning Objectives

Oftentimes small business owners focus on the income statement but give little consideration to managing the firm's assets. That is a big mistake. The purpose of this chapter is to help you know how to manage the company's assets. By studying this chapter, you should be able to . . .

22-1 Describe the working capital cycle of a small business.

22-2 Identify the important issues in managing a firm's cash flows.

22-3 Explain the critical issues in managing accounts receivable.

22-4 Discuss the key financial issues in managing inventory.

22-5 Describe the important issues in managing accounts payable.

22-6 Calculate and interpret a company's cash conversion period.

22-7 Discuss the techniques commonly used in making capital budgeting decisions.

22-8 Describe the capital budgeting practices of small firms.

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Spotlight on Small Business

Nathan Perry, founder, Cutting Edge Elite, Inc.

www.ceenyc.com

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Nathan Perry, co-owner of The Cutting Edge Elite (CEE) founded in New York City, and now in multiple cities, puts maximum effort into building great relationships with the firm's customers. The catering business, now 14 years old, uses professional models and actors who are experienced and educated in the art of service. Their mission is to be poised and charismatic when working an event. Coming from all walks of life and ethnic backgrounds, they add diversity and a unique energy to every event.

The firm's website describes the management's business philosophy as follows:

> Cutting Edge Elite is more than an event staffing agency. We are an extension of you. CEE has been in the industry for 14 years and counting. We wouldn't be where we are today without our incredible field & corporate staff as well as our loyal client base. Through leadership, dialogue, and honesty, we build teams and communities with the power to meet any expectations. When staff work with CEE they are a part of our family and more than just a "number." We take care of our team so they can take care of our clients.

Perry hasn't always been able to focus on building unique experiences with customers, however. In the early days, he had to devote energy to collecting on accounts receivable. He begrudged spending his time in this way, finding it to be a major distraction from where his passions lie. But he desperately needed the cash for operations.

"When someone would tell you the check was in the mail, it didn't mean anything," observed Perry. At that time, almost all small service businesses would complete work for a customer, send a bill, and then have to wait for weeks (even months) to receive payment, possibly tying up thousands of dollars in accounts receivable. Even today it is not unusual for a small business to give a customer 30 days to pay an invoice, but for the customer to take 60 to 90 days before actually paying.

Perry, along with many other small business owners, are now relying on mobile payment devices and other technologies to collect what is owed immediately. Instead of sending an invoice after a job and waiting 30 days or longer to be paid, customers now pay as soon as the work is completed by using a mobile payment service. The result: Many small business owners can now use the money to pay salaries and to purchase supplies, which means that they have less of their own money tied up in working capital.

But there are no free lunches. Generally, the fees associated with mobile payments are comparable to credit card processing fees. As customers increasingly use their smartphones for more tasks, paying the small fee is balanced by the advantage of having the mobile payment option available to small businesses. While there are certainly trade-offs, the payment revolution powered by mobile devices continues to grow, to the benefit of many small business owners like Nathan Perry.

Given the growth of the business and the use of technology, Perry now focuses on investing in personnel, specifically with training, direction, and teamwork. He seeks to advance his businesses by innovating their service and value to both clients and employees and believes all leadership must hold itself to those standards.

Sources: Adapted from Angus Loten and Emily Maltby, "Mobile Payments Brighten Cash Flow for Small Business," http://online.wsj.com/article/SB10001424127887323699704578328851902509698.html?mod5WSJ_SmallBusiness_LEFTTopStories, February 27, 2013, accessed September 15, 2021; and www.ceenyc.com, accessed October 2, 2021.

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In the opening Spotlight feature, we described Nathan Perry's efforts to use technology to collect what customers owe him on a timelier basis, so that more of his time could be spent cultivating customers. The same story could be told by almost all small businesses that extend credit to their customers. Collections are a never-ending challenge. In fact, most novice entrepreneurs are shocked by how much time and energy they must commit to collections. Controlling all of a firm's assets requires the same commitment from a firm's management. This chapter focuses on this important issue.

22-1 The Working Capital Cycle

22-1 Describe the working capital cycle of a small business.

In Chapters 10 and 11, respectively, we defined *working capital* as a firm's current assets (primarily cash, accounts receivable, and inventory), and *net working capital* as current assets less current (short-term) liabilities. **Working capital management**—managing current assets and short-term sources of financing (current liabilities)—is extremely important to most small companies. In fact, no financial management process is more important and, yet, more misunderstood. Good business opportunities can be irreparably damaged by ineffective management of current assets and short-term liabilities. We have made this point repeatedly when discussing the importance of managing cash.

A firm's **working capital cycle** is the flow of resources through the company's accounts as part of its day-to-day operations. As shown in Exhibit 22.1, the steps in a firm's working capital cycle are as follows:

Step 1. Purchase or produce inventory for sale, which increases inventory on hand and (a) decreases cash if cash is used to pay for the inventory or (b) increases accounts payable if the inventory is purchased on credit.

Step 2. a. Sell the inventory for cash, which increases cash, or

b. Sell the inventory on credit, which increases accounts receivable.

Step 3. a. Pay the accounts payable, which decreases accounts payable and decreases cash.

b. Pay operating expenses and taxes, which decreases cash.

Step 4. Collect the accounts receivable when due, which decreases accounts receivable and increases cash.

Step 5. Begin the cycle again.

Note that the only current liability included in the working capital cycle is accounts payable, which affects the timing of payments for inventory. Accrued expenses, although shown on financial statements as a short-term liability, primarily result from an accountant's effort to match revenues and expenses. Little can be done to "manage" accruals, and so we ignore them as part of the working capital cycle. Also, a short-term bank note, while shown as a current liability is not considered to be part of the working capital cycle. *In this context, think of working capital as the liquid assets (cash and those assets soon to be converted into cash) that are required to run and grow the business less any credit provided by suppliers in the form of accounts payable.*

working capital management
The management of current assets and current liabilities.

working capital cycle
The daily flow of resources through a firm's working capital accounts.

Depending on the industry, the working capital cycle may be long or short. For example, it is only a few days in a restaurant business. It is longer, most likely months, in most computer hardware businesses. Whatever the industry, however, management should be working continuously to shorten the cycle.

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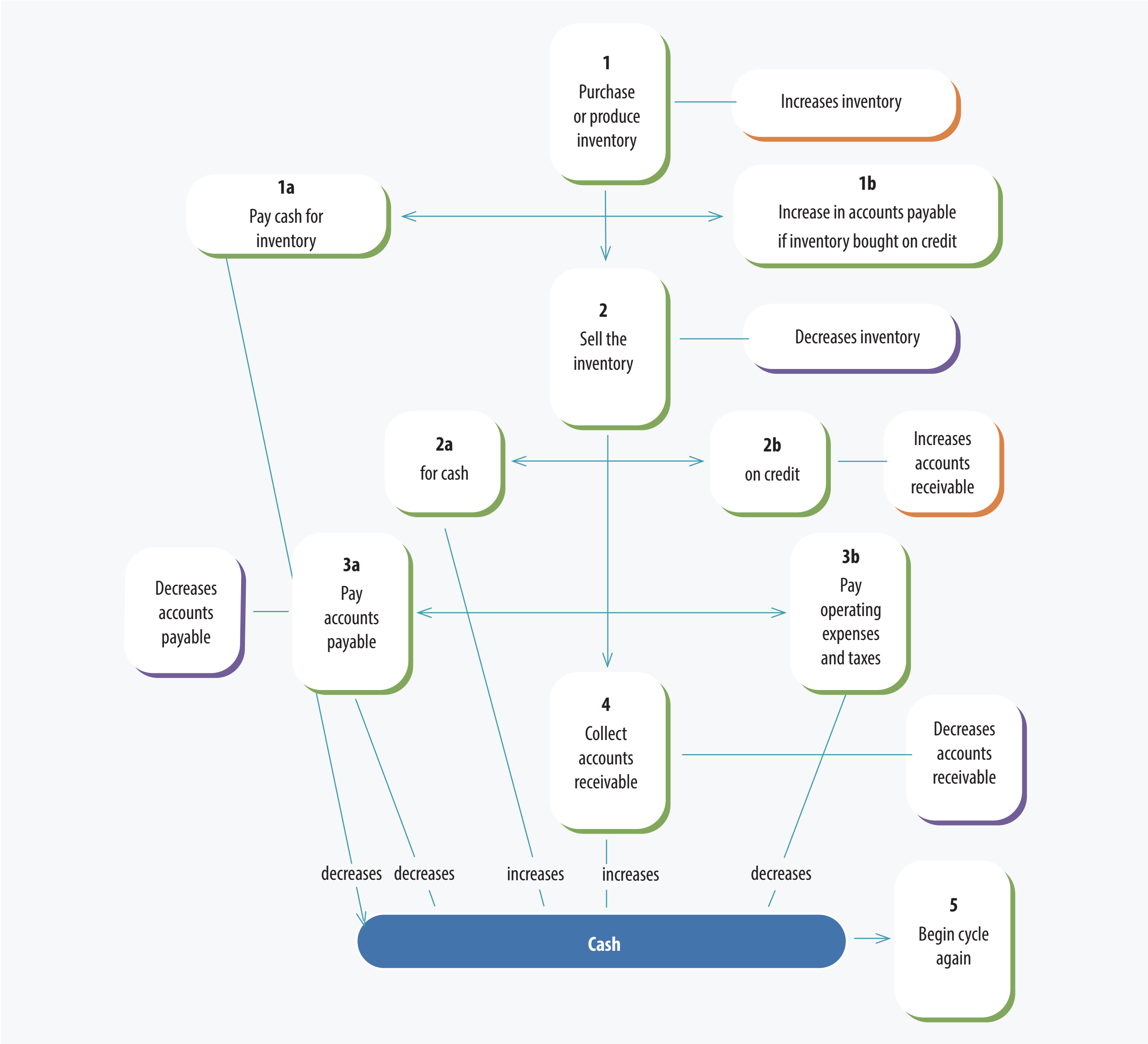
Exhibit 22.1 Working Capital Cycle



22-1a The Timing and Size of Working Capital Investments

It is imperative that owners of small companies understand the working capital cycle, in terms of both the timing of investments and the size of the investment required (for example, the amounts necessary to maintain inventory and accounts receivable). Too many entrepreneurs wait until a problem with working capital develops to examine these relationships. An owner's failure to do so underlies many of the financial problems of small companies.

Exhibit 22.2 shows the chronological sequence of a hypothetical working capital cycle. The timeline reflects the order in which events unfold, starting with purchasing

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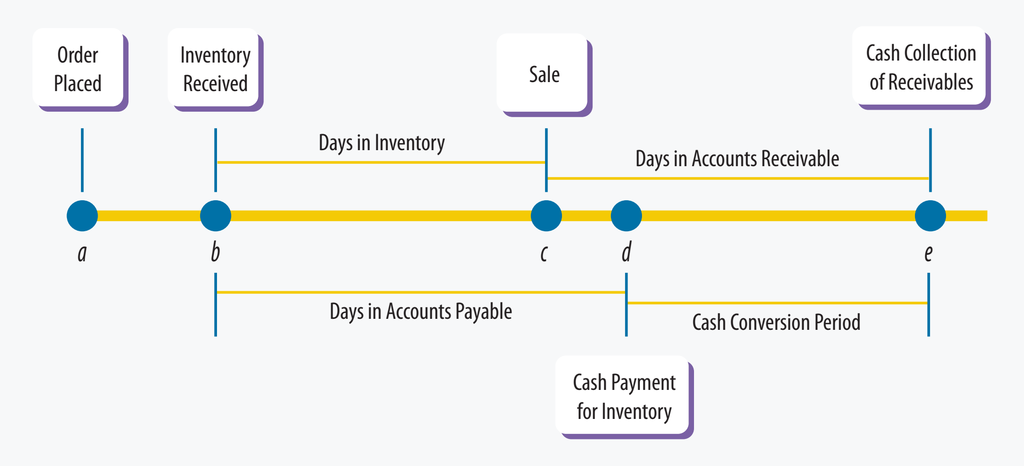
Exhibit 22.2 Working Capital Timeline



inventory and ending with collecting accounts receivable. The key dates in the exhibit are as follows:

Day a: Inventory is ordered in anticipation of future sales.

Day b: Inventory is received, and the supplier extends credit in the form of accounts payable.

Day c: Inventory is sold on credit.

Day d: Accounts payable for purchases of inventory come due and are paid.

Day e: Accounts receivable are collected.

The investing and financing implications of the working capital cycle reflected in Exhibit 22.2 are as follows:

- Money is invested in inventory from day *b* to day *c*.
- The supplier provides financing for the inventory from day *b* to day *d*.
- Money is invested in accounts receivable from day *c* to day *e*.
- Financing of the firm's investment in accounts receivable must be provided from day *d* to day *e*. This time span, called the **cash conversion period**, represents the number of days required to complete the working capital cycle, which ends with the conversion of accounts receivable into cash. During this period, the firm no longer has the benefit of supplier financing (accounts payable). The longer this period lasts, the greater the potential cash flow problems for the firm.

22-1b Examples of Working Capital Management[1]

Exhibit 22.3 offers an example of working capital management for two hypothetical firms with contrasting working capital cycles: Pokey, Inc., and Quick Turn Company. On August 15, both firms ordered inventory that they received on August 31, but the similarity ends there.

Pokey, Inc., must pay its supplier for the inventory on September 30, before eventually reselling it on October 15. It collects from its customers on November 30. As you can see, Pokey, Inc., must pay for the inventory two months prior to collecting from its customers. Its cash conversion period—the time required to convert the paid-for inventory and accounts receivable into cash—is 60 days. The firm's managers must

cash conversion period
The time required to convert paid-for inventory and accounts receivable into cash.

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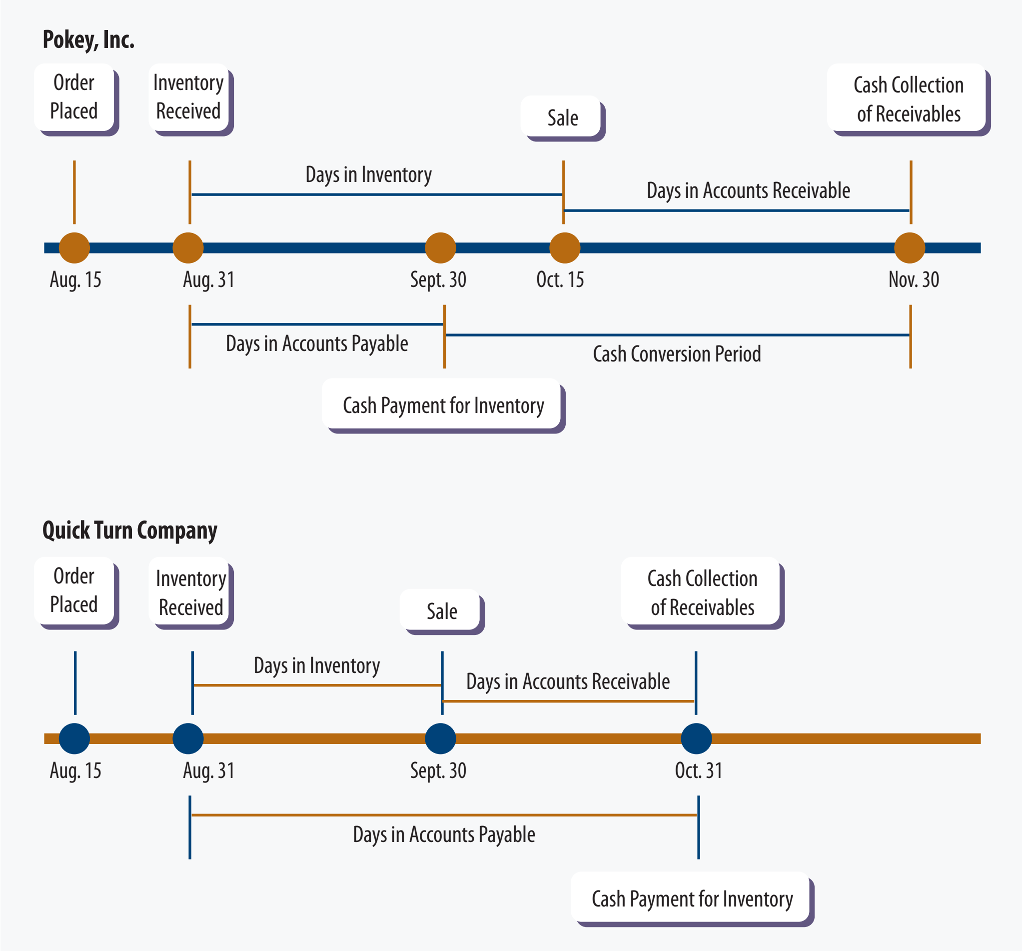
Exhibit 22.3 Working Capital Timelines for Pokey, Inc., and Quick Turn Company



find a way to finance this investment in inventory and accounts receivable or else the company will experience cash flow problems. Furthermore, although increased sales should produce higher profits, the cash flow problems will be compounded because the company will have to finance the investment in inventory until the accounts receivable are collected 60 days later.

Now consider Quick Turn Company's working capital cycle, shown in the bottom portion of Exhibit 22.3. Compared to Pokey, Quick Turn Company has an enviable working capital position. By the time Quick Turn must pay for its inventory purchases (October 31), it has sold its product (September 30) and collected from its customers (October 31). Thus, there is no cash conversion period because the supplier is essentially financing Quick Turn's working capital needs.

To gain an even better understanding of the working capital cycle, let's see what happens to Pokey's balance sheet and income statement. To do so, we will need more information about the firm's activities. A month-by-month listing of its activities and their effects on its balance sheet follow. Pay close attention to the firm's working capital, especially its cash balances.

July: Pokey, Inc., is a new company, having started operations in July with $1,000, financed by $300 in long-term debt and $700 in common stock. At the outset, the owner

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purchased $600 worth of fixed assets, leaving the remaining $400 in cash. At this point, the balance sheet would appear as follows:

Cash	$ 400
Fixed assets	600
TOTAL ASSETS	$1,000
Long-term debt	$ 300
Common stock	700
TOTAL DEBT AND EQUITY	$1,000

August: On August 15, the firm's managers ordered $500 worth of inventory, which was received on August 31 (see Exhibit 22.3). The supplier allowed Pokey 30 days from the time the inventory was received to pay for the purchase. Thus, inventory and accounts payable both increased by $500 when the inventory was received. As a result of these transactions, the balance sheet would appear as follows:

	July	**August**	**Changes: July to August**
Cash	$ 400	$ 400	
Inventory	0	500	+$500
Fixed assets	600	600	
TOTAL ASSETS	$1,000	$1,500	
Accounts payable	$ 0	$ 500	+$500
Long-term debt	300	300	
Common stock	700	700	
TOTAL DEBT AND EQUITY	$1,000	$1,500	

So far, so good—no cash problems yet.

September: On September 30, the firm paid for the inventory. Both cash and accounts payable decreased by $500, shown as follows:

	July	**August**	**September**	**Changes: August to September**
Cash	$ 400	$ 400	($ 100)	−$500
Inventory	0	500	500	
Fixed assets	600	600	600	
TOTAL ASSETS	$1,000	$1,500	$1,000	
Accounts payable	$ 0	$ 500	$ 0	−$500
Long-term debt	300	300	300	
Common stock	700	700	700	
TOTAL DEBT AND EQUITY	$1,000	$1,500	$1,000	

Now Pokey, Inc., has a cash flow problem in the form of a cash deficit of $100.

October: October was a busy month for Pokey. On October 15, merchandise was sold on credit for $900. Sales (in the income statement) and accounts receivable increased by that amount. The firm incurred operating expenses (selling and administrative

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expenses) in the amount of $250, to be paid in early November. Thus, operating expenses (in the income statement) and accrued operating expenses (current liabilities in the balance sheet) increased by $250. (An additional $25 in accrued expenses resulted from accruing taxes that will be owed on the firm's earnings.) Finally, in October, the firm's accountant recorded $50 in depreciation expense (to be reported in the income statement), resulting in accumulated depreciation on the balance sheet of $50. The results are as follows:

	July	August	September	October	Changes: September to October
Cash	$ 400	$ 400	($ 100)	($ 100)	
Accounts receivable	0	0	0	900	+$900
Inventory	0	500	500	0	–500
Fixed assets	600	600	600	600	
Accumulated depreciation	0	0	0	(50)	–50
TOTAL ASSETS	$1,000	$1,500	$1,000	$1,350	
Accounts payable	$ 0	$ 500	$ 0	$ 0	
Accrued operating expenses	0	0	0	250	+$250
Income tax payable	0	0	0	25	+25
Long-term debt	300	300	300	300	
Common stock	700	700	700	700	
Retained earnings	0	0	0	75	+75
TOTAL DEBT AND EQUITY	$1,000	$1,500	$1,000	$1,350	

The October balance sheet shows all the activities just described, but there is one more change in the balance sheet: It now shows $75 in retained earnings, which had been $0 in the prior balance sheets. As you will see shortly, this amount represents the firm's income. Note also that Pokey, Inc., continues to be overdrawn by $100 on its cash. None of the events in October affected the firm's cash balance. All the transactions were the result of accruals recorded by the firm's accountant, offsetting entries to the income statement. The relationship between the balance sheet and the income statement is as follows:

Change in the Balance Sheet		Effect on the Income Statement
Increase in accounts receivable of $900	—>	Sales of $900
Decrease in inventory of $500	—>	Cost of goods sold of $500
Increase in accrued operating expenses of $250	—>	Operating expenses of $250
Increase in accumulated depreciation of $50	—>	Depreciation expense of $50
Increase in accrued taxes of $25	—>	Tax expense of $25

November: In November, the accrued expenses were paid, which resulted in a $250 decrease in cash along with an equal decrease in accrued expenses. At the end of November, the accounts receivable were collected, yielding a $900 increase in cash and a $900 decrease in accounts receivable. Thus, net cash increased by $650. The final series of balance sheets is as follows:

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	July	August	September	October	November	Changes: October to November
Cash	$ 400	$ 400	$ (100)	$ (100)	$ 550	+$650
Accounts receivable	0	0	0	900	0	–900
Inventory	0	500	500	0	0	
Fixed assets	600	600	600	600	600	
Accumulated depreciation	0	0	0	(50)	(50)	
TOTAL ASSETS	$1,000	$1,500	$1,000	$1,350	$1,100	
Accounts payable	$ 0	$ 500	$ 0	$ 0	$ 0	
Accrued operating expenses	0	0	0	250	0	–$250
Income tax payable	0	0	0	25	25	
Long-term debt	300	300	300	300	300	
Common stock	700	700	700	700	700	
Retained earnings	0	0	0	75	75	
TOTAL DEBT AND EQUITY	$1,000	$1,500	$1,000	$1,350	$1,100	

As a result of the firm's activities, Pokey, Inc., reported $75 in profits for the period. The income statement for the period ending November 30 is as follows:

Sales revenue		$ 900
Cost of goods sold		(500)
Gross profit		$ 400
Operating expenses:		
Cash expense	$ (250)	
Depreciation expense	(50)	
Total operating expenses		$ (300)
Operating income		$ 100
Income tax (25%)		(25)
Net income		$ 75

The $75 in profits are reflected as retained earnings on the balance sheet to make the numbers match.

The somewhat contrived example of Pokey, Inc., illustrates an important point that deserves repeating: Owners of small firms must understand the working capital cycle of their firms. Although the business was profitable, Pokey ran out of cash in September and October (–$100) and didn't recover until November, when the accounts receivable were collected. This 60-day cash conversion period represents a critical time when the firm must find another source of financing if it is to survive. Moreover, when sales are ongoing throughout the year, the problem can be an unending one, unless financing is found to support the firm's sales. Also, as much as possible, a firm should arrange for earlier payment by customers (preferably in advance) and negotiate longer payment schedules with suppliers (preferably over several months).

An understanding of the working capital cycle provides a basis for examining the primary components of working capital management: cash flows, accounts receivable, inventory, and accounts payable.

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22-2 Identify the important issues in managing a firm's cash flows.

22-2 Managing Cash Flows

Cash flows are critical at every point in a company's life—when buying inventory, making a capital improvement, or hiring a new employee. Also, without the needed cash on hand, an owner cannot attract financing or secure a line of credit.

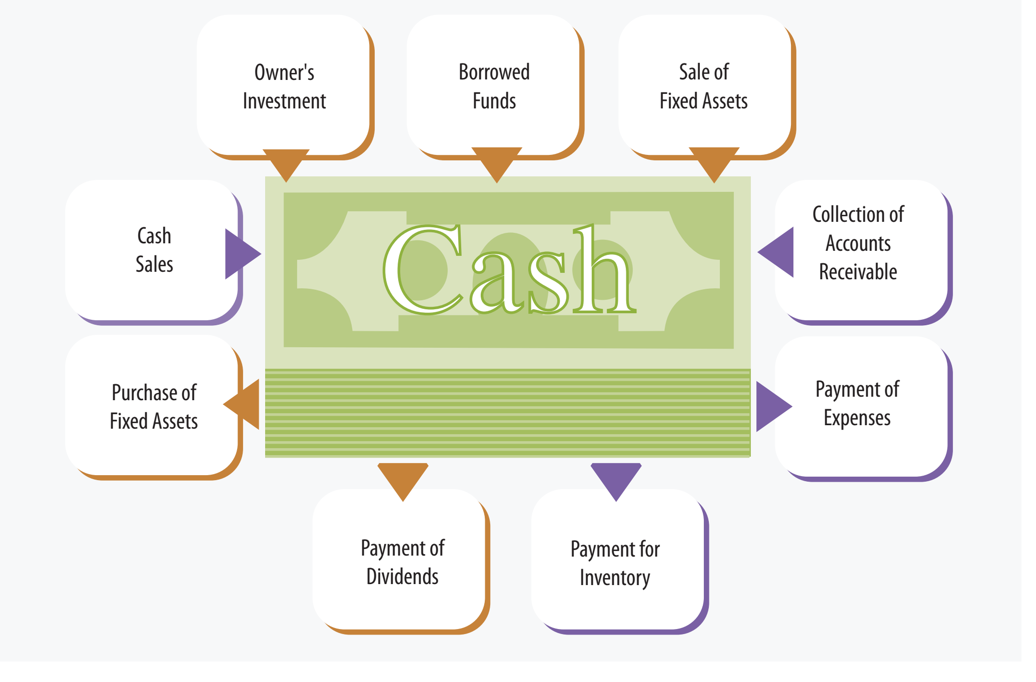
The examples of Pokey, Inc., and Quick Turn Company in the previous section illustrate that monitoring cash flows is at the core of working capital management. Cash is continually moving through a business. It flows in as customers pay for products or services, and it flows out as payments are made to other businesses and individuals who provide products and services to the firm, such as suppliers and employees. The typically uneven nature of cash inflows and outflows makes it imperative that they be properly understood and managed for the firm's well-being.

A firm's net cash flow may be determined quite simply by examining its bank account. Monthly cash deposits less checks written during the same period equal a firm's net cash flow. If deposits for a month add up to $100,000 and checks total $80,000, the firm has a net positive cash flow of $20,000. That is, the cash balance at the end of the month is $20,000 higher than it was at the beginning of the month.

Exhibit 22.4 graphically represents the flow of cash through a business. It includes not only the cash flows that arise as part of the firm's working capital cycle (shown in Exhibit 22.1) but other cash flows as well, such as those from purchasing fixed assets and issuing stock. More specifically, cash sales, collection of accounts receivable, payment of expenses, and payment for inventory reflect the inflows and outflows of cash that relate to the working capital cycle. The other items in Exhibit 22.4 represent other, longer-term cash flows.

As we have emphasized on several occasions, calculating cash flows requires that a small business owner be able to distinguish between sales revenue and cash receipts—they are seldom the same. Revenue is recorded at the time a sale is made but does not affect cash flows at that time unless the sale is a cash sale. Cash receipts,

Exhibit 22.4 Flow of Cash through a Business



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on the other hand, are recorded when money actually flows into the firm, often a month or two after the sale. Similarly, it is necessary to distinguish between expenses and disbursements. Expenses occur when materials, labor, or other items are used. Payments (disbursements) for these expense items may be made later, when checks are issued. Depreciation, while shown as an expense, is not a cash outflow.

Given the difference between cash flows and profits, it is absolutely essential that the entrepreneur develop a cash budget to anticipate when cash will enter and leave the business. (The cash budget was explained in Chapter 11 when we described financial forecasting.)

22-3 Managing Accounts Receivable

22-3 Explain the critical issues in managing accounts receivable.

Chapter 16 discussed the extension of credit by small firms, and the managing and collecting of accounts receivable. This section considers the impact of credit decisions on working capital and particularly on cash flows. The most important factor in managing cash well within a small firm is the ability to collect accounts receivable quickly.

22-3a How Accounts Receivable Affect Cash

Granting credit to customers, although primarily a marketing decision, directly affects a firm's cash account. By selling on credit and thus allowing customers to delay payment, the selling firm delays the inflow of cash.

The total amount of customers' credit balances is carried on the balance sheet as accounts receivable—one of the firm's current assets. Of all noncash assets, accounts receivable are close to becoming cash. Sometimes called *near cash*, or *receivables*, accounts receivable typically are collected and become cash within 30 to 60 days following a sale.

22-3b The Life Cycle of Accounts Receivable

The receivables cycle begins with a credit sale. In most businesses, an invoice is then prepared and mailed to the purchaser. When the invoice is received, the purchaser processes it, prepares a check, and mails the check in payment to the seller.

Under ideal circumstances, each of these steps is taken in a timely manner. Obviously, delays can occur at any stage of this process. For example, a shipping clerk may batch invoices before sending them to the office for processing, thus delaying the preparation and mailing of invoices to customers. Such a practice will also hold up the receipt of customers' money and its deposit in the bank—money that is then used to pay bills. In other words, receivables may be past due because of problems in a company's organization, where information is not getting transferred on a timely basis among salespeople, operations departments, and accounting staff. The result: delayed payments from customers and larger investments in accounts receivable.

Credit management policies, practices, and procedures affect the life cycle of receivables and the flow of cash from them. It is important for small business owners, when establishing credit policies, to consider cash flow requirements as well as the need to stimulate sales. A key goal of every business should be to minimize the average time it takes customers to pay their bills. By streamlining administrative procedures, a firm can facilitate the task of sending out bills, thereby generating cash more quickly.

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Knowing how long, on average, it is taking to collect accounts receivable requires calculating the **days sales outstanding**, also called the **average collection period**, by dividing a firm's accounts receivable by daily credit sales, as follows:

$$\text{Days sales outstanding} = \frac{\text{Accounts receivable}}{\text{Annual credit sales} \div 365 \text{ days}}$$

Consider the following information about two businesses, Fast Company and Slow Company:

	Fast Company	Slow Company
Total sales	$1,000,000	$1,000,000
Credit sales	$ 700,000	$ 700,000
Average credit sales per day	$ 1,918	$ 1,918
Accounts receivables	$ 48,000	$ 63,300

These two companies are very similar in that they both have $1 million in annual sales, including $700,000 in credit sales. Thus, they both have average daily credit sales of $1,918 ($700,000 total credit sales ÷ 365 days). However, there is an important difference between the two firms. Fast Company has only $48,000 in accounts receivable, while Slow Company has $63,300 in accounts receivable. Why the difference? It is simple: Fast Company collects its credit sales every 25 days on average, while Slow Company takes 33 days to collect its accounts receivable, calculated as follows:

Fast Company:

$$\text{Days sales outstanding} = \frac{\text{Accounts receivable}}{\text{Annual credit sales} \div 365 \text{ days}} = \frac{\$48{,}000}{\$700{,}000 \div 365} = 25 \text{ days}$$

Slow Company:

$$\text{Days sales outstanding} = \frac{\text{Accounts receivable}}{\text{Annual credit sales} \div 365 \text{ days}} = \frac{\$63{,}300}{\$700{,}000 \div 365} = 33 \text{ days}$$

days sales outstanding (average collection period)
The number of days, on average, that a firm extends credit to its customers.

In other words, Slow Company takes longer to convert its accounts receivable into cash. It could very well have a cash flow problem if it does not have the ability to finance the greater investment in accounts receivable. This illustration, while hypothetical, is a real problem for many small businesses. Most business owners never think about the difficulties in collecting receivables when they start their own business.

In a meeting, Johnny Stites, former CEO of J&S Construction, told an interesting story. Without saying anything, he posted a graph that was visible to the employee responsible for collecting receivables. The graph showed how quickly accounts receivable were being collected over time and Stites's goal for how long he wanted it to take. He had intended to discuss the graph with the employee but failed to do so. Nevertheless, without anything else being done, the time that accounts receivable

Zouhair Serrar/Shutterstock.com

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were outstanding began to decline. By providing a clear picture of actual performance versus desired performance, Stites enabled the employee to take ownership of achieving the goal. The outcome: Cash became available for other purposes.[2]

When dealing with large corporations, small companies are especially vulnerable to problems caused by slow collections. Some large firms have a practice of taking 60 or 90 days to pay an invoice, regardless of the credit terms stated in the invoice. Many small companies have had to file for bankruptcy because they could not get a large customer to pay according to the terms of the sale. It follows that what you do before you deliver a product or service on credit is far more important than what you do after you are owed.

The following credit management practices can also have a positive effect on a firm's cash flows:

- *Minimize the time between shipping, invoicing, and sending notices on billings.*
- *Review previous credit experiences to determine impediments to cash flows,* such as the continued extension of credit to slow-paying or delinquent customers.
- *Provide incentives for prompt payment* by granting cash discounts or charging interest on delinquent accounts.
- *Age accounts receivable on a monthly or even a weekly basis* in order to identify any delinquent accounts as quickly as possible.
- *Use the most effective methods for collecting overdue accounts.* For example, prompt phone calls to customers with overdue accounts can improve collections considerably.
- *Use a* **lock box**—a post office box for receiving remittances. If the firm's bank maintains the lock box to which customers send their payments, it can immediately deposit any checks received into the company's account.

22-3c Accounts Receivable Financing

Some small businesses speed up the cash flow from accounts receivable by borrowing against them. By financing receivables, these firms can often secure the use of their money 30 to 60 days earlier than would be possible otherwise. Although this practice was once concentrated largely in the apparel industry, it has expanded to many other types of small businesses, such as manufacturers, food processors, distributors, and home building suppliers. Such financing is provided by commercial finance companies and some banks.

Two types of accounts receivable financing are available. The first type uses a firm's **pledged accounts receivable** as collateral for a loan. Payments received from customers are forwarded to the lending institution to pay off the loan. In the second type of financing, a business sells its accounts receivable to a finance company, a practice known as *factoring* (discussed in Chapter 12). The finance company thereby assumes the bad-debt risk associated with the receivables it buys.

The obvious advantage of accounts receivable financing is the immediate cash flow it provides for firms that have limited working capital. As a secondary benefit, the volume of borrowing can be quickly expanded proportionally in order to match a firm's growth in sales and accounts receivable.

A drawback to this type of financing is its high cost. Rates typically run several points above the prime interest rate, and factors charge a fee to compensate them for their credit investigation activities and for the risk that customers may default in payment. Another weakness of accounts receivable financing is that pledging receivables may limit a firm's ability to borrow from a bank by removing a prime asset from its available collateral.

lock box
A post office box for receiving remittances from customers.

pledged accounts receivable
Accounts receivable used as collateral for a loan.

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22-4 Discuss the key financial issues in managing inventory.

22-4 Managing Inventory

Inventory is a "necessary evil" in a financial management system. It is "necessary" because supply and demand cannot be managed to coincide precisely with day-to-day operations. It is an "evil" because it ties up funds that are not actively productive.

22-4a Reducing Inventory to Free Cash

Inventory is a bigger problem for some small businesses than for others. The inventory of many service companies, for example, consists of only a few supplies. A manufacturer, on the other hand, has several types of inventory: raw materials, work in process, and finished goods. Retailers and wholesalers—especially those with high inventory turnover rates, such as firms in grocery distribution—are continually involved in solving inventory management problems.

Chapter 21 discussed several ideas related to purchasing and inventory management that are designed to minimize inventory carrying costs and processing costs. The emphasis in this section is on practices that will minimize average inventory levels, thereby releasing funds for other uses. The correct minimum level of inventory is the amount needed to maintain desired production schedules and/or a certain level of customer service. A concerted management effort can trim excess inventory and pay handsome dividends.

22-4b Monitoring Inventory

When it comes to managing inventory, small business owners tend to overstock. One of the first steps in managing inventory is to discover what is in inventory and how long it has been there. Too often, items are purchased, warehoused, and essentially forgotten. A yearly inventory for accounting purposes is inadequate for proper inventory control. Items that are slow movers may sit in a retailer's inventory beyond the time when they should have been marked down for quick sale. Software programs can provide assistance in inventory identification and control. Although a physical inventory may still be required, its use will only serve to supplement the computerized system.

A commonly used statistic for monitoring inventory is **days in inventory**, which is the number of days, on average, that a business holds its inventory. Similar in concept to days sales outstanding (described earlier), it is calculated as follows:

$$\text{Days in inventory} = \frac{\text{Inventory}}{\text{Cost of goods sold} \div 365 \text{ days}}$$

Recall that both Fast Company and Slow Company had \$1 million in annual sales. Let's assume that they also had the same cost of goods sold of \$600,000. So, they both sold their products for \$1 million, and it cost them \$600,000 to produce the products that were sold. If we restate the annual cost of goods sold to a daily cost of goods sold, we find it to be \$1,644 (\$600,000 cost of goods sold ÷ 365 days) for both companies. But while they sold the same amount of product at identical cost, Fast Company carries only \$46,000 in inventory compared to Slow Company, which maintains an inventory of \$57,500.

	Fast Company	Slow Company
Total sales	$1,000,000	$1,000,000
Cost of goods sold	$ 600,000	$ 600,000
Daily cost of goods sold	$ 1,644	$ 1,644
Inventory	$ 46,000	$ 57,500

days in inventory
The number of days, on average, that a company holds inventory.

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Why would Slow Company have more inventory than Fast Company, given that they both have the same amount of sales? The answer is that Slow Company takes longer to sell its inventory. Fast Company, on average, carries inventory for 28 days, compared to 35 days for Slow Company.

Fast Company:

$$\text{Days in inventory} = \frac{\text{Inventory}}{\text{Cost of goods sold} \div 365 \text{ days}} = \frac{\$46,000}{\$600,000 \div 365 \text{ days}} = 28 \text{ days}$$

Slow Company:

$$\text{Days in inventory} = \frac{\text{Inventory}}{\text{Cost of goods sold} \div 365 \text{ days}} = \frac{\$57,500}{\$600,000 \div 365 \text{ days}} = 35 \text{ days}$$

In other words, Slow Company's slow rate of moving its inventory can lead to cash flow problems if it does not have the ability to finance the larger inventory.

22-4c Controlling Stockpiles

Small business managers tend to overbuy inventory for several reasons. First, enthusiasm may lead the manager to forecast greater demand than is realistic. Second, the personalization of the business–customer relationship may motivate a manager

Living the Dream

Taking Stock of Inventory Management

Managing inventory effectively can make the difference between making or losing money—and maybe even bankruptcy. Take Walking Equipment Company, now Fissionable Canes, as an example. The company, owned by Stephen Carroll, was a $3 million business selling assistive walking products, shipping up to 500 packages a day.

The company's inventory was divided into three different categories: domestically produced, overseas resellers items, and manufactured overseas items. He knew that he needed about three turns on inventory for items manufactured, two turns for products from overseas, and one turn for items he can get domestically. (Inventory turns are measured as cost of goods sold ÷ inventory, indicating how much in sales you are generating for each dollar of inventory you are having to carry. You prefer higher turns over lower turns.)

Carroll used Stone Edge software from Monsoon Commerce. The software lets employees know where an item is and when it was taken off the shelves and shipped. In addition, it helps to create purchase orders based on past order history and to automate the order fulfillment process. Carroll explained, "I no longer sat on inventory I didn't need, which really helped my cash flow."

Carroll started using add-on software to ensure that orders were packaged correctly. With the add-on, warehouse packing employees used handheld barcode readers that made the packing process more efficient. Carroll explained,

> I could hire new employees, and within a few minutes they could be ready to pack an order. Previously, I had to rely on employees who memorized the product locations in the warehouse.

The new system allowed the order packers to scan a barcode on an order, which indicated the items needed and the location in the warehouse. They then scanned the barcode on the item and could hear an audible notification to indicate if it was the correct item on the order. It also gave an audible notification when all the items on the order had been picked.

By closely managing inventory, Carroll said his company saved tens of thousands of dollars annually.

Sources: Personal communication with Stephen Carroll, September 26, 2014; and https://www.stoneedge.com/order-manager/inventory-management/, accessed October 23, 2021.

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to stock everything customers want. Third, a price-conscious manager may be overly susceptible to a vendor's appeal to "buy now, because prices are going up."

Managers must exercise restraint when stockpiling. Improperly managed and uncontrolled stockpiling may greatly increase inventory carrying costs and place a heavy drain on the funds of a small business.

22-5 Describe important issues in managing accounts payable.

22-5 Managing Accounts Payable

Cash flow management and accounts payable management are intertwined. As long as a payable is outstanding, the buying firm can keep cash equal to that amount in its own checking account. When payment is made, however, that firm's cash account is reduced accordingly.

All else being the same, a small business owner would want to delay payment as long as possible, without damaging the firm's reputation by failing to live up to its agreements. Although payables are legal obligations, they can be paid at various times or even renegotiated in some cases. Any business is subject to an emergency situation and may find it necessary to ask creditors to postpone payment on its payable obligations. Usually, creditors will cooperate in working out a solution because it's in their best interest for a client firm to succeed.

"Buy now, pay later" is the motto of many entrepreneurs. By buying on credit, a small business is using creditors' funds to supply short-term cash needs. The longer creditors' funds can be borrowed, the better. Payment, therefore, should be delayed as long as acceptable under the agreement. As we did with accounts receivable and inventory, we can compute **days in payables**, which tells us how many days a company takes to pay its accounts payable. We compute it as follows:[3]

$$\text{Days in payables} = \frac{\text{Accounts payable}}{\text{Cost of goods sold} \div 365\ \text{days}}$$

Using the information already provided for Fast Company and Slow Company, and knowing that they have \$65,800 and \$49,300 in accounts payable, respectively, we can compute the days in payables for each firm as follows:

Fast Company:

$$\text{Days in payables} = \frac{\text{Accounts payable}}{\text{Cost of good sold} \div 365\ \text{days}} = \frac{\$65{,}800}{\$600{,}000 \div 365\ \text{days}} = 40\ \text{days}$$

Slow Company:

$$\text{Days in payables} = \frac{\text{Accounts payable}}{\text{Cost of good sold} \div 365\ \text{days}} = \frac{\$49{,}300}{\$600{,}000 \div 365\ \text{days}} = 30\ \text{days}$$

Typically, accounts payable (trade credit) involve payment terms that include a cash discount. With trade discount terms, paying later may be inappropriate. For example, terms of 3/10, net 30, offer a 3 percent potential discount. Exhibit 22.5 shows the possible settlement costs over the credit period of 30 days. Note that for a \$20,000 purchase, a settlement of only \$19,400 is required if payment is made within the first 10 days (\$20,000 less the 3 percent discount of \$600). Between day 11 and day 30, the full settlement of \$20,000 is required. After 30 days, the settlement cost may exceed the original amount, as late-payment fees are added.

days in payables
The number of days, on average, that a business takes to pay its accounts payable.

The timing question then becomes "Should the account be paid on day 10 or day 30?" There is little reason to pay \$19,400 on days 1 through 9, when the same amount will settle the account on day 10. Likewise, if payment is to be made after day 10, it makes sense to wait until day 30 to pay the \$20,000.

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Exhibit 22.5 An Accounts Payable Timetable for Terms of 3/10, Net 30

Timetable (days after invoice date)	Settlement Costs for a $20,000 purchase
Days 1 through 10	$19,400
Days 11 through 30	$20,000
Day 31 and thereafter	$20,000 + possible late penalty and deterioration in credit rating

By paying on the last day of the discount period, the buyer saves the amount of the discount offered. The other alternative of paying on day 30 allows the buyer to use the seller's money for an additional 20 days by forgoing the discount. As Exhibit 22.5 shows, the buyer can use the seller's $19,400 for 20 days at a cost of $600. The percentage annual interest rate can be calculated as follows:

$$\begin{aligned}\text{Percentage annual interest rate} &= \frac{\text{Days in year}}{\text{Net period} - \text{Cash discount period}} \times \frac{\text{Cash discount \%}}{100\% - \text{Cash discount \%}} \\ &= \frac{365}{30-10} \times \frac{3\%}{100\% - 3\%} \\ &= 18.25 \times 0.030928 \\ &= 0.564, \text{ or } 56.4\%\end{aligned}$$

By failing to take a discount, a business typically pays a higher rate for use of a supplier's money—56.4 percent per year, in this case. Payment on day 10 appears to be the most logical choice. Recall, however, that payment also affects cash flows. If funds are extremely short, a small firm may have to wait to pay until the last possible day in order to avoid an overdraft at the bank.

22-6 Cash Conversion Period Revisited

22-6 Calculate and interpret a company's cash conversion period.

Earlier in the chapter, we presented the working capital cycle, explaining that the cash conversion period should be a key concern for any small business. As you will recall, the cash conversion period is the time span during which the firm's investment in accounts receivable and inventory must be financed or, more simply, the time required to convert paid-for inventory and accounts receivable into cash. To reinforce this concept, we can use the information we have for Fast Company and Slow Company to compute the cash conversion periods for these two firms:

$$\text{Cash conversion period} = \text{Days in inventory} + \text{Days sales outstanding} - \text{Days in payables}$$

	Fast, Inc.	Slow, Inc.
Days in inventory	28	35
Days sales outstanding	25	33
Days in inventory and receivables	53	68
Less days in payables	(40)	(30)
Cash conversion period (days)	13	38

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So, the time from inventory being purchased until it is sold on credit and the accounts receivable are collected is 53 days for Fast Company and 68 days for Slow Company. However, both firms are granted trade credit from their suppliers. Fast Company has negotiated credit terms of 40 days before having to pay for its purchases, compared to Slow Company's 30 days. Essentially, Fast Company's suppliers have granted it a loan for 40 days, while Slow Company has a loan for only 30 days.

We see that Fast Company will need to finance 13 days with working capital, while Slow Company will have to finance 38 days. Thus, as both firms grow, Slow Company will have much more pressure on its cash flows than will Fast Company.

22-7 Discuss the techniques commonly used in making capital budgeting decisions.

22-7 Capital Budgeting Techniques

We turn now to the management of a small firm's long-term assets—equipment and plant—or what is called *capital budgeting*. Some capital budgeting decisions that might be made by a small firm include the following:

1. Develop a new product that shows promise but requires additional study and improvement.
2. Replace a firm's delivery trucks with newer models.
3. Expand sales activity into a new territory.
4. Construct a new building.
5. Hire additional salespersons to intensify selling in the existing market.

Capital budgeting analysis forms the framework for a company's long-term future development and can have a profound effect on a company's future earnings and growth. For this reason, it is important that a small business owner makes capital budgeting decisions based only on careful analysis.

Capital budgeting analysis
An analytical method that helps managers make decisions about long-term investments.

The three major techniques for making capital budgeting decisions are the accounting return on investment technique, the payback period technique, and the discounted cash flow technique, using either net present value or internal rate of return. They all attempt to address whether future benefits from an investment will exceed the cost of making the investment. However, each technique takes a different perspective when providing an answer:

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1. *Accounting return on investment:* How many dollars in average profits are generated per dollar of average investment?
2. *Payback period:* How long will it take to recover the original investment outlay?
3. *Discounted cash flows:* How does the present value of future benefits from the investment compare to the investment outlay?

Three simple rules are used in judging the merits of an investment. Although they may seem trite, the rules state in simple terms the best thinking about the attractiveness of an investment.

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1. The investor prefers more cash rather than less cash.
2. The investor prefers cash sooner rather than later.
3. The investor prefers less risk rather than more risk.

With these criteria in mind, let's now look at each of the three capital budgeting techniques in detail.

22-7a Accounting Return on Investment

A small business invests to earn profits. The **accounting return on investment technique** compares the average annual after-tax profits a firm expects to receive to the average book value of the investment.

Average annual after-tax profits can be estimated by adding the after-tax profits expected over the life of the project and then dividing that amount by the number of years the project is expected to last. The average book value of an investment is equivalent to the average of the initial outlay and the estimated final projected salvage value. In making an accept–reject decision, the owner compares the calculated return to a minimum acceptable return, which is usually determined based on past experience.

To examine the use of the accounting return on investment technique, assume that you are contemplating buying a piece of equipment for $10,000 and depreciating it over four years to a book value of $0 (it will have no salvage value). Further assume that you expect the investment to generate after-tax profits each year as follows:

Year	After-Tax Profits
1	$1,000
2	2,000
3	2,500
4	3,000

The accounting return on the proposed investment is calculated as follows:

$$\text{Accounting return on invesment} = \frac{\text{Average annual after-tax profits}}{\text{Average book value of the investment}}$$

$$\text{Accounting return on invesment} = \frac{\left(\dfrac{\$1{,}000 + \$2{,}000 + \$2{,}500 + \$3{,}000}{4}\right)}{\left(\dfrac{\$10{,}000 - \$0}{2}\right)}$$

$$= \frac{\$2{,}125}{\$5{,}000} = 0.425, \text{ or } 42.5\%$$

For most people, a 42.5 percent profit rate would seem outstanding. Assuming the calculated accounting return on investment of 42.5 percent exceeds your minimum acceptable return, you will accept the project. If not, you will reject the investment—provided, of course, that you have confidence in the technique.

Although the accounting return on investment is easy to calculate, it has two major shortcomings. First, it is based on accounting profits rather than actual cash flows received. An investor is more interested in the future cash produced by the investment than in the reported profits. Second, this technique ignores the time value of money. Thus, although popular, the accounting return on investment technique fails to satisfy any of the three rules concerning an investor's preference for receiving more cash sooner with less risk.

accounting return on investment technique
A capital budgeting technique that compares expected average annual after-tax profits to the average book value of an investment.

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22-7b Payback Period

The **payback period technique**, as the name suggests, measures how long it will take to recover the initial cash outlay of an investment. It deals with cash flows as opposed to accounting profits. The merits of a project are judged on whether the initial investment outlay can be recovered in less time than some maximum acceptable payback period. For example, an owner may not want to invest in any project that will require more than five years to recoup the original investment.

To illustrate the payback method, let's assume that a small business owner is considering an investment in equipment with an expected life of 10 years. The investment outlay will be $15,000, with the cost of the equipment depreciated on a straight-line basis, at $1,500 per year. If the owner makes the investment, the annual after-tax profits have been estimated to be as follows:

Years	After-Tax Profits
1–2	$1,000
3–6	2,000
7–10	2,500

To determine the after-tax cash flows from the investment, the owner merely adds back the depreciation of $1,500 each year to the profit. The reason for adding the depreciation to the profit is that it was deducted when the profits were calculated (as an accounting entry), even though it was not a cash outflow. The results, then, are as follows:

Years	After-Tax Cash Flows
1–2	$2,500
3–6	3,500
7–10	4,000

By the end of the second year, the owner will have recovered $5,000 of the investment outlay ($2,500 per year). By the end of the fourth year, another $7,000, or $12,000 in total, will have been recouped. The additional $3,000 would then be recovered in the fifth year, when $3,500 is expected for the full year. Thus, it will take 4.86 years $\left[4 \text{ years} + (\$3{,}000 \div \$3{,}500)\right]$ to recover the investment. Since the maximum acceptable payback is less than five years, the owner will accept the investment.

Many managers and owners of companies use the payback period technique in evaluating investment decisions. Although it uses cash flows rather than accounting profits, this technique has two significant weaknesses. First, it does not consider the time value of money (cash is preferred sooner rather than later). Second, it fails to consider the cash flows received after the payback period (more cash is preferred, rather than less).

payback period technique
A capital budgeting technique that measures the amount of time it will take to recover the initial cash outlay of an investment.

discounted cash flow (DCF) techniques
Capital budgeting techniques that compare the present value of future cash flows with the cost of the initial investment.

22-7c Discounted Cash Flows

Managers can avoid the deficiencies of the accounting return on investment and payback period techniques by using discounted cash flow analysis. Discounted cash flow techniques take into consideration the fact that cash received today is more valuable than cash received one year from now (called the *time value of money*). For example, interest can be earned on cash that is available for immediate investment. This is not true for cash to be received at some future date. **Discounted cash flow (DCF) techniques** compare the present value of future cash flows with the investment outlay. Such an analysis may take either of two forms: net present value or internal rate of return.

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The **net present value (NPV)** method estimates the current value of the cash that will flow into the firm from the project in the future and deducts the amount of the initial outlay. To find the present value of expected future cash flows, we discount them back to the present at the firm's cost of capital, where the cost of capital is equal to the investors' required rate of return. If the net present value of the investment is positive (i.e., if the present value of future cash flows discounted at the rate of return required to satisfy the firm's investors exceeds the initial outlay), the project is acceptable.

The **internal rate of return (IRR)** method estimates the rate of return that can be expected from a contemplated investment. To calculate the IRR, you must find the discount rate that gets the present value of all future cash inflows just equal to the cost of the project, which is also the rate that gives you a zero net present value. For the investment outlay to be attractive, the internal rate of return must exceed the firm's cost of capital—the rate of return required to satisfy the firm's investors.

Discounted cash flow techniques can generally be trusted to provide a more reliable basis for decisions than can the accounting return on investment technique or the payback period technique.

22-8 Capital Budgeting Practices in Small Firms

22-8 Describe the capital budgeting practices of small firms.

In the past, few small business owners relied on any type of quantitative analysis in making capital budgeting decisions. The decision to buy new equipment or expand facilities was based more on intuition and instinct than on economic analysis. If any quantitative analysis was used, it was usually the payback period technique, followed by the accounting return on investment technique. Rarely did small business owners use the discounted cash flow (DCF) methods.

More recently, an increasing number of small business owners are using some form of quantitative measure to assess a capital investment, but it is complemented by judgment based on their experience. It is also encouraging that a larger number of owners are attempting to forecast future cash flows as part of their analysis. Still, only a small number of owners rely on discounted cash flow techniques.

We could conclude that small business owners are still not very sophisticated about using theoretically sound financial methods. However, the cause of their limited use of DCF tools probably has more to do with the nature of small business itself than with the owners' unwillingness to learn. Several important reasons might explain the limited use of these financial techniques, including the following:

- *For many owners of small firms, the business is an extension of their lives*—that is, business events affect them personally. The same is true in reverse: What happens to the owners personally affect their decisions about the firm. The firm and its owner are inseparable. Consequently, nonfinancial variables may play a significant part in an owner's decisions. For example, the desire to be viewed as a respected part of the community may be more important to an owner than the present value of a business decision.
- *Survival often becomes the top priority* when the undercapitalization and liquidity problems of a small business directly affect the decision-making process. Long-term planning, therefore, is not viewed by the owner as a high priority in the total scheme of things.
- *The greater uncertainty of cash flows within small firms makes long-term forecasting and planning seem unappealing and even a waste of time.* The owner

net present value (NPV)
The present value of expected future cash flows less the initial investment outlay.

internal rate of return (IRR)
The rate of return a firm expects to earn on a project.

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simply has no confidence in their ability to predict cash flows beyond two or three years, so calculating the cash flows for the entire life of a project is viewed as a futile effort.

- *The value of a closely held firm is less easily observed* than that of a publicly held firm, whose securities are actively traded in the marketplace. Therefore, the owner of a small firm may consider the market-value rule of maximizing net present values irrelevant. Estimating the cost of capital is also much more difficult for a small company than for a large firm.
- *The limited size of a small firm's projects may make net present value computations less feasible in a practical sense.* The time and expense required to analyze a capital investment are generally the same whether the project is large or small, so it is relatively costlier for a small firm to conduct such a study.
- *Financial management talent within a small firm is a scarce resource.* The owner-manager frequently has a technical background, as opposed to a business or finance orientation, and their perspective is influenced greatly by that background.

These characteristics of a small business and its owner have a significant effect on the decision-making process within the firm. The result is often a short-term mindset, caused partly by necessity and partly by choice. However, the owner of a small firm should make every effort to use discounted cash flow techniques and to be certain that contemplated investments will, in fact, provide returns that exceed the firm's cost of capital.

22-1. Describe the working capital cycle of a small business.

- A firm's working capital cycle is the flow of resources through the company's accounts as part of its day-to-day operations.
- The only current liability included in the working capital cycle is accounts payable.
- The working capital cycle begins with the purchase or production of inventory and ends with the collection of accounts receivable.
- The cash conversion period is critical because it is the time period during which cash flow problems can arise.

22-2. Identify the important issues in managing a firm's cash flow.

- A firm's cash flows consist of cash flowing into a business (through sales revenue, borrowing, etc.) and cash flowing out of the business (through purchases, operating expenses, etc.).
- Calculating cash flows requires that a small business owner distinguish between sales revenue and cash receipts and between expenses and disbursements.
- To anticipate when cash will enter and leave a business, an owner *must* develop a cash budget.

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22-3. Explain the critical issues in managing accounts receivable.

- The most important factor in managing cash well is the ability to collect accounts receivable quickly.
- Granting credit to customers, although primarily a marketing decision, directly affects a firm's cash account.
- Days sales outstanding measures how many days, on average, that a firm extends credit to its customers.
- Some small businesses speed up the cash flows from receivables by borrowing against them.
- The two types of accounts receivable financing are pledged accounts receivable and factoring.

22-4. Discuss the key financial issues in managing inventory.

- A concerted effort to manage inventory can trim excess inventory and free cash for other uses.
- Days in inventory represents the number of days, on average, that a company carries inventory.
- Improperly managed and uncontrolled stockpiling may greatly increase inventory carrying costs and place a heavy drain on the funds of a small business.

22-5. Describe the important issues in managing accounts payable.

- Accounts payable, a primary source of financing for small firms, directly affect a firm's cash flow situation.
- Financial management of accounts payable hinges on paying at various times and renegotiating in some cases.
- Days in payables is a measure of how long a business takes to pay its suppliers.

22-6. Calculate and interpret a company's cash conversion period.

- The cash conversion period is the time span during which a firm's investment in accounts receivable and inventory must be financed.
- A cash conversion period equals days in inventory plus days sales outstanding minus days in payables.

22-7. Discuss the techniques commonly used in making capital budgeting decisions.

- Capital budgeting techniques include accounting return on investment, payback period, and discounted cash flows.
- The accounting return on investment technique compares the average annual after-tax profits a firm expects to receive to the average book value of the investment.
- This technique has two significant shortcomings: It is based on accounting profits rather than actual cash flows received, and it ignores the time value of money.
- The payback period technique measures how long it will take to recover the initial cash outlay of an investment.
- This technique also has two major weaknesses: It ignores the time value of money, and it doesn't consider cash flows received after the payback period.
- The discounted cash flow (DCF) techniques—net present value and internal rate of return—compare the present value of future cash flows with the investment outlay.
- DCF techniques provide the best basis for decision-making in capital budgeting analysis.

22-8. Describe the capital budgeting practices of small firms.

- Increasing numbers of small business owners are using some type of quantitative measure to assess a capital investment, along with judgment based on their experience.
- The short-term mindset of small firms may explain, to some degree, why they seldom use the conceptually richer techniques for evaluating long-term investments.
- Nonfinancial variables, attempts to just survive, the uncertainty of cash flows, difficulty in estimating the cost of capital, the limited size of its projects, and an owner's lack of a financial management background all affect the decision-making process in a small company.

Key Terms

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Discussion Questions

1. List the events in the working capital cycle that directly affect cash and those that do not. What determines the length of a firm's cash conversion period?
2. What are some examples of cash receipts that are not sales revenue? Explain how expenses and cash disbursements during a month may be different.
3. How may a seller speed up the collection of accounts receivable? Give examples that may apply to various stages in the life cycle of receivables.
4. Suppose that a small firm could successfully shift to a just-in-time inventory system—an arrangement in which inventory is received just as it is needed. How would this affect the firm's working capital management?
5. How do working capital management and capital budgeting differ?
6. Compare the different techniques that can be used in capital budgeting analysis.
7. What does net present value measure?
8. Define internal rate of return.
9. a. Find the accounting return on investment for a project that costs $10,000, will have no salvage value, and has expected annual after-tax profits each year of $1,000.

   b. Determine the payback period for a capital investment that costs $40,000 and has the following after-tax profits. (The projected outlay of $40,000 will be depreciated on a straight-line basis over seven years to a zero salvage value.)

Year	After-Tax Profits
1	$4,000
2	5,000
3	6,000
4	6,500
5	6,500
6	6,000
7	5,000

10. Why would owners of small businesses not be inclined to use the net present value or internal rate of return measurements?

You Make the Call

Situation 1

A small company specializing in the sale and installation of swimming pools was profitable but has devoted very little attention to the management of its working capital. It had, for example, never prepared or used a cash budget.

To be sure that money was available for payments as needed, the firm kept a minimum of $25,000 in a checking account. At times, this account grew larger; it totaled $43,000 on one occasion. The owner felt that this approach to cash management worked well for the small company because it eliminated all of the paperwork associated with cash budgeting. Moreover, it enabled the firm to pay its bills in a timely manner. (*Note:* In answering the questions for this situation, refer both to this chapter and to Chapter 10, where we describe cash budgets.)

Question 1 What are the advantages and weaknesses of the minimum cash balance practice?

Question 2 There is a saying, "If it ain't broke, don't fix it." In view of the firm's present success in paying bills promptly, should it be encouraged to use a cash budget? Be prepared to support your answer.

Situation 2

Ruston Manufacturing Company is a small firm selling entirely on a credit basis. It has experienced successful operations and earned modest profits.

Sales are made on the basis of net payment in 30 days. Collections from customers run approximately 70 percent in 30 days, 20 percent in 60 days, 7 percent in 90 days, and 3 percent remain uncollected.

The owner has considered the possibility of offering a cash discount for early payment. However, the practice seems costly and possibly unnecessary. As the owner puts it, "Why should I bribe customers to pay what they legally owe?"

Question 1 Is offering a cash discount the equivalent of a bribe?

Question 2 How would a cash discount policy relate to bad debts?

Question 3 What cash discount policy, if any, would you recommend?

Question 4 What other approaches might the owner use to improve cash flows from receivables?

Situation 3

Below are the financial statements of two general contractors. The two companies are primarily commercial builders, as opposed to residential builders. They typically bid for the opportunity to build such facilities as office buildings, hospitals, and university buildings. As the general contractor, they use subcontractors who undertake most of the actual work. (*Note:* While the financial information provided is real in this situation, the names of the companies have been changed to maintain confidentiality.)

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Balance Sheets	BRC,Inc.		Arch Construction	
Assets				
Current assets:				
Cash	$ 1,199,921	4.1%*	$ 2,826,328	10.2%*
Short-term investments	14,704,137	50.4%	16,239,811	58.7%
Accounts receivable	12,460,468	42.7%	7,307,234	26.4%
Other current assets	21,482	0.1%	34,067	0.1%
Total current assets	$ 28,386,008	97.2%	$ 26,407,440	95.5%
Property and equipment	807,592	2.8%	1,252,408	4.5%
TOTAL ASSETS	$ 29,193,600	100.0%	$ 27,659,848	100.0%
Debt (Liabilities) and Equity				
Current liabilities:				
Short-term notes	$ 72,322	0.2%*	$ 79,564	0.3%*
Accounts payable	19,975,233	68.4%	14,898,131	53.9%
Accrued liabilities	899,472	3.1%	2,068,695	7.5%
Total current liabilities	$ 20,947,027	71.8%	$ 17,046,390	61.7%
Long-term debt	1,862,265	6.4%	1,782,700	6.4%
Total debt	$ 22,809,292	78.1%	$ 18,829,090	68.1%
Stockholders' equity:				
Common stock	$ 4,254	0.0%	$ 4,254	0.0%
Paid in capital	768,281	2.6%	768,281	2.8%
Retained earnings	5,611,773	19.2%	8,058,223	29.1%
Total stockholders' equity	$ 6,384,308	21.9%	8,830,758	31.9%
TOTAL DEBT AND EQUITY	$ 29,193,600	100.0%	$ 27,659,848	100.0%

*All percentages have been rounded.

Income Statements	BRC,Inc.		Arch Construction	
Construction revenues	$ 90,070,000	100.0%*	$72,822,725	100.0%*
Cost of goods sold	(86,889,570)	(96.5)%	(68,090,781)	(93.5)%
Gross profits	$ 3,180,430	3.5%	$ 4,731,944	6.5%
Interest income	941,631	1.0%	1,308,801	1.8%
Total revenues	$ 4,122,061	4.6%	$ 6,040,745	8.3%
Operating expenses	1,665,711	1.8%	2,033,400	2.8%
Interest expense	226,367	0.3%	172,158	0.2%
Other expense	79,630	0.1%	123,737	0.2%
Total expenses	$ (1,971,708)	(2.2)%	$ (2,329,295)	(3.2)%
Net profits	$ 2,150,353	2.4%	$ 3,711,450	5.1%

* All percentages have been rounded.

Question 1 Based on the information in the balance sheets, what do you notice about the nature of the general contracting business in terms of working capital? How are the two companies alike, and how do they differ?

Question 2 Have a general contractor explain to you what the financial statements say about this type of business.

Question 3 Compute the cash conversion period for each company, and interpret your findings.

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Experiential Exercises

1. Interview the owner of a small company to determine the nature of the firm's working-capital timeline. Try to estimate the cash conversion period.
2. Interview a small business owner or credit manager regarding the extension of credit and/or the collection of receivables in that firm. Summarize your findings in a report.
3. Identify a small business in your community that has recently expanded. Interview the owner of the firm about the methods used in evaluating the expansion.
4. Either alone or with a classmate, approach an owner of a small company about getting data on a current problem or one the company encountered at some time in the past, to see whether you would reach the same decision as the owner did.

Chapter 22

Please see Appendix A for the Chapter 22 Case Study.

Endnotes

1. The illustration in this section will remind you of the Lemonade Kids example in Chapter 10.
2. Personal interview with Johnny Stites, March 16, 2021.
3. We use cost of goods sold in these equations as a reasonable approximation in order to simplify the presentation. To be more accurate, the equations should use the amount of purchases a company has made from suppliers, where purchases would be represented as follows:

$$\text{Purchases} = \begin{array}{c}\text{Cost of}\\ \text{goods sold}\end{array} + \begin{array}{c}\text{Change in inventory}\\ \text{for the time period}\end{array}$$

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Chapter 23

Managing Risk

Looking Ahead

Learning Objectives

This chapter will help entrepreneurs to recognize many business risks and to learn how to protect against them. By studying this chapter, you should be able to. . .

23-1 Define *business risk* including its two dimensions.

23-2 Identify the basic types of pure risk.

23-3 Describe the steps in the risk management process and how risk management can be used in small companies.

23-4 Explain the basic principles used in evaluating an insurance program.

23-5 Identify the common types of business insurance coverage.

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Spotlight on Small Business

Collin Street Bakery

https://cafe.collinstreet.com

When a Collin Street Bakery accounting clerk in Corsicana, Texas, reported irregularities in the company's computerized accounting system, the bakery never expected that its own corporate controller, Sandy Jenkins, had embezzled over $16 million from the company. During the five years that Jenkins was employed at Collin Street Bakery, he wrote over 800 phony checks to creditors and manipulated the accounting system to show that the checks had been voided.

With these checks, Jenkins funded a lavish lifestyle, which included owning 43 luxury vehicles, maintaining a vacation home in Santa Fe, and owning a multimillion-dollar watch and jewelry collection. Both Jenkins and his wife would frequently travel on private planes for vacations and incurred over $11 million in charges on American Express credit cards, all of which was at the expense of the bakery.

Jenkins's scheme came to light when an accounting clerk asked him about the discrepancies. She became suspicious when his explanation was that it was simply an error and not to worry about it. The clerk then looked further into the check register report and noticed 16 cleared checks that were not reflected in the accounting system. She reported it to the vice president of finance.

Eventually, Jenkins was accused of fraud and terminated from the company. He pleaded guilty and was ultimately sentenced in 2015 to 10 years in prison. His wife, Kay, also pleaded guilty to conspiracy to commit money laundering and was sentenced to 5 years of probation. Sandy later passed away in 2019 in a prison hospital.

If Collin Street Bakery had purchased employee dishonesty insurance, it would not have incurred the entire $16 million loss from Jenkins's dishonest actions. Even more regrettable, this story is played out in small businesses every day.

Sources: "FBI Searches Home of Former Collin Street Bakery Official," KBTX, July 26, 2013, http://www.kbtx.com/home/headlines/FBI-Searches-Home-Of-Former-Collin-Street-Bakery-Official-217096701.html, accessed April 8, 2015; and "Grand Jury Indicts Wife of Former Executive at Collin Street Bakery on Felony Conspiracy," Federal Bureau of Investigation, March 12, 2014, http://www.fbi.gov/dallas/press-releases/2014/grand-jury-indicts-wife-of-former-executive-at-collin-street-bakery-on-felony-conspiracy-money-laundering-and-false-statement-charges, accessed April 8, 2018.

We live in a world of uncertainty, so understanding risk is vitally important in almost all dimensions of life. Risk must certainly be considered in making any business decisions. As sixth-century Greek poet and statesman Solon wrote:[1]

> There is risk in everything that one does, and no one knows where he will make his land-fall when his enterprise is at its beginning. One man, trying to act effectively, fails to foresee something and falls into great and grim ruination, but to another man, one who is acting ineffectively, a god gives good fortune in everything and escapes from his folly.

Solon's insight reminds us that little is new in the world—including the need to acknowledge and compensate as best we can for the risks we encounter.

Risk means different things to different people. For a student, it might be represented by the prospect of failing an exam. For a retired person, risk could be the likelihood of not being able to live comfortably on limited income. For an entrepreneur, it takes the form of the possibility that a new venture will fail.

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Benjamin Franklin once said, "In this world, nothing can be said to be certain, except death and taxes." Small business owners might extend this adage to include business risks. Chapter 1 noted the moderate risk-taking propensities of entrepreneurs and their desire to exert some control over the perilous situations in which they find themselves by minimizing business risks as much as possible. This final chapter discusses types of business risk and ways to manage that risk, including business insurance coverage.

23-1 What Is Business Risk?

23-1 Define *business risk, including* its two dimensions.

Simply stated, *risk* is the possibility of suffering harm or loss. **Business risk**, then, is the possibility of losses associated with the assets and earnings potential of a firm. Here, the term *assets* includes not only inventory and equipment but also such factors as a firm's employees, its customers, and its reputation.

The nature of business risk can be observed from two perspectives: market risk and pure risk. **Market risk** is the uncertainty associated with an investment decision. Entrepreneurs who invest in a new business hopes for a gain but realize that the eventual outcome may be a loss. Only after identifying the investment opportunity, developing strategies, and committing resources will they learn the result.

Pure risk describes a situation where only loss or no loss can occur—there is no potential gain. Owning property, for instance, creates the possibility of loss due to fire or severe weather. The only outcomes are loss or no loss. As a rule, only pure risk is insurable. That is, insurance is not intended to protect investors from market risks, where the chances of both gain and loss exist.

23-2 Basic Types of Pure Risk

23-2 Identify the basic types of pure risk.

The pure risks that any business faces can be categorized as property, liability, and personnel. Let's look at these types of pure risk, which are related to the physical, legal, and human aspects of a business.

23-2a Property Risks

While establishing a business, an owner acquires the property that will be necessary to provide the products and services of the company. If this property is damaged or destroyed, the business sustains a loss. In addition, the temporary loss of use of the property can add to the negative financial impact on the business. Several characteristics of business property and the risks associated with it are worthy of attention.

There are two general types of property—real property and personal property. **Real property** consists of land and anything physically attached to the land, such as buildings. Some business owners purchase land and buildings, while others choose to lease necessary real property. It is important to note, however, that some leases make the lessee responsible for any damage or loss to the leased real property. **Personal property** can be defined simply as any property other than real property. Personal property includes machinery, equipment (such as computers), furniture, fixtures, inventory, and vehicles. While the location of real property is fixed, personal property can be moved from place to place. Among the risks to the personal property of the small firm are the security threats to its computers posed by hackers and spyware.

business risk
The possibility of losses associated with the assets and earnings potential of a firm.

market risk
The uncertainty associated with an investment decision.

pure risk
The uncertainty associated with a situation where only loss or no loss can occur.

real property
Land and anything physically attached to the land, such as buildings.

personal property
Any property other than real property, including machinery, equipment, inventory, and vehicles.

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Property can be valued in several ways. The **replacement value of property** is the cost of replacing personal property and rebuilding real property at today's prices. For example, a building that was constructed 10 years ago at a cost of $1,000,000 may have a current replacement value of $1,400,000 because of the rising costs of materials and labor. The **actual cash value (ACV)** of property is very different from its replacement value, as this insurance term refers to the depreciated value of property. Assuming a rate of depreciation of 3 percent per year for the same 10-year-old building, we would find the building to have an estimated actual cash value of $980,000 (that is, $1,400,000 − [0.03 × 10 × $1,400,000]). By common practice, most commercial property insurance policies provide replacement value coverage, as opposed to actual cash value coverage. However, insurance companies may only offer actual cash value coverage for extremely old buildings or buildings in very poor condition.

Property insurance also considers two primary features: perils (the causes of loss) and losses (the resulting damage).

Perils

A **peril** is defined as a cause of loss. Some perils are naturally occurring events, such as windstorms, floods, earthquakes, and lightning. The location of a property may increase the likelihood of its loss from certain perils—for example, coastal properties are more susceptible to wind damage and flooding, and properties near fault lines are more prone to damage from earthquakes.

Not all perils, however, are natural events. Some are related to the actions of people. Perils such as theft and vandalism involve criminal acts performed by people against business owners. E-commerce has led to new forms of dishonest acts, such as hacking, ransomware attacks, and the unauthorized disclosure of confidential information.

Losses

Usually, when you think of property loss, you envision a **direct loss**, in which physical damage to property reduces its value to the property owner. Direct loss of property because of a windstorm, fire, or explosion is obvious to everyone and has the potential to significantly hinder any business.

A less obvious type of property loss is an **indirect loss**, which arises from an inability to carry on normal operations due to a direct loss. For example, if a retail store is damaged because of a fire, the resulting loss of the building's use can have quite a negative effect on the store owner. The indirect loss component of this event may cause a reduction in revenue and/or an increase in expenses (from having to lease additional space at another location), either of which will have an adverse financial impact on the store owner.

Business income can also be reduced by events or conditions that are not related to direct losses. For example, a strike by UPS employees several years ago created serious logistical problems for many of its business customers, which were unable to receive deliveries from suppliers or distribute products to customers.

The financial impact of such a labor action may be just as real to a business as physical damage to property, but the insurance protection available for indirect losses applies only when *direct* damage events trigger the loss of use. This issue is discussed in more detail later in the chapter.

replacement value of property
The cost of replacing personal property and rebuilding real property at today's prices.

actual cash value (ACV)
An insurance term that refers to the depreciated value of property.

peril
A cause of loss, either through natural events or through the actions of people.

direct loss
A loss in which physical damage to property reduces its value to the property owner.

indirect loss
A loss arising from an inability to carry on normal operations due to a direct loss of property.

23-2b Liability Risks

A growing business risk today is the legal liability that may arise from various business activities. A society creates laws to govern interactions among its members. Individual rights and freedoms are protected by these laws. If a business or any of its agents

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violates these protected rights, the business can be held accountable for any resulting loss or damage to the affected party. Legal liability may arise from statutory liability, contractual liability, or tort liability.

Statutory Liability

Some laws impose a statutory obligation on a business. For example, each state has enacted **workers' compensation legislation** that in most cases requires employers to provide certain benefits to employees when they are injured in a work-related incident, without regard to fault. While the benefits differ slightly from state to state, most workers' compensation statutes require employers to provide the following benefits to employees injured at work: coverage of medical expenses, compensation for lost wages, payment of rehabilitation expenses, and death benefits for employees' families.

This statutory liability is potentially significant for any business. The attacks on the World Trade Center provided a stark example of the magnitude of this liability, especially for companies whose employees worked in a concentrated area. Marsh & McLennan, one of the leading insurance brokers in the world, lost 295 employees in the 9/11 terrorist attacks, creating an enormous financial obligation on the part of the employer to the families of the victims.

Most businesses protect themselves from this type of financial loss through the purchase of workers' compensation insurance. Some large employers choose to self-insure a certain portion of this potential financial loss (that is, they set aside part of their earnings to offset any potential future losses), but even then, most large employers purchase *some* element of insurance protection to guard against catastrophic events, such as the 9/11 tragedy.

Contractual Liability

Businesses often enter into contracts with other parties. These contracts could involve, for example, a lease of premises, a sales agreement with a customer, or an arrangement with an outsourcing firm or a construction company. One common denominator among most of these contracts is the inclusion of some sort of indemnification clause. As businesses sign contracts containing indemnification clauses, they need to be aware of the potential legal liabilities they may be assuming by the language used. Simply put, an **indemnification clause** requires one party (the indemnitor) to assume the financial consequences of another party's legal liabilities (the indemnitee). In other words, the indemnitor agrees to pay on behalf of the indemnitee the legal liabilities of the indemnitee.

The idea behind the contractual transfer of liability is to shift the responsibility to the party with the most control over the risk exposure. Consider, for example, a general contractor who signs an agreement to construct a new building on a piece of land for an owner. Should someone be injured during the building process, it is highly unlikely that the injury would be a result of the negligence of the property owner. Likely, the negligent party—the party causing or contributing to the accident—would be the general contractor or perhaps a subcontractor hired by the general contractor. Therefore, it is quite common and most appropriate for the general contractor to agree to indemnify the owner for any liability arising from the construction work.

In many cases, insurance covers the potential legal liabilities that a business may assume because of an indemnification clause in a contract. However, good communication between a business owner and his or her insurance agent or broker is

workers' compensation legislation
Laws that obligate an employer to pay employees for injury or illness related to employment, regardless of fault.

indemnification clause
A contractual clause that requires one party to assume the financial consequences of another party's legal liabilities.

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essential. In a review of contracts that contain indemnification clauses, the insurance agent or broker should be able to point out the main limitations or shortcomings of an insurance policy as they pertain to the firms assuming the legal liabilities of another party.

Tort Liability

Civil wrongs include breach of contract and torts. **Torts** are wrongful acts or omissions for which an injured party can take legal action against the wrongdoer to seek monetary damages. Tort actions commonly include an allegation of negligence, but four elements must be present for someone to be found guilty of a negligent act:

1. *Existence of a legal duty between the parties*. For example, a restaurant owner has a legal duty to provide patrons with food and drink that are fit for consumption. Likewise, an employee making a delivery for an employer has a duty to operate a vehicle safely on public roads.
2. *Failure to provide the appropriate standard of care*. The standard of care normally used is the **reasonable (prudent person) standard**, based on what a reasonable or prudent person would do under similar circumstances. This standard of care may be elevated, however, if a "professional" is involved. In professional liability actions, the standard of care is determined by the established standards of the profession. For example, a negligent action against a CPA would use the standards of the accounting profession as the benchmark. Expert witnesses are often used to help establish the standard and determine what clients can reasonably expect.
3. *Presence of injury or damages*. Negligence may exist, but if no injury or damage is sustained by the claimant, tort liability does not exist. The two types of damages that may be awarded in a tort action are compensatory damages and punitive damages.

torts
Wrongful acts or omissions for which an injured party can take legal action against the wrongdoer for monetary damages.

reasonable (prudent person) standard
The typical standard of care, based on what a reasonable or prudent person would have done under similar circumstances.

compensatory damages
Economic or noneconomic damages intended to make the claimant whole by compensating the claimant for any injuries or loss arising from the negligent action.

economic damages
Compensatory damages that relate to economic loss, such as medical expenses and loss of income.

noneconomic damages
Compensatory damages for such losses as pain and suffering, mental anguish, and loss of physical abilities.

punitive damages
A form of punishment beyond compensatory damages that intends to punish wrongdoers for gross negligence or callous disregard and to have a deterrent effect.

Compensatory damages are intended to make the claimant whole—that is, to compensate the claimant for any injuries or loss arising from the negligent action. Compensatory damages can be economic or noneconomic in nature. **Economic damages** relate to economic loss, such as medical expenses, loss of income, and the cost of property replacement/restoration. Economic damages are relatively easy to quantify. **Noneconomic damages** cover such losses as pain and suffering, mental anguish, and loss of physical abilities. In comparison to economic damages, noneconomic damages are difficult to express in financial terms. Civil courts usually have a hard time setting these awards, but many of today's substantial awards include a large amount for noneconomic damages. In an effort to curtail the amount of litigation in our society (which many describe as a litigious society), some states have enacted statutes which limit (or cap) the amount of noneconomic damages that might be recovered in a lawsuit.

Punitive damages are a form of punishment that goes beyond any compensatory damages. Punitive damages have a dual purpose. First, they punish wrongdoers in instances where there is gross negligence or a callous disregard for the interests of others. Second, they are intended to have a deterrent effect, sending a message to society that such conduct will not be tolerated. In fact, punitive damages are sometimes referred to as *exemplary damages*. In other words, one of their purposes is to make an "example" out of the defendant. Whether or not an insurance policy will pay the punitive damages awarded against a business is determined by the state in which the lawsuit is filed. As a matter of public policy, some states allow insurance companies to pay punitive damages, while other states do not.

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4. *Evidence that the negligent act is the proximate cause of the loss.* Generally speaking, **proximate cause** is defined as a negligent act that clearly produces an accident. Without such *cause*, the accident would not have occurred; in other words, there must be proof that the negligence caused the damages sustained. There may be negligence and there may be damages, but if no link can be established between the two, there is no tort liability.

Tort liability can arise from a number of business activities. Some of the more significant sources of tort liability follow:

- *Premises liability.* People may sustain injuries while on a business's premises. Retailers have significant premises liability exposure because they have many customers entering their stores to purchase goods. Some other businesses; however, have little in the way of premises liability exposure. A consulting firm or a Web-design company, for example, would not typically have clients visit its business location, so its premises liability exposure would be minimal.
- *Operations liability.* People may also sustain injuries as a result of a company's operations that take place away from its premises. Contractors have significant operations liability exposure because they are performing work at various job sites, and such work could easily result in injury to another person. At the same time, some businesses (such as retailers) have little in the way of operations liability exposure; their exposure is limited to their store's premises.
- *Professional liability.* Any business providing professional services to the public is potentially subject to professional liability claims. Recognizing this exposure is important, since separate liability insurance is necessary to properly protect a business from professional liability claims. Organizations that have professional liability exposure include accounting firms, architecture and engineering firms, dental offices, and doctors' offices.
- *Employers' liability.* As previously mentioned, employers have a statutory obligation to pay certain benefits to employees injured in the course of employment. In exchange for these benefits, employees are then prohibited from suing their employer in most circumstances. At the same time, it is possible that an employer may be sued by an altogether different party as a result of an injury to an employee. If the employee's injury in the workplace was caused by a faulty piece of equipment manufactured by another firm, the employee may sue the manufacturer of that faulty product. The manufacturer may then act against the employer, alleging that the employer failed to maintain the equipment, which consequently caused injury to the employee.
- *Automobile liability.* A business that uses vehicles for various purposes has automobile liability exposure. Even a company that does not own or lease vehicles has potential liability if employees use their personal vehicles for business purposes.
- *Product liability.* The products manufactured or sold by a business can be a source of legal liability. For example, someone who was injured while using a product may claim that the product was defective. The injured person might allege that there was a manufacturing defect, a design defect, or a marketing defect. A **manufacturing defect** exists when something actually goes wrong during the manufacturing process and the product is not made according to the manufacturer's specifications. A **design defect** exists when the product is made in accordance with the manufacturer's specifications, but the product is still unreasonably dangerous as designed. For example, a rotating blade inside a piece of equipment may not be properly covered by a shield. Finally, a **marketing defect** exists when the manufacturer has failed to convey to

proximate cause
A negligent act that is the clear cause of damages sustained.

manufacturing defect
A defect resulting from a problem that occurs during the manufacturing process, causing the product to subsequently not be made according to specification.

design defect
A defect resulting from a dangerous design, even though the product was made according to specifications.

marketing defect
A defect resulting from failure to convey to the user that hazards are associated with a product or to provide adequate instructions on safe product use.

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the user of the product a fair indication of the hazards associated with the product or adequate instructions on how to use the product safely.

- *Completed operations liability*. The completed operations or completed work of a business can be a source of legal liability. Consider, for example, a general contractor who has constructed a new building for another party. Someone standing on a balcony of the new building leans against a rail that gives way, thus causing the person to fall and sustain bodily injury. Generally, this would result in a lawsuit against the general contractor.
- *Employment practices liability*. An increasing concern among businesses today is the threat of lawsuits arising from employment-related issues and practices. Current employees, prior employees, and even job applicants may take legal action against employers and claim damages arising from discrimination, sexual harassment, or wrongful termination. Discrimination claims may include discrimination based on age, disability, race, color, national origin, sex, and religion.

23-2c Personnel Risks

Personnel risks are risks that directly affect individual employees but may have an indirect impact on a business as well. The primary risks in this category include premature death, poor health, and insufficient retirement income.

Premature Death

The risk associated with death is not if, but when. While we all expect to die, there is a risk that we may die early in life. This risk poses a potential financial problem for both the family and the employer of the person. Individuals deal with this risk by maintaining a healthy lifestyle and purchasing life insurance to protect family members who rely on their income.

Employers can be quite adversely impacted by the untimely death of an employee if that employee cannot be easily replaced. And what if a partner or owner of the business dies? Normally, such an event triggers a buyout of the interest of the deceased owner. Life insurance is often used to fund these buyout provisions.

personnel risks
Risks that directly affect individual employees but may have an indirect impact on a business as well.

Poor Health

A more likely occurrence than the death of an employee is poor health. The severity of poor health varies, ranging from a mild disorder to a more serious, disabling illness. And as with premature death, the consequences of this event may affect an employer as well as the employee's family members.

The financial consequences of poor health have two dimensions. First are medical expenses, which can range from the cost of a doctor's visit to catastrophic expenses related to surgeries and hospitalization. Second are the consequences of the inability to work. Disability most often is a temporary condition, but it can be lengthy or even permanent. A worker's permanent disability can have an even more devastating financial impact on the individual's family than death. A permanent disability causes a family to not only lose the earning capacity of the disabled worker but also to have the added expenses associated with the long-term care of the disabled person.

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Employers often provide some form of health insurance as a benefit of employment. In most instances, the cost of the health insurance is shared by the employer and the

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employee; in others, the bulk of the cost is absorbed by the employer. In addition to the health insurance costs, not having the services of the employee for some time period may add to the adverse financial impact on the business.

Insufficient Retirement Income

The final category of personnel risk involves the possibility of outliving one's wealth. The goal in dealing with this risk is to defer income and accumulate sufficient wealth to provide a satisfactory level of income during the nonworking years.

There are three primary sources of retirement income: Social Security, employer-funded retirement programs, and personal savings. Social Security provides a retirement income benefit, although for most retirees this benefit is not sufficient to meet expected consumption during retirement. To supplement this income, most workers have a retirement program associated with their employment. In the past, these programs were primarily funded by employers as a form of deferred compensation. While employer-funded pension plans still exist, it is more common today to encounter employee-funded retirement plans, where the employee can elect to defer current income for retirement. Usually, these plans are partially funded by employers as an incentive for employees to participate. Finally, individual savings can be used to accumulate wealth for retirement. All of these sources should be carefully considered in the retirement income planning process.

23-3 Risk Management

23-3 Describe the steps in the risk management process and how risk management can be used in small companies.

Risk management consists of all efforts to preserve the assets and earning power of a business. Since risk management has grown out of insurance management, the two terms are often used interchangeably. However, risk management has a much broader meaning, covering both insurable and uninsurable risks and including noninsurance approaches to reducing all types of risk. It is concerned with finding the best possible way to reduce the costs of dealing with risk. Insurance is only one of several approaches to minimizing the pure risks a firm is sure to encounter. A full discussion of all forms of liability protection goes beyond the scope of this text. Experts and specific sources of information on protecting a small business should be consulted when making these decisions.

risk management Ways of coping with risk that are designed to preserve the assets and earning power of a firm.

23-3a The Process of Risk Management

Five steps are required to develop and implement a typical risk management program:

Step 1. *Identify and understand risks.* To reduce the chance of overlooking important risks, a business should adopt a systematic approach to identifying risks. A business owner's insurance agent or broker can prove very helpful in this process. Useful identification methods also include insurance policy checklists, questionnaires, analysis of financial statements, and careful analysis of a firm's operations, customers, and facilities. Exhibit 23.1 depicts just a few of the risks that a small company may encounter.

MARK ANDERSON, ANDERTOONS.COM, WWW.ANDERTOONS.COM

"I'm disappointed; if anyone should have seen the red flags, it's you."

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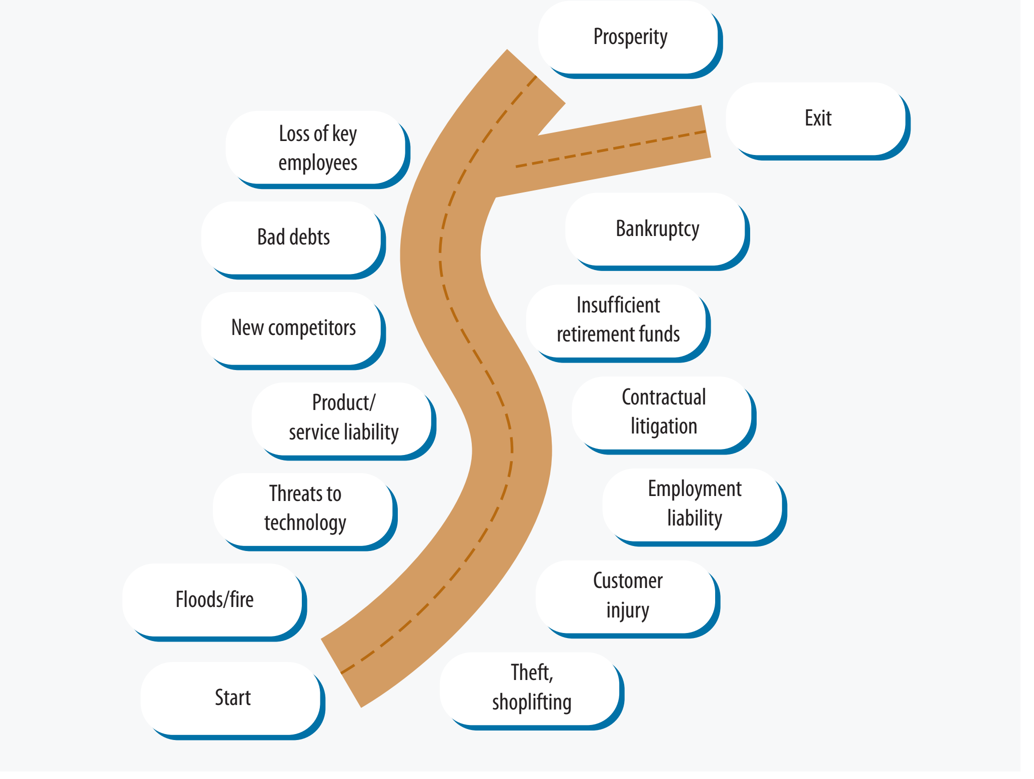
Exhibit 23.1 Risks on the Road to Success



Step 2. *Evaluate the potential severity of risks*. Once the various risks have been identified, they must be evaluated in terms of the potential size of each loss and the probability that it will occur. At a minimum, risks should be classified into three groups: critical (losses that could result in bankruptcy), extremely important (losses that would require investment of additional capital to continue operations), and moderately important (losses that could be covered with current income or existing assets).

Step 3. *Select methods to manage risk*. The two approaches used in dealing with risk are risk control and risk financing, both of which will be discussed later in this chapter.

Step 4. *Implement the decision*. Once the decision has been made to use a particular technique or techniques to manage a firm's risks, this decision must be followed by action, such as purchasing insurance and setting aside dedicated funds to cope with any risks that have been retained. Failure to act—or even simple procrastination—could be fatal.

Step 5. *Review and evaluate*. Review and evaluation of the chosen risk management technique are essential because conditions change—new risks arise, and old ones disappear. Also, reviewing earlier decisions to use a specific method may identify previously made mistakes.

23-3b Risk Management in the Small Business

Regardless of the nature or size of a business, risk management is a serious issue. Too often, small businesses pay insufficient attention to analyzing potential risk. They

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often spend more time planning their company social events than for an event that could put them out of business.

Risk management in a small business differs from that in a large firm. In a large firm, the responsibility of managing risk is frequently assigned to a specialized staff manager. It is more difficult for a small company to cope with risk management since its risk manager is usually the owner, who already has so many roles to perform. For this reason, the small business owner needs to rely on his or her insurance agent for advice. Furthermore, risk management is not something that requires immediate attention—until something happens. A prudent small business owner will take the time to identify the different types of risks faced by the firm and find ways to cope with them, through either risk control or risk financing.

Risk Control

Risk control involves minimizing loss through prevention, avoidance, and/or reduction of risk.

Loss prevention, as the name implies, focuses on preventing losses from ever happening. For example, a business with a machine shop or manufacturing process may require all employees to wear safety glasses so as to prevent foreign particles from injuring their eyes.

Loss avoidance is achieved by choosing not to engage in a particular hazardous activity. For instance, the liability exposure associated with operating a large truck on an interstate highway for the purposes of delivering a company's products to the marketplace is quite severe. An accident caused by a large truck on the highway can result in serious bodily injury and/or property damage. To avoid this liability exposure, a business may choose to hire a common carrier to deliver its products to the marketplace. This eliminates the exposure altogether.

Loss reduction addresses the potential frequency, severity, or unpredictability of loss, thereby lessening the impact of the loss on the business. Crisis planning is a form of loss reduction in that it provides a template to follow in the case of a catastrophic loss. Installing automatic sprinkler systems in a building is another good example of a loss reduction strategy. If a fire occurs in a building with an automatic sprinkler system, the sprinklers will be activated, minimizing the amount of fire damage to the building.

Risk Financing

Risk financing focuses on making funds available for losses that cannot be eliminated by risk control. It involves transferring the risk or retaining the risk. **Risk transfer** is accomplished largely through buying insurance but can also be achieved by making other contractual arrangements that transfer the risk to others. As described earlier, indemnification clauses provide a means by which risk can be transferred from one party to another.

Risk retention entails financing all or part of a loss from a company's cash flows. Assuming that a firm's balance sheet is strong enough, the owner may choose to carry a high deductible applicable to property losses (perhaps a $50,000 deductible instead of a $10,000 deductible). For example, in the event of fire damage to a company's building, the business owner would pay up to $50,000 out of pocket. The higher the deductible, the lower the insurance premium paid to the property insurance carrier.

Self-insurance, which is usually appropriate only for larger companies, is similar to risk retention. Under self-insurance programs, a part of the organization's earnings is earmarked for a contingency fund against possible future losses. Self-insurance should not be confused with having no insurance. Business owners who choose not to insure against a particular loss exposure do not set aside funds for possible future losses. True self-insurance incorporates a discipline of establishing a contingency fund.

risk control
Minimizing potential losses by preventing, avoiding, and/or reducing risk.

loss prevention
Keeping a loss from happening.

loss avoidance
Choosing not to engage in hazardous activities.

loss reduction
Lessening the frequency, severity, or unpredictability of potential losses.

risk financing
Making funds available to cover losses that cannot be eliminated by risk control.

risk transfer
Buying insurance or making contractual arrangements that transfer risk to others.

risk retention
Financing loss intentionally, through a firm's cash flows.

self-insurance
Designating part of a firm's earnings as a cushion against possible future losses.

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23-4 Explain the basic principles used in evaluating an insurance program.

23-4 Basic Principles of a Sound Insurance Program

What kinds of risks can be covered by insurance? What types of coverage should be purchased? How much coverage is adequate? Unfortunately, there are no clear-cut answers to these questions. A small business owner should become as knowledgeable as possible about the types of insurance that are available and then work with a reputable insurance agent in evaluating risks and designing proper protection plans. Three basic principles should be followed in evaluating an insurance program:

1. *Consider the various insurance policies that may be appropriate for your business.* "Bread-and-butter" type policies that are needed by almost all small businesses include property insurance for buildings and personal property, commercial general liability insurance, automobile insurance, workers' compensation insurance, and crime insurance. (Each of these policies is more fully described later in the chapter.) At the same time, other insurance policies will likely be needed, depending on the particular industry. A construction business, for example, may need an inland marine policy uniquely designed to cover its equipment (bulldozers, forklifts, etc.), which may be located at a job site.
2. *Secure insurance coverage for all major potential losses.* Small businesses must avoid incurring major uninsured losses that have the capacity to threaten the very existence of the business. For example, the total destruction of a building in a significant fire or windstorm event would be exceedingly difficult to overcome. For this reason, a business owner should make certain that insurance covers the *full replacement value* of the firm's buildings and personal property. Equally devastating might be a $1 million liability judgment against the business as a result of an automobile accident or someone being injured by the firm's products. It is imperative for the longevity of the business that these major potential loss exposures be properly insured.
3. *Consider the feasibility and affordability of insuring smaller potential losses.* Smaller potential losses do not pose the same threat as major potential losses do, so an owner will need to weigh the feasibility and affordability of absorbing those smaller losses. Of course, what determines whether a potential loss is "small" or "large" varies, depending on the strength of a company's financial position. As an example, claims that arise from employee lawsuits alleging wrongful termination, sexual harassment, or discrimination in the workplace range from $50,000 to $150,000, with annual insurance premiums ranging from $2,500 to $7,500. Only the owner can decide if the potential loss would be best handled through self-insurance or through payment of annual premiums. In this case, there is no single right answer.

23-5 Identify the common types of business insurance coverage.

23-5 Common Types of Business Insurance

In this section, we examine the basic insurance policies used by many small companies. These policies fall under one of two categories: property and casualty insurance, or life and health insurance.

23-5a Property and Casualty Insurance

Property and casualty insurance includes property insurance, commercial general liability insurance, automobile insurance, workers' compensation insurance, and crime insurance, as well as some miscellaneous policies.

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Property Insurance


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A property insurance policy is used by a business owner to insure buildings and personal property owned by the business, as well as buildings not owned by the business but which the business owner, as the lessee, may have a responsibility to insure. As previously mentioned, property can be insured for either its replacement value or its actual cash value.

When purchasing property insurance, a business owner must also determine which "perils" will be covered by the policy. With the **named-peril approach** (also known as the Basic Form in most insurance policies), the specific perils covered by the policy are identified. Covered perils generally include damage caused by fire, smoke, lightning, explosion, windstorm, hail, aircraft, vehicles, rioting, vandalism, sprinkler leakage, sinkhole collapse, and volcanic activity. With this approach, any damage caused by a peril not named in the policy is simply not covered. Examples of claims not covered by the named-peril approach include damage caused by frozen pipes within the building, falling objects, the weight of snow, and theft.

In contrast to the named-peril approach, a business owner can use the **all-risk approach** (also known as the Special Form in most insurance policies), which provides the broadest protection available. With the all-risk approach, all direct damage to property is covered except damage caused by perils specifically excluded. In other words, if it's not excluded, it's covered. Exclusions typically include damage caused by flood, earthquake, fungus or mold, normal wear and tear, and loss caused by the dishonest acts of employees.

An important provision in the property insurance policy is the **coinsurance clause**, which requires a business owner to insure the company's building and personal property for at least 80 percent of what it would cost to replace the building and the personal property. If, at the time of a claim, the building and personal property are insured for less than 80 percent of their replacement cost, then the business owner is assessed a penalty by the insurance company and, in essence, becomes a co-insurer.

One type of optional coverage that can be added to a property insurance policy is **business interruption insurance**. As previously noted, the financial loss associated with a property loss is not limited to direct damage to the property. There may be an indirect loss associated with the "loss of use" of the damaged property. Business interruption insurance provides coverage for loss of income following the interruption of business operations. Without such income, it would be difficult for a business to continue paying for ongoing expenses, such as payroll expenses. This coverage also provides reimbursement for income that would have been earned by the business had no damage occurred.

In addition, business interruption insurance may cover "extra expenses" incurred following an insured loss. For example, following major fire damage to a building, an owner may have to secure a temporary location elsewhere in order to continue business operations and avoid losing customers. Business interruption insurance is a critical element of coverage for a business owner's survival following a significant property loss event. Unfortunately, many owners fail to appreciate the importance of this coverage.

There was a tremendous amount of controversy associated with the thousands of business interruption claims presented to insurance companies by businesses all across America due to the mandatory closings as a result of COVID-19.

named-peril approach
Identifying the specific perils covered in a property insurance policy.

all-risk approach
Stating in a property insurance policy that all direct damages are covered except those caused by perils specifically excluded.

coinsurance clause
A provision in a property insurance policy that requires the owner to have insurance for at least 80 percent of what it would cost to rebuild the building or replace the personal property.

business interruption insurance
Coverage that reimburses a business for the loss of anticipated income following the interruption of business operations.

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Due to COVID-19, businesses all across America had to shut down and lost tremendous revenue. Claims by those businesses to their respective insurance companies were basically denied across the board.

While litigation over these denied claims may linger for years, one of the absolute key elements in establishing a legitimate business interruption claim is that there *first* be a physical damage to a building thus resulting in an interruption. Insurance companies across America consistently denied claims under the presumption that COVID-19 had not caused any *actual* physical damage to their buildings.

Commercial General Liability Insurance

A **commercial general liability (CGL) insurance** policy is the cornerstone liability policy for small businesses, protecting them from a variety of potential liability loss exposures. A CGL policy protects against premises liability, operations liability, product liability, and completed operations liability. Simply put, we live in a litigious society, and small businesses are easy targets for liability lawsuits. A CGL policy provides frontline protection against claims arising from any accident that results in either bodily injury or property damage and is not otherwise excluded by the policy. It does not cover automobile liability, professional liability, or employer liability, all of which require a separate policy for adequate protection.

Automobile Insurance

An **automobile insurance** policy is designed to provide liability protection as well as physical damage coverage as a result of such insured perils as collision, theft, vandalism, hail, and flood. The risk of physical damage to vehicles is much less than the risk of a large liability lawsuit following an at-fault accident. Small business owners may choose to self-insure against the lesser exposure from physical damage but should *not* self-insure when it comes to liability exposure.

Workers' Compensation Insurance

Workers' compensation insurance provides benefits to employees injured at work, in compliance with states' statutes. Generally speaking, these benefits include coverage for medical expenses, loss of wages, and rehabilitation expenses, as well as death benefits for employees' families. Employers' liability insurance offers additional protection for the business owner against various types of liability lawsuits that may arise following an injury to or the death of an employee. Such lawsuits against employers are rare, however, as workers' compensation benefits are intended to be the exclusive remedy available to an employee following an accident.

Crime Insurance

While there are different types of crime insurance coverage that the small business owner may want to consider, first and foremost is coverage against employee dishonesty. Small business owners are generally very trusting of their employees and would not knowingly have someone working in the organization if they thought that person was dishonest. Unfortunately, not every employee is honest. The weak financial controls often found in a small business offer a perfect opportunity for a dishonest employee to embezzle large sums of money. The potential for loss can easily be covered by a **crime insurance** policy at a nominal cost. Premiums vary according to the size of the small business, running from $1,000 up to $5,000 for a $500,000 policy. Because it is possible for an embezzlement scheme to continue for a number of years, an insurance limit should be selected that is high enough to cover a multiyear loss.

commercial general liability (CGL) insurance
Coverage for general liability loss exposure, including premises liability, operations liability, product liability, and completed operations liability.

automobile insurance
Coverage designed to provide liability and physical damage protection for a vehicle.

workers' compensation insurance
Coverage that provides benefits to employees injured at work.

crime insurance
Coverage primarily against employee dishonesty.

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Other elements of crime insurance that should not be overlooked include funds transfer fraud coverage and social engineering fraud coverage. Cyber criminals have been increasingly innovative in finding ways to steal money, including the electronic wire transfer of funds out of a business's bank account. **Funds transfer fraud** involves transferring money without the knowledge or consent of the insured. For example, a thief may create a new computer virus that is sent to a business in the form of an email attachment. If the attachment is opened, the virus will extract important bank account numbers and passwords, thereby enabling the thieves to successfully transfer money out of a bank account. **Social engineering fraud**, on the other hand, involves manipulating people to gain unauthorized access. A perpetrator of social engineering fraud may create a fraudulent email that is typically sent from a manager's email address to a bookkeeper or someone in accounts payable who has the authority to release company funds. The employee then acts on what he or she believes is the manager's authority. This particular deception has been exceedingly successful in stealing from firms in recent years.


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Miscellaneous Policies

A variety of miscellaneous insurance policies can also be utilized by small businesses. These include employment practices liability policies, umbrella liability policies, inland marine policies, professional liability policies, and cyber liability policies. As mentioned earlier, *employment practices liability policies* are designed to protect the business owner against employment-related lawsuits arising from discrimination, sexual harassment, or wrongful termination. *Umbrella liability policies* provide supplemental layers of liability protection. Such policies may provide an additional $1,000,000 (or more) of liability insurance in excess of the liability limits provided by automobile insurance, a CGL policy, and employers' liability insurance. Umbrella liability policies can be of extreme importance to small businesses in the event of a significant accident that severely injures or kills someone, resulting in a multimillion-dollar lawsuit.

Inland marine policies are unique policies designed to insure personal property against the risk of physical damage when such property is located *away* from a firm's premises. For example, construction equipment being used at a job site and manufactured products being transported by a truck to a customer's warehouse can be insured under an inland marine policy. *Professional liability policies* are used to protect professionals against lawsuits arising from errors made while providing their services. Professionals that need such coverage include physicians, dentists, accountants, architects, engineers, attorneys, insurance agents, and real estate agents.

Cyber liability policies are available to protect businesses against the broad range of loss exposures arising from their use of the Internet and their holding of confidential information. Coverage may include the following:

- *Protection against lawsuits arising from the loss or unauthorized disclosure of confidential data that are in the care and custody of a business.* The loss or unauthorized disclosure of confidential data is the result of a *hacker* who has somehow maliciously gained access to the business owner's computer system.
- *The costs incurred by a business following a network security breach*. These costs include computer forensic expenses to determine the extent of the breach, notification costs to affected individuals, credit monitoring costs, and crisis management and public relation costs.

funds transfer fraud
The unauthorized transfer of funds from a bank account.

social engineering fraud
The manipulation of an employee to voluntarily release unauthorized funds.

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Living the Dream

Duffy Group

duffygroup.com

Kathleen Duffy Ybarra

President, the Duffy Group

It can happen before you know it. One day, your business is running smoothly and customers are happy; the next day, your website is down and you can't access your email. And it is completely out of your control. A hacker has found a way to sneak into your accounts, view sensitive information, and steal from your business. This scenario has become a cruel reality for many small business owners, and it presents a risk for anyone who conducts business. According to an SBA survey, 88 percent of small business owners felt vulnerable to a cyberattack. Security Magazine tells us that a cyberattack occurs every 39 seconds.

Kathleen Duffy Ybarra is CEO of Duffy Group, a recruitment firm that helps people find joy in their work. One seemingly random day in March of 2021, she was notified that there was a potential issue with her company's email server. Within minutes, three of the company's servers were shut down. She and her team were unable to access their emails, files, or data. And there was only one apparent solution: pay a ransom fee to the hackers behind the cybersecurity attack.

The situation lasted for two-and-a-half weeks for Duffy Group. They hired an IT expert to help them decrypt the data for a lower cost than the ransom payment would be, and only had to pay about $3,000 to get the data back and their systems operating again. The $3,000 seemed like pennies to Kathleen, given the high ransom fees many small businesses have to pay after cybersecurity attacks.

Though Kathleen feels lucky her company was able to survive the attack with minimal damages, she has learned a huge lesson in the process. Unfortunately, hackers have the upper hand in these situations—it is often best for a small business to negotiate what they can do to get their systems back up. For some companies, ransom fees may even be more than the cash the company has on hand.

Sources: Kathleen Duffy, "My Company Was the Target of a Cyberattack, and Yours Could Be Too," *Enturepreneur .com*, https://www.entrepreneur.com/article/378829, August 9, 2021, accessed November 28, 2021; and "Stay Safe from Cybersecurity Threats," https://www.sba.gov/business-guide/manage-your-business/stay-safe-cybersecurity-threats, accessed November 28, 2021.

- *The costs incurred by a business following a ransomware attack* (also known as cyber extortion). These costs include the expenses of expert IT personnel to evaluate the situation and the payment of a ransom in the event a hacker threatens to damage the business's software management system or release confidential data.
- *Protection against the loss of revenue that a business might incur as a result of a ransomware attack*. Following such an attack, all business operations typically come to a screeching halt until such time as a ransom is paid or it is determined that it is in the best interest of the business owner *not* to pay the ransom but rather recover their data from their back-up source and possibly even purchase new computer hardware.

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- *Protection against cyber criminal activities and deception*. Much of the criminal activity falls under the same heading as *social engineering fraud* as previously described under crime insurance. While crime insurance policies differ by insurance company, many insurance companies are becoming increasingly reluctant to provide social engineering fraud, while cyber insurance policies pick up this exposure. The real challenge associated with cyber crime is keeping up with every newly developed fraudulent and deceptive scheme developed by cyber criminals.

A significant challenge that businesses now have in obtaining cyber insurance policies is even *qualifying* for coverage. Cyber insurance underwriters have become exceedingly strict in their underwriting practices and expect certain elements of controls implemented by businesses before even offering cyber insurance policies. For example, leading the list for favorable review by an underwriter requires the inclusion of multifactor authentication (MFA). MFA works by requiring a network system user to provide two or more pieces of evidence to verify their identity and gain access to an app or digital resource. The user typically has to also respond to a text, phone call, or email before access is allowed.

23-5b Life and Health Insurance

Three types of insurance provide coverage for employees within a business: health insurance, key-person life insurance, and disability insurance. (Workers' compensation insurance was discussed earlier as a type of property and casualty insurance.)

Health Insurance

Also commonly referred to as medical insurance, *health insurance* is one of the most valuable benefits that a small business can offer its employees. Group health insurance policies offer coverage for medical care at hospitals, doctors' offices, and rehabilitation facilities. These policies also cover outpatient services, prescription drugs, and preventive care.

Coverage is usually offered to employees through a specific group of health care providers, or "network." Types of health insurance plans that fall into this category include **health maintenance organizations (HMOs)** and **preferred provider organizations (PPOs)**. An HMO is a managed-care network that provides health insurance that is generally less expensive than a PPO, but it limits employees' choices of medical care providers more than a PPO does. However, with a PPO, employees still must stay within a network of providers or face higher out-of-pocket expenses in the event of a claim.

health maintenance organizations (HMO)
A managed-care network providing health insurance that is less expensive than that of a PPO but more limiting in choices of medical care providers.

preferred provider organizations (PPO)
A managed-care network providing health insurance that is more expensive than that of an HMO but offers a broader choice of medical providers.

Out-of-pocket expenses that employees themselves must pay, regardless of the type of health insurance plan provided by the employer, generally include the following:

- A co-pay at the doctor's office for each office visit.
- A co-pay at the pharmacy for each prescription drug purchased.
- A percentage of the total cost of the health care provided by a hospital, usually between 20 and 30 percent, up to a maximum out-of-pocket cost to the employee.

Key-Person Life Insurance

By carrying **key-person life insurance**, a small business can protect itself against the death of key personnel. Such insurance may be written on an individual or group basis. It is purchased by a firm, with the firm as the sole beneficiary.

key-person life insurance
Coverage that provides benefits to a firm upon the death of key personnel.

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Living the Dream

Ten Security Tips for Small Businesses

Broadband and information technology are powerful tools for small businesses that want to reach new markets and increase sales and productivity. However, cybersecurity threats are very real, and businesses must implement the best tools and tactics to protect themselves, their customers, and their data.

Here are 10 key cybersecurity tips offered by the US Federal Communications Commission for protecting your small business:

1. Establish basic security practices and policies for employees, and train them well. Require the use of strong passwords, and establish appropriate Internet use guidelines that detail penalties for violating the company's cybersecurity policies.
2. Be sure that you regularly update your security software, browser, and operating system. They are the best defenses against viruses, malware, and other online threats.
3. Provide firewall security for your Internet connection.
4. Create a mobile device action plan. Require employees to password-protect their devices, encrypt their data, and install security apps to prevent criminals from stealing information while the phone is being used on public networks.
5. Back up data automatically, if possible, or at least weekly, and store the copies either offsite or in the cloud.
6. Control physical access to your computers, and create user accounts for each employee.
7. If you have a Wi-Fi network for your workplace, make sure that it is secure, encrypted, and hidden.
8. Employ best practices on payment cards. Work with banks or processors to ensure that the most trusted and validated tools and antifraud services are being used.
9. Limit employee access to data and information, and limit their authority to install software.
10. Require employees to use unique passwords and to change those passwords every three months. Consider implementing multifactor authentication, which requires additional information beyond a password to gain entry.

The FCC's Cybersecurity Hub at www.fcc.gov/cyberforsmallbiz has additional information, including links to free and low-cost security tools. You can also create a free, custom small business cybersecurity planning guide at www.fcc.gov/cyberplanner.

Source: Adapted from FCC, "Ten Cyber Security Tips for Small Business," https://www.fcc.gov/general/cybersecurity-small-business, accessed November 28, 2021.

Most small business advisers suggest term insurance for key-person life insurance policies, primarily because of lower premiums. How much key-person life insurance to buy is more difficult to decide. Face values of such policies usually begin around $500,000 and may go as high as several million dollars.

Disability Insurance

disability insurance
Coverage that provides benefits to a key employee upon his or her disability.

disability buyout insurance
Coverage that guarantees a healthy partner enough cash to buy out a partner who becomes disabled.

One risk that small businesses often do not consider is loss due to the disability of a partner or other key employees of the company. Statistics, however, show that the odds of a person becoming disabled are much higher than most people think.

The most common type of **disability insurance** provides for the payment of a portion (typically two-thirds) of the disabled person's normal monthly income for a period of time after the disability occurs. However, it protects only the disabled person and not the business. Alternatively, partners can purchase **disability buyout insurance**. This type of disability insurance protects both partners by guaranteeing that the healthy

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partner will have enough cash to buy out the disabled partner without draining capital from the business.

Also available is disability insurance that replaces lost business revenue because of the disability of a key employee. For example, if a firm's top salesperson, who brings in $25,000 a month, becomes disabled, this coverage will provide the company up to 125 percent of replacement income for a year or more. This gives the business time to recruit and train someone else.

Another type of disability insurance is designed to cover fixed overhead expenses, such as rent, utilities, employee salaries, and general office expenses, while an owner or other key employee recuperates. This type of insurance is especially well suited for a sole proprietorship, since the firm would have no income if the owner were unable to work.

There is no question that risk is a part of life, but how you manage it will affect the success of your small business. That's why an understanding of business risks, the basic principles of a sound insurance program, and the various types of business insurance is so important. It can help you deal with many of the uncertainties that you will surely encounter.

23-1. Define *business risk, including* its two dimensions.

- Business risk is the possibility of losses associated with the assets and earnings potential of a firm.
- Business risks can be classified into two broad categories: market risk and pure risk.
- Market risk is the uncertainty associated with an investment decision.
- Pure risk exists in a situation where only loss or no loss can occur—there is no potential gain.
- In general, only pure risk is insurable.

23-2. Identify the basic types of pure risk.

- Pure risks that any business faces fall into three groups: property risks, liability risks, and personnel risks.
- Property risks involve potential damage to or loss of real property (e.g., land and buildings) and personal property (e.g., equipment).
- Liability risks arise from statutory liability, contractual liability, or tort liability.
- Personnel risks, such as premature death, poor health, and insufficient retirement income, directly affect individuals but may indirectly impact the business as well.

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23-3. Describe the steps in the risk management process and how risk management can be used in small companies.

- Risk management is concerned with protecting the assets and the earning power of a business against loss.
- The risk management process involves identifying and understanding risks, evaluating the potential severity of risks, selecting methods to manage risk, implementing the decision, and reviewing and evaluating the chosen risk management technique.
- The two ways to manage business risks are risk control and risk financing.
- Risk control is designed to minimize loss through prevention, avoidance, and/or reduction of risk.
- Risk financing—making funds available for losses that cannot be eliminated by risk control—involves transferring the risk to another party or retaining the risk within the firm.

23-4. Explain the basic principles used in evaluating an insurance program.

- Three basic principles should be followed in evaluating an insurance program: (1) consider the various policies appropriate for the business, (2) secure coverage for all major potential losses, and (3) consider the feasibility and affordability of insuring smaller potential losses.
- Basic coverage needed by almost all small businesses includes property insurance, commercial general liability insurance, automobile insurance, workers' compensation insurance, and crime insurance.
- Property insurance should cover the full replacement value of a firm's buildings and personal property.
- A small business owner must determine what distinguishes a "smaller" potential loss from a "major" potential loss and then decide if it makes sense to insure against smaller potential losses.

23-5. Identify the common types of business insurance coverage.

- Basic insurance policies used by many small companies fall under one of two categories: property and casualty insurance, or life and health insurance.
- A property insurance policy is used to insure both buildings and personal property owned or leased by the business.
- A decision must be made by the business owner as to whether to insure the firm's property using a named-peril approach or an all-risk approach.
- Business interruption insurance, which reimburses a firm for the loss of anticipated income following the interruption of operations, should be given careful consideration as an optional coverage that can be added to the property insurance policy.
- A commercial general liability insurance policy is the cornerstone liability policy for small businesses and protects against premises liability, operations liability, product liability, and completed operations liability.
- An automobile insurance policy is designed to provide liability protection for the business owner arising from the use of vehicles for business purposes as well as physical damage coverage on owned vehicles.
- Workers' compensation insurance provides employee benefits in compliance with states' statutes to those employees injured at work.
- A small business owner must accept the fact that he or she is vulnerable to the possibility of employee dishonesty and purchase the appropriate crime insurance coverage.
- Employment practices liability policies, umbrella liability policies, inland marine policies, professional liability policies, and cyber insurance policies are also available to small business owners.
- The three types of life and health insurance that provide protection for employees within a business are health insurance, key-person life insurance, and disability insurance.

Key Terms

actual cash value (ACV) p. 630
all-risk approach p. 639
automobile insurance p. 640
business interruption insurance p. 639
business risk p. 629
coinsurance clause p. 639
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Discussion Questions

1. Define *business risk*, and then distinguish between pure risk and market risk.
2. What are the different types of risk that a business may encounter?
3. What are the basic ways to manage risk in a business?
4. Describe the different sources of legal liability.
5. Why would a business owner want to insure against smaller potential losses?
6. What are the common types of property and casualty insurance?
7. What are some of the key provisions that should be considered when purchasing property insurance?
8. What are the common types of life and health insurance?
9. Describe a business owner's policy, including the types of insurance coverage available with a BOP. List the advantages of this type of policy.
10. What is the purpose of a coinsurance clause, and how does it work?

You Make the Call

Situation 1

The Amigo Company manufactures motorized wheelchairs in its Bridgeport, Michigan, plant, under the supervision of Alden Thieme. Alden is the brother of the firm's founder, Allen Thieme. The company has 100 employees and does $10 million in sales a year. Like many other firms, Amigo is faced with increased liability insurance costs. Although Alden is contemplating dropping all coverage, he realizes that the users of the firm's product are individuals who have already suffered physical and emotional pain. Therefore, if an accident occurred and resulted in a liability suit, a jury might be strongly tempted to favor the plaintiff. In fact, the company is currently facing litigation. A woman in an Amigo wheelchair was killed by a car on the street. Because the driver of the car had no insurance, Amigo was sued.

Question 1 Do you agree that the type of customer to whom the Amigo Company sells should influence Thieme's decision regarding insurance?

Question 2 In what way, if any, should the outcome of the current litigation affect Thieme's decision about renewing the company's insurance coverage?

Question 3 What options does Amigo have if it drops all insurance coverage? What is your recommendation?

Situation 2

Pansy Ellen Essman is a 48-year-old grandmother who is chairperson of a company that does $5 million in sales each year. Her company, Pansy Ellen Products, Inc., based in Atlanta, Georgia, grew out of a product idea that Essman had as she was bathing her squealing, squirming granddaughter in the bathroom tub. Her idea was to produce a sponge pillow that would cradle a child in the tub, thus freeing the caretaker's hands to clean the baby. From this initial product, the company expanded its product line to include nursery lamps, baby food organizers, strollers, and hook-on baby seats. Essman has seemingly managed her product mix risk well. However, she is concerned that other sources of business risk may have been ignored or slighted.

Question 1 What types of business risk do you think Essman might have overlooked? Be specific.

Question 2 Would risk retention be a good strategy for this company? Why or why not?

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Question 3 What kinds of insurance coverage should this type of company carry?

Situation 3

H. Abbe International, owned by Herb Abbe, is a travel agency and freight forwarder located in downtown Minneapolis. When the building that housed the firm's offices suffered damage as a result of arson, the firm was forced to relocate its two computers and 11 employees. Moving into the offices of a client, Abbe worked from this temporary location for a month before returning to his regular offices. The disruption cost him about $70,000 in lost business and moving expenses. In addition, he had to lay off four employees.

Question 1 What are the major types of risk faced by a firm such as H. Abbe International? What kind of insurance will cover these risks?

Question 2 What kind of insurance would have helped Abbe cope with the loss resulting from arson? In purchasing this kind of insurance, what questions must be answered about the amount and terms?

Question 3 Would you have recommended that Abbe purchase insurance that would have covered the losses in this case?

Experiential Exercises

1. Find two articles on small business startups on *Entrepreneur* magazine's website at www.entrepreneur.com. The articles should include one new firm that is marketing a product and another that is selling a service. Compare the firms' situations relative to business risks. Report on your analysis to the class.
2. Contact a local small business owner and obtain his or her permission to conduct a risk analysis of the business. Report to the class on the business's situation with regard to risk and what preventive or protective actions you would suggest to its owner.
3. Arrange to interview the owner or one of the agents of a local insurance agency. Determine in the interview the various types of coverage the agency offers for small businesses. Write a report on your findings.

Chapter 23 Case

Please see Appendix A for the Chapter 23 Case Study.

Endnote

1. Translated by Arthur W. H. Adkins from the Greek text of Solon's poem "Prosperity, Justice and the Hazards of Life," in M. L. West (ed.), *Iambi et Elegi Graeci: Ante Alexandrum Cantati*, Vol. 2 (Oxford: Clarendon Press, 1972).

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The Lip Bar

Pursuing an opportunity around you and being adaptable

Case 1

Melissa Butler grew up in Detroit, Michigan, with a mother who worked as a crane operator in a steel factory. And as you might expect, her mother instilled a strong work ethic within Butler and taught her to stand up for herself.

Butler attended an all-Black high school before going on to a Historically Black College, where she obtained a bachelor's degree in Business Finance. After graduation, she went to work as a stockbroker for Barclays Bank on Wall Street. She also started making her bars of soap at home in her kitchen, with different scents, shapes, and colors. She started selling online, calling her business "The Soap Bar." On one occasion, she called on a supplier, asking for pigments for her soap. The supplier asked her, "Do you want soap pigments or lipstick pigments?" Although she was really looking for soap pigments, she responded, "lipstick pigments," deciding to try something new.

Looking back on this conversation, Butler doesn't know why she was so quick to switch directions, but immediately felt it was the right decision. She knew she wanted to produce vegan products that were as natural as possible. She also saw value in her experiences as a Black woman who had always been frustrated with the beauty industry's lack of representation for women who looked like her.

Butler began reading books, researching online, and watching YouTube videos to learn how to make lipsticks. She would make large batches of lipsticks, go to work the next day to try them out on other employees, and repeat the same process when she got home. She next would have friends and family test the products. Based on their reactions, she began selling online.

Then in 2012, Butler decided to launch The Lip Bar as a business, spending $30,000 of her savings on inventory and shipping. After months of working on it, she quit her job at Barclays, planned a launch party, and focused on product innovation, marketing, and growing the business. After about a year, she decided to leave New York and return home to Detroit, a city that had recently experienced a resurgence in the community and innovation.

She worked to grow the company and eventually received an opportunity to pitch her idea to Shark Tank. Although that experience did not turn out well for The Lip Bar, Butler was thankful for the opportunity, as it steered her in a good direction. She went on to pitch to some 200 investors. Her response? Keep going. Things turned around for her in 2018, when she met Richelieu Dennis, CEO of SheaMoisture, at a trade show. Dennis eventually became the brand's first investor.

Butler has continued to pursue her mission of making products that are vegan and cruelty free. Looking back on her experience so far with The Lip Bar, she believes several factors helped her get to where she is today:

- A willingness to ask questions and learn from experts
- A readiness to apply a trial and error process in product development
- Finding creative ways to grow her network
- A willingness to make changes in her company
- Being persistent in overcoming failure
- Raising money with the right investors

Without these philosophies, Butler says that The Lip Bar would not be where it is today.

The story of Melissa Butler and The Lip Bar demonstrates the entrepreneurial spirit and process, the motivations required of an entrepreneur to continue on the often-difficult path to success, and the impact of serving customers by fulfilling a socially conscious mission.

Sources:https://www.linkedin.com/in/melissa-butler-4b7ba766/; https://www.entrepreneur.com/article/333194; and https://thelipbar.com/; https://www.npr.org/2020/11/20/937079808/the-lip-bar-melissa-butler

Questions

1. What opportunities did Melissa identify, and how did she capitalize on those opportunities?
2. How did Melissa's background help her identify and tackle the problems she discovered in the beauty industry?
3. Describe how The Lip Bar can impact a growing segment of their customer base.
4. Describe The Lip Bar's competitive advantage(s).
5. How does The Lip Bar's mission help the company make an difference in the beauty industry? What should businesses be concerned with regarding social entrepreneurship?
6. Visit The Lip Bar's website at https://thelipbar.com/ and explore the offerings provided. What stands out about these products?

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Case
2

Hydraloop

Recycling Water to Serve the Greater Good

Some new ventures are the product of intentional efforts by social entrepreneurs to address broader social needs. This doesn't mean that these business owners are unconcerned with making money; rather, financial gain is just one of an expanded set of goals. In these cases, the outcomes of interest are sometimes referred to as the "triple bottom line" because they focus on people, profits, and the planet. Businesses cannot exist for long if they are unable to make a profit, so financial performance is always a consideration. But a growing number of entrepreneurs are creating ventures that are also concerned with people and the environment. The founders of Hydraloop may fit the description of this specific group of new small business owners.

The Hydraloop system is a self-recycling water system for homes, residential and commercial buildings, and businesses. The unit collects, treats, and reuses the water from washers, showers and baths, heat pumps and air conditioning units, often called grey water. After treatment, the reclaimed water is clean, clear, safe, and disinfected. This water is not drinkable, but it can be recycled for toilet flushing, laundry, garden irrigation, topping off swimming pools, and a number of other purposes. It is estimated that installing a Hydraloop system would save an average homeowner 45 percent on their water bill, suggesting that it simply makes good financial sense.

Hydraloop is marketed to areas where water consumption is a concern, including rural areas, arid desert regions, large cities, and off-the-grid locations. Though their manufacturing facility is in the Netherlands, the company has an international presence through offices in the Netherlands, the Middle East, and the United States. In anticipation of increased demand for its systems in the future, Hydraloop is planning to build a second manufacturing facility that will be located in the United States. This will require significant investment and a long-term commitment. To keep its operations lean and manage its cash flow, the company has chosen to distribute its products through a network of sales and installation partners. It has also centralized its production and does everything it can to keep inventory levels low. Given that the base-unit price for the product runs to $4,389, having units sitting in warehouses or retail locations around the world would end up being a major expense. But because Hydraloop has chosen to adopt a business model that depends on partners to sell, order, install, and service its units instead of creating its own physical retail facilities to handle these operations, overhead costs are kept low.

The company's founders, Arthur Valkiese and Sabine Stuiver, developed and tested the Hydraloop prototype in their home in Holland. In 2017, the duo put together two units that they then were able to use for product demonstrations. To generate interest in their innovative system, they attended 27 trade shows around the world that year with the goal of proving to potential customers that Hydraloop systems could perform as promised. This promotional journey was an arduous one, but the founders' persistence finally paid off when it was announced that the company was to receive four impressive awards at the 2020 Consumer Electronics Show in Las Vegas. That was clearly a turning point, and it launched the company internationally. Up until that time, the entrepreneurs had to finance the company themselves, but the awards and resulting positive press brought a flood of inquiries and great promise for the investment they would need to grow their new venture. The timing could not have been better as reports of ongoing drought in many regions of the world had been predicted to drive up demand for new water conservation technologies.

Shortly after the news of Hydraloop's awards became public, interested investors began to take notice of the start-up and decide to take a chance on its future potential. As evidence of this, Valkiese and Stuiver were able to complete their first round of funding in the summer of 2020. And that November, the manufacturer Niverplast and the Dutch multinational banking and financial services company Rabobank came through with even more investment, enough to see that Hydraloop's plans were fully underwritten. This vote of confidence led to even better news for the company. As of January 2022, Hydraloop had signed partner agreements in 10 U.S. states for the delivery, installation, and service of their units. It seems that meeting the needs of people and helping to save the planet has the potential to chart a path to healthy profits.

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Questions

1. Do you believe Hydraloop is a good example of a social venture? If this is determined by a start-up's performance on the "triple bottom line" (people, profits, and the planet), on which of these outcomes does the company seem to perform best? Please list these in rank order and offer your justification for that order.
2. If you were to purchase a Hydraloop system for your home, apartment, or workplace, how would you research the product? Would you need to see one before investing over $5,000 for purchase and installation? How do you feel about the location and sales strategy the founders have selected?
3. Assess the future potential of Hydraloop. What factors do you think will contribute most to its performance in the years ahead? What factors could potentially hold its performance back? What recommendations would you have for Valkiese and Stuiver as they attempt to capitalize on positive factors and navigate the potential risks that they are likely to encounter?

Sources: Crowdcube, "Hydraloop," https://www.crowdcube.com/companies/hydraloop/pitches/leaN4l, accessed May 5, 2022; Michal Christine Escobar, "CES 2021 News: HydraLoop Debuts Two New Water Recycling Systems," *Hospitality Technology,* January 14, 2021, https://hospitalitytech.com/ces-2021-news-hydraloop-debuts-two-new-water-recycling-systems, accessed May 5, 2022; Hydraloop, https://www.hydraloop.com/products-residential, accessed on May 4, 2022; Kelsey Nowakowski, "Dutch Couple Creates First of its Kind In-Home Water Recycling System: Hydraloop," *Lampoon,* June 12, 2021, https://lampoonmagazine.com/article/2021/06/12/hydraloop-brave-blue-world, accessed May 5, 2022; TopDutch, "From Local to Global in 4 Years: The Timeline of Hydraloop's Success in the TopDutch Region," https://www.topdutch.com/one-minute-reads/from-local-to-global-in-4-years-the-timeline-of-hydraloops-success-in-the-topdutch-region, accessed on May 5, 2022; and Arthur Valkieser, "I Don't See Problems as Obstacles, but as Favors," *MT/Sprout*, March 2, 2022, https://www.hydraloop.com/post/arthur-valkieser-hydraloop-in-mt-sprout-i-don-t-see-problems-as-obstacles-but-as-favours, accessed on May 5, 2022.

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Case
3

Dollar Shave Club

Selecting Strategies that Capture Opportunities

Michael Dubin, founder of Dollar Shave Club (DSC), has been hailed as the one of the most "innovative marketers" to have started a direct-to-consumer venture (that is, a business that sells its products directly to end users, thus bypassing wholesalers and retailers and the high costs that naturally result from selling through such intermediaries). He was so successful with DSC that it caught the attention of Unilever Company, which purchased the fast-growing venture in 2016—an impressive outcome since DSC had been launched only a few years earlier. This achievement underscores a compelling story of an entrepreneur who was able to clue into customers' pain and use those insights to take on a field of long-established industry players with exceedingly deep pockets and still score more than his share of victories.

Most people are familiar with the hassles involved when shopping for razors. It usually starts with the inconvenience of figuring out who has the key to the razor case, which can be a challenge in itself. But then, after getting them to unlock the case, confusion sets in as the buyer has to almost guess which razor is correct for the handle they have at home. And only after some quick mental calculations can they determine which purchase option is best for them since the price tags vary so much, depending on the number of razor heads in the pack.

Sizing up the situation after careful study, Dubin settled on a profound and very timely DSC solution: a subscription razor service. In one of the company's iconic YouTube videos, he explained in simple terms how the service would work: "For a couple dollars a month, we send high quality razors right to your door." With that straightforward idea as its foundation, Dubin launched the company in December 2010, offering men's razors as its only product. An associate helped him secure the necessary inventory to get started.

To be sure, the path forward presented its share of hurdles. For example, getting the company off the ground required Dubin to invest his life savings into the business. He also had to leave his job, moving eventually into a studio/bungalow to come closer to making ends meet. Fortunately, DSC received a lifeline of $100,000 in 2011 from an incubator called Science Inc. That seed money gave Dubin and his colleagues the financial boost they needed to rebuild the website, secure distributors, network for talent, and meet with bloggers to increase awareness. At the time the venture was launched, the shaving industry market size was about $2.6 billion and was dominated by two razor giants, Gillette and Schick.

A redesigned and expanded DSC website offering three products for sale went live at 6:30 am (Pacific time) on March 6, 2012. It was relaunched with a wacky and very entertaining YouTube video featuring Dubin walking through a warehouse while discussing the subscription service with zany humor and slapstick charm. It was clearly targeted toward men who shave regularly and think purchasing razors is a hassle, and it definitely hit the mark. The video was picked up by more bloggers and channels than anticipated, driving so much traffic to the website that it had already crashed by 7:30 that same morning. After working through a very frantic 24 hours, the DSC team finally was able to restore the site to keep the venture's momentum going. That same day, it was announced that the start-up had received $1 million in additional seed funding from angel investors.

The good times continued to roll for DSC. Tens of thousands of new members signed up for the subscription in just three days, and the company also sold out of inventory over that same very short period. Because of the crush of interest in DSC's service, the company had to inform many customers that they would not receive any deliveries for 3 months. But at an average cost of just $6 a month, the new subscribers were not upset and happily rooted for the razor-pitching underdog.

The company's YouTube commercial, which turned out to be a mega-hit with viewers, cost a mere $5,000 to produce. Dubin worked with friends in the video production business that he had from his years in marketing and improv to create a number of additional clever, edgy, and often indelicate commercials that appealed to the company's target market. This led to an expanded range of products to include hair and skin and haircare cream offerings, as well as deodorant, oral care, and other products. The explosive growth of the company and its direct-to-consumer selling platform represented an innovative approach that eventually stirred Unilever to acquire DSC. But recognizing Dubin as the creative genius of the venture, the consumer-products giant was able to persuade him to stay on as CEO of the company, a position he retained until January 2021.

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Questions

1. Review the concept of broad-based strategies in Chapter 3. When Dubin first launched Dollar Shave Club in 2010 and for the first few years of its existence, was he following a cost-based strategy, a differentiation-based strategy, or focus strategy emphasizing cost or differentiation? Support your selection with facts and the appropriate terminology.
2. Regarding the Types of Star-tup Ideas section in the chapter, do you think Dubin launched his company to pursue a *new market idea,* a *new technology idea*, or a *new benefit idea?* Explain your reasoning.
3. Take a moment to look at the section of the chapter that summarizes Outside-In Analysis. Then, list and explain a few of the major factors that you believe may have led Dubin to decide to launch his new venture as a subscription razor star-tup.

Sources: Dollar Shave Club, www.dollarshaveclub.com, accessed April 29, 2022; Dollar Shave Club, https://www.youtube.com/watch?v=ZUG9qYTJMsI (March 6, 2012), accessed April 29, 2022; Lloyd Greif Center of Entrepreneurial Studies, University of Southern California (October 26, 2013), https://www.youtube.com/watch?v=Rh1FXXW-qIk, accessed April 29, 2022; and Diana Ransom, "Michael Dubin Makes His Exit from Dollar Shave Club," Inc., January 15, 2021, https://www.inc.com/diana-ransom/dollar-shave-club-michael-dubin-omnichannel-direct-to-consumer-branding.html, accessed April 29, 2022.

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Case 4

Two Men and a Truck®/ International, Inc.

Exceeding Customers' Expectations

Background

In 2021, TWO MEN AND A TRUCK®/INTERNATIONAL, Inc., was recognized on *Entrepreneur* magazine's list of Top 500 (it was ranked at number 181). It was also named as one of America's top global franchises, listed on *Franchise Business Review*'s "Franchise 50," and selected as one of the top 25 franchises for Hispanics by the National Minority Franchising Initiative. The Military Times Best: Franchises in 2018 ranked the company 13th. According to the company's website (www.twomenandatruck.com), it is the first and largest local moving franchise system in the United States and offers a full range of home and business moving services.

History

TWO MEN AND A TRUCK started in the early 1980s as a way for two brothers to make extra money while they were in high school. Now, over 35 years later, the company has grown to more than 380 locations and 3,000 trucks worldwide (www.twomenandatruck.com).

Brothers Brig Sorber and Jon Sorber started moving people in the Lansing, Michigan, area using an old pickup truck. They had their mom, Mary Ellen Sheets, develop a logo to put in a weekly community newspaper. That stick men logo still rests on every truck, sign, and advertisement for the company. After the brothers left for college, Sheets continued to field calls for moving services while she also worked a full-time data-processing job with the State of Michigan. In 1985, she decided to make things official by purchasing a 14-foot truck for $350 and hiring a pair of movers. That $350 is the only capital Sheets has ever invested in the company. Her experience with data analysis, combined with her commitment to customer service, earned her a spot on a 1988 graduate business panel at Michigan State University. When a fellow panelist suggested she franchise her little company, Sheets decided to consult with an attorney.

In 1989, Sheets awarded the first location outside of Michigan to her daughter, Melanie Bergeron. The office was in Atlanta, Georgia. When the company reached 39 franchisees, Sheets asked Bergeron to assume the role of company president while she pursued a seat in the Michigan State Senate. Bergeron is now chair of the board. TWO MEN AND A TRUCK's long track record of aggressive growth continues under Bergeron's progressive leadership and keen business strategies. Her accomplishments have been showcased on the cover of *Franchising World* magazine and in numerous other publications, including *Franchise Times.* Brig and Jon Sorber returned to their Lansing roots in the mid-1990s to team up with their mom and older sister. Brig has been president and co-CEO, and currently serves as the company's chief brand officer. Jon is the executive vice president. The first truck that Sheets bought in 1985 has now multiplied into a fleet of more than 1,200 trucks.

Customers benefit from having trained, uniformed movers who are insured and bonded to handle any home move and business moving tasks. The company has come a long way – and logged a lot of miles – since Sheets sketched the first "stick men." TWO MEN AND A TRUCK continues to pave the way for future growth and innovation, while remaining focused on exceeding customers' expectations.

The firm has more than 380 locations operating worldwide, including in 42 U.S. states, Canada, the United Kingdom, and Ireland. In 2010 it completed 317,841 moves, in 2005 over 2 million, and by 2021 over 8.5 million. This growth did not go unnoticed, and in August of 2021 ServiceMaster Brands (SMB) completed its acquisition of TWO MEN AND A TRUCK. SMB is a portfolio company of Roark Capital Group, a private equity company that specializes in multilocation service-oriented franchises.

Franchising

Standard franchise territories are based on population, generally between 420,000 and 600,000 people per marketing area. The initial franchise fee is $45,000. Total startup costs (including facility, trucks, equipment, and other expenses) range from $179,000 to $585,000. To be considered, applicants must have $150,000 in liquid assets and a net worth of $400,000.

After conducting significant market research in 2017, management realized there was a largely neglected market ready to be served. The mini-market model was launched, targeting areas with a population range between 100,000

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and 225,000 people. The mini-market model replicates the standard market model requiring a building, a truck and moving equipment. Franchisees must have $80,000 in liquid assets and a net worth of $160,000. The startup costs range from $100,000 to $192,000 with an initial $30,000 franchise fee.

TWO MEN AND A TRUCK has always focused on training its employees with the latest techniques and the best equipment available – and on treating everyone as they would want their grandmother treated, otherwise known as THE GRANDMA RULE®. Before a new franchisee can open a location, he or she must attend a two-week training course in Lansing, Michigan, conducted by home office staff at STICK MEN UNIVERSITY®. There, franchisees are taught by subject-matter experts about the computer systems, how to market their new business, and how to hire, manage, and lead their teams. (Throughout the year, STICK MEN UNIVERSITY offers online classes that cover everything from marketing tactics to leadership to making accurate estimates. Several instructor-led courses are also available online.)

Franchisees also work in a two-story home built inside the TWO MEN AND A TRUCK headquarters. During this portion of the training, students are taught how to maneuver, wrap, pack, and load items such as a grand piano, a China cabinet filled with breakables, glass tables, a washer and dryer, and a flat-screen television. Students are expected to be able to recognize obstacles and empty the house as quickly and efficiently as possible. A truck box, built to scale, is also located in the training facility. Students must be able to fully pack the back of the truck with the items from the home.

Many other tools are available to franchisees, including detailed monthly reports, newsletters, extranet, a system-wide annual meeting, a toll-free support line, a tradeshow booth, a complete line of TWO MEN AND A TRUCK branded clothing and professional marketing materials, and a system-wide purchasing system.

Questions

1. Limiting sales territories is one of the common restrictions that franchise contracts impose on franchisees. Do an Internet search for TWO MEN AND A TRUCK franchises in your immediate area. How many are there? Does this number reflect the company's population requirements?
2. Which moving companies compete with TWO MEN AND A TRUCK in your area? Are there differences in their rates of success? How could you measure those differences? Are there differences in their advertising? In their rates for items such as boxes and packing supplies? Which companies have an advantage, and why?
3. Suppose that after owning a TWO MEN AND A TRUCK franchise for five years, you decided to go out on your own with a new moving company called Four Movers. What kinds of legal issues would you face?

Source: Compiled from interviews and information provided by TWO MEN AND A TRUCK. www.twomenandatruck.com. © 2012, 2022 Cengage Learning.

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Case 5

Judd's Hill Winery and MicroCrush

Family business

In the early 1970s, Art Finkelstein began making wine in his garage. Then in 1979 Art and his brother, Alan Steen, purchased a vineyard just south of St. Helena, California. Art was a certified architect, who then designed and built Whitehall Lane Winery, named after the road that ran along the south border of the property. That is where Art began his professional winemaking career. Whitehall released its first wine, a Cabernet Sauvignon, in 1980. As demand grew and production increased, the founders realized they enjoyed making wine, not managing a large-scale business. By 1988, the winery was producing over 30,000 cases a year, and the brothers decided to sell.

Art and his wife, Bunnie, purchased a 14-acre vineyard nearby, where he designed and built his second winery, Judd's Hill. Art felt Judd's Hill was a way to get back to the basics and embrace their true passion of winemaking. They planned to produce no more than 3,000 cases of wine annually. Their first Cabernet Sauvignon was released in 1989.

MicroCrush was added as a unique service based on customer inquiries. MicroCrush allows other vineyards to bring their grapes to be processed, and wine enthusiasts can blend wines to create their personalized small lots of premium wine. As of 2021, there were over 700 grape growers and 475 wineries in Napa County. Ninety-two percent of the wineries are family owned. Nearly 80 percent produce fewer than 10,000 cases annually.

Art built Judd's Hill and named it after his son purposefully, to "sucker him into the business." But Judd did not rush into the family business. He received a bachelor's degree in Television Production from the Walter Cronkite School of Journalism and Telecommunication at Arizona State University and pursued his dreams of working in the entertainment business before embracing the family business. While working on a movie project Judd realized he wasn't truly happy and decided, "Wine ain't so bad" (Small Business Revolution n.d.). Winemaking was in his blood having grown up in Napa Valley with two parents passionate about wine.

In one interview, Judd recalls, "I was 6 years old and I snuck a sip of 1977 Oak Pass – a Cabernet Sauvignon–Merlot blend that my dad made in the garage of our Benedict Canyon home. It was the first wine I tasted that wasn't Manischewitz, and it was good" (Finz 2008). Judd and his wife, Holly, moved to Napa in 2004 to work at the winery. Now he does everything from running the tasting room, managing the bottle line, holding grape blending camps, to writing and delivering a podcast and radio shows.

Art passed away in 2010. His passion for winemaking left a huge impact on the family business and Napa Valley. He founded The California Cabernet Society in 1991 and mentored countless Napa Valley winemakers. At Napa Valley Community College, he developed and taught "Designing the Small Winery." Judd's Hill has remained an artisanal, small winery specializing in the art of wine making, blending, and teaching. Judd's Hill prides itself on being a certified Napa Valley Green Winery. The company has installed solar lighting and developed recycling and composting programs, along with environmentally efficient drainage systems, all designed to minimize its footprint. These were aspects that Art valued, and his family has continued.

Judd has added his personal artistic passion to the business through his Judd's Enormous Wine Show podcasts, Judd's Hill TV on YouTube, and the annual Uke-A-Palooza. Bunnie, a long-time wine enthusiast and poet, said the "symbiosis of poetry and wine hit me a few years ago" (https://www.juddshill.com/about-us/). In 1999, they published the first Judd's Hill Newsletter, which included wine-related poems from friends and wine buyers. This turned into the Judd's Hill Annual Poetry contest, with links on the company website. Holly is heavily involved in the Napa Valley Community, volunteering with the Napa Valley Vintners association and on local health initiatives. She heads the wineries' philanthropy efforts – as well as hula dancing when Judd plays the ukulele.

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Questions

1. This family business has made numerous transitions. It started as two brothers and their wives (Whitehall), then became a husband and wife team (Judd's Hill), and finally parents with their son and daughter-in-law. If you had to create a family business constitution or family creed for Judd's Hill, what three items would you include?
2. As a small winery, Judd's Hill's biggest challenge is standing out among the fierce competition in Napa Valley. How has the Finkelstein family brought their unique talents into the business to help it compete?
3. What impacts have Art Finkelstein's values had on the current operations of the winery?
4. The book mentions numerous issues that family businesses have when planning for continuity (remaining in the hands of family members). Specifically, these include socioemotional wealth and typical fears that succeeding generations have about joining the family business. Judd himself was not immediately enticed to join the winery. What fears would you have about taking over a family enterprise such as the Judd's Hill winery?

Sources: "Story #32: Judd's Hill Winery," Small Business Revolution, https://smallbusinessrevolution.org/small-business-revolution/story/judds-hill-winery/; "About Us," Judd's Hill, https://www.juddshill.com/about-us/; "Judd's Hill MicroCrush," in Wine Country, https://www.youtube.com/watch?v=Zl_bAppL2RY; "Whitehall Lane Winery," The Napa Wine Project, https://www.napawineproject.com/whitehall-lane-winery/; "Judd's Hill Winery and MicroCrush," Kazzit, https://kazzit.com/winery/judds-hill-winery-and-microcrush.html; Stacy Finz, "Uncorked: Tiki-loving Winemaker Plays all the Right Notes," SF Gate, April 25, 2008, https://www.sfgate.com/wine/article/Uncorked-Tiki-loving-winemaker-plays-all-the-3286131.php; Dan Pine, "Jewish Winemakers Go Hawaiian," Jewish News of Northern California, February 24, 2006, https://www.jweekly.com/2006/02/24/jewish-winemakers-go-hawaiian/; "'Uke-a-Palooza at Oxbow' returns to Napa Valley," February 21, 2020, Napa Wine Taste, https://napawinetaste.com/live/best-of-the-rest/article_30548090-9f80-11e9-b60c-97fcc1d27152.html; Katherine Nicols, "A Strum Heard Across the Sea," Star Bulletin 12 (127) (May 7, 2007), http://archives.starbulletin.com/2007/05/07/features/story01.html; Napa Valley Fast Facts, https://napavintners.com/press/docs/napa_valley_fast_facts.pdf; "Family Constitution and By-laws," Morgan Stanley, https://advisor.morganstanley.com/michelle.ward/documents/field/w/wa/ward-sofia-michelle/Family_Constitution_and_Family_By_Laws.pdf

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Case
6

Telesian Technology

The Business Model: From Scientist to Marketer to Entrepreneur

As a product manager in the computer industry, Shari Worthington was responsible for understanding and prioritizing customer needs. Her job was to work with complex computer peripheral products that measure and analyze real-time data, such as temperature, pressure, or speed, taking them from development to launch. This was a great match for Worthington as she was a trained scientist who understood the jobs and frustrations of her target customers—scientists and engineers working with real-time automation systems.

Customer needs were assessed through a variety of avenues, mostly focused on one-to-one conversations and surveys. To respond to those customers' needs, Worthington worked with her company's engineering and marketing teams to create a vision for new products, as well as an actionable go-to-market plan. Along the way, she had an opportunity to work with a variety of advertising and PR agencies. In Worthington's words:

> *The output from the big agencies we worked with was creative and outside the box. But projects generally took longer than we'd hoped as most agencies did not understand our highly technical customers and specialized products. We had to train them for each project. Even then, many of the recommendations ended up flashy business-to-consumer, B2C,[i] theatrics instead of the data-driven, information-packed campaigns that resonated with our customers.*

After 10 years in the computer industry, Worthington decided to address that problem. She launched Telesian Technology with what she called an anti-agency business model. She thought of Telesian as a full-service marketing agency with a difference. The staff are technical marketers—scientists and engineers who also have marketing and/or MBA degrees. They understand strategy, research, and marketing as well as technical customers and complex technologies. This expands Telesian's customer value proposition beyond that of advertising and PR agencies. The company offers end-to-end services, from business strategy and market positioning to go-to-market product launch programs to ongoing lead generation focused on customer needs. And because employees and contractors have technical backgrounds, they can be brought up to speed faster than most agencies. This allows the Telesian team to develop more compelling value propositions for their clients—directly addressing customer benefits and clearly differentiating their organizations and products from those of competitors.

For Telesian, Worthington extended the traditional agency business model in what was, at the time, an unusual direction that focused on selling strategy and marketing services to a niche customer segment. Telesian specializes in working with developers of complex computing technology for scientists, engineers, and manufacturers. Initially, she targeted SME manufacturers of automation equipment and related software. As her network grew, her team was brought in to work on projects in larger firms, like Intel, Apple, and Raytheon, who had the same needs as her smaller clients but on a larger scale. As the size of client projects grew, the Telesian team had to expand. In addition to the core team of employees, contractors were brought in as needed to perform such functions as strategy development, technical writing, and graphic design.

Over the years, Worthington's strategy did not waver. For instance, during the heyday of the dotcom boom in the late 1990s and early 2000s, a number of her peers encouraged her to take the web software tools Telesian was developing and expand from selling services to selling products. Worthington knew that was a whole different business model that would require a major rework of the company's internal activities. It would also require a significant investment in their own marketing programs as they had been relying primarily on word-of-mouth referrals for growth.

While Worthington advised clients who were raising investment capital and knew the process well, she was not interested in taking that path herself. She most enjoyed working on client projects, creating new strategies and helping innovative companies grow. From the beginning, her goal was to create a small, boutique firm with little hierarchy, where she could be involved in most client projects. Now, 30 years later, she's still in the thick of it.

[i] A business-to-consumer model, B2C, characterizes businesses selling to consumers, as opposed to a business-to-business model, B2B, selling primarily to other businesses. See Chapter 9, pp. 235–237, for further explanation on these two models.

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Questions

1. What were Worthington's motivations for founding Telesian Technology? What kinds of risks was she taking?
2. Worthington viewed Telesian as an advertising agency when she started the company. When she was a product manager, she worked closely with advertising agencies and public relations companies. In what ways do you think she differentiated Telesian from her advertising competitors at the beginning?
3. How was Worthington able to identify customer segments and match them to Telesian's value proposition?
4. Do you feel that Worthington made the right decision to stay focused on selling services and not products? If she had decided to grow the company by offering products, in what ways would that have impacted her business model? What would have been the greatest threats that she would have faced?
5. Why do you think Telesian has survived for 30 years? What have been the key factors internal to the firm that led to its success? Have any external factors influenced the sustainability of the firm?
6. View Worthington's profile on LinkedIn. (https://www.linkedin.com/in/sharilee/.) Does she have a personal value proposition? Today is a very different world from the one in which Worthington started her company. What changes, if any, do you think Telesian will need to make in the future?

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Case

7

Altes Original Detroit Lager

"A Detroit Tradition Restored"

Beginning in 1910, Altes Original Detroit Lager (Altes) was the beer of choice for hard-working Detroiters. Altes is a Bavarian type of lager, designed as a less heavy and easier drinking beverage. Initially bottled at the Tivoli Brewery on the corner of Mack Avenue and Hurlbut, it came in a classic 12-oz. tint can, consisting of three colors, red, white, and gold. By the 1960s, Altes was a proud sponsor of the Detroit Lions and Detroit Tigers. During the 1990s consolidation of beer-brewing companies, Altes met an unremarkable end.

In 2016, Eric Stief, co-founder of Detroit National Brewing Company (DNBC), along with Pat Kruse and Carl Erickson, relaunched Altes. The threesome were lifelong friends, Metro Detroiters, and home brewers. They chose to relaunch a historic beer because it provided instant brand recognition. Through interviews with people familiar with Altes, they realized it still had significant brand equity. For example, former police officers had stories about a dedicated tap room for off-duty cops where they could drink Altes. At least two separate bar owners reported burying their fathers with Altes beer bottles in the coffin. Other comments included "the beer I stole from my grandfather's garage," and "the first beer I ever tasted."

Competing with the overwhelming number of craft beers available would have cost a lot of money and time, so having an old brand that people remembered was essential. A major component of their marketing plan was capitalizing on the "retro Detroit" coolness and the underdog rising from the ashes. Their value proposition being a sense of hometown pride as a Detroit-native brewery with local ownership gained traction. Altes landed a front page "relaunch" story in the Detroit Free Press without even reaching out, the paper called them.

In December 2021, DNBC launched a second product, Altes Sportsman Copper Lager, with a flavor profile that is a bit darker, more malt forward, and less hoppy. The marketing and beer can are focused on "all Michigan" as opposed to Detroit specific branding. The Sportsman's can is adorned with Michigan facts and cliches like "First virgin copper source in America." The idea was to appeal to the Michigan craft beer drinker looking more for a sweet malt versus a hoppy taste.

Altes Original Detroit Lager is currently being sold in over 500 stores, bars, and restaurants across Michigan. The top target market is Generation X males, ages 45 to 60, in the Metro-Detroit/Detroit area. The average salary for this group is $66,000, and their educational attainment level varies from an associate to a master's degree. Like the founders, they would associate the brand with early memories of family celebrations and sporting events. That market is still clearly the most popular, but they are dying off, drinking less, or both.

Their secondary market is males and females, ages 21 to 39 in the Metro-Detroit/Detroit area that support Detroit nostalgia. They have an average household salary around $56,000 per year and educational attainment from high school diplomas through master's degrees. DNBC found the younger age groups harder to reach given the recent popularity of alcoholic seltzers, malt beverages such as spiked lemonades, craft canned cocktails, and the exploding cannabis market. DNBC has been targeting hip hotspot bars, increased its use of Instagram, and has hired college students to do more rapid social postings. It plans to advertise at festivals again once they reopen, as they were a great pre-pandemic activity.

For the last four years, DNBC's public relations team made some significant efforts to increase awareness and recognition. Altes team members have appeared on channels 7, 94.7, WWJ, Fox 20 Detroit, NBC25 Saginaw, and Fox 66 Flint. The company posts on Facebook, Instagram, Twitter, and LinkedIn, and has a YouTube channel. It has adopted an integrated marketing plan; posts on the various platforms are scheduled to reinforce a specific message using similar text and identical images.

DNBC's main competitor is the Stroh's Brewing Company. Stroh's was founded in Detroit in 1850 and is owned by Pabst Brewing Company (PBR). Stroh's Bohemian Style Pilsner was revived in 2016 in Corktown, a community in Detroit. Stroh's also plays on the nostalgia of older beer drinkers and Detroit natives. However, Stroh's isn't exclusively brewed in Detroit and is sold throughout the US. The Pabst product line plays to the needs of a greater market of beer drinkers by producing multiple craft beers.

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Questions

1. Based on the marketing activities DNBC has tried, do you think it has a production-oriented marketing or a consumer-oriented philosophy? Explain your reasoning with examples.
2. Research the city of Detroit and the Metropolitan Detroit area. Does DNBC understand its target market? Explain why you think that.
3. Conduct a SWOT on DNBC—the company, not the products. Provide two or three statements per section.

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Case
8

Couchsurfing International

A Story of Start-up, Growth, and Transformation

In ancient civilizations, it was a common practice to open one's home to travelers who needed a place to sleep. This prompted the sharing of news, stories, and information. Couchsurfing International, a travel-oriented social networking site based in San Francisco, is dedicated to reviving the ancient practice and the social exchange that goes along with it.

Chapter One: The Founders

THE CONCEPTIONIST After graduating from college in 1997, with a degree in computer science, Casey Fenton decided to see some of the world before settling down. When he came across a relatively inexpensive flight from Boston to Reykjavik, Iceland, he decided to buy it but had no idea where he would stay or what he should see while there. He knew that he did not want to be a garden-variety tourist, staying in a hotel and traveling to the typical sights. Rather, he wanted to immerse himself in the Icelandic way of life—this, he believed, was what traveling should be all about.

To zero in on definite travel plans, Fenton called and emailed almost 2,000 students from the University of Iceland, asking if they had a couch or spare room that he could stay in for a night or two. He received more than 50 offers for possible accommodations—not only in Reykjavik, where the university is situated, but also in other towns located nearby. Using these leads, he made connections, set up specific travel plans, and left for his Icelandic adventure.

The trip ended up being a truly unforgettable experience. The locals showed him things he could never have found on his own, and he built great friendships along the way. Fenton decided that he wanted to help others see the world as he was able to, through the eyes of native hosts. On the flight home, he came up with the idea that would become the foundation of "The Couchsurfing Project." Fenton spent the next couple of years programming and setting up the website for Couchsurfing.org. He also took a position with a start-up called Fuxito Worldwide, but he continued working on the code that would lead to the eventual launch of his slowly blossoming website project.

THE ENTREPRENEUR Daniel Hoffer had three well-defined passions that developed at a young age: a love for traveling, helping others, and computer programming. An avid traveler since he was a boy, he gained a sense of purpose and perspective from learning about different cultures. With this confidence and direction, he figured out how to use his computer science skills to fulfill his desire to help others. The first online community that Hoffer launched grew into what would become a nonprofit educational program in Massachusetts and an online bulletin board that allowed physically disabled patients to connect with high school students.

Prior to getting his MBA from Columbia Business School and working for numerous computer technology companies, Hoffer studied philosophy at Harvard University. Apparently, his studies weren't enough to keep him busy because he remained actively engaged in the computer science world during that time and helped launch multiple start-ups. One of these companies, founded in 1999 as a venture-backed operation, was an international soccer website called Fuxito Worldwide. Although this endeavor was only one of hundreds of projects with which Hoffer would become involved, Fuxito was the venture that would lead Hoffer to his true calling.

THE VISIONARY Sebastian Le Tuan was born to help cultivate a world of cultural acceptance through travel. A native of France, Le Tuan eventually followed his heart and his love for technology to Silicon Valley in California. But while he was still a teenager, he spent time with a host family in Catalan, Spain, which helped him to understand that experiencing cultures on a personal level is paramount to releasing judgment and embracing differences. Though he had an undergraduate degree in cognitive science from the University of California at Berkley, Le Tuan managed to harness his passion for software development, as well, through various research initiatives. He worked for several companies as a software designer, with a focus on user experience. Eventually, he landed a position working with Hoffer at Fuxito Worldwide, where he would come to find his broad span of interests and experience perfectly matched for an innovative endeavor that was just waiting to come together.

THE TECHNICAL MIND Though less has been reported about his role in the launch and early formation of Couchsurfing International, Leonardo Bassani da Silveira was also a co-founder of the business. A Brazilian who studied information systems and decision sciences at

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Louisiana State University, Bassani da Silveira brought critical software-design talent to the effort. His time at the start-up led him later to create yet another venture, an Estonia-based tech outfit called Rankshaper, which offered a free Search Engine Optimization tool that client firms could use to figure out how to make their websites rank higher in Google searches. This post-Couchsurfing venturing experience and the half dozen product development and brand-shaping positions he has held over the years in tech-leaning companies provide further insight into why Bassani da Silveira was an important member of the start-up team. His skills provided a vital support to the development of the intermediating technology platform that was fundamental to Couchsurfing's business model. His contribution to the anticipated success of the start-up offered great value:

> *While [Couchsurfing] was not the first hospitality exchange platform, its beginnings became a key "focus" from which members developed a shared identity. It drew, connected, and served a geographically dispersed network of strangers based around shared beliefs, norms of participation and attitudes toward hospitality, openness, tolerance, communal sharing and intercultural exchange.*

Figuring this out required more than a theoretical understanding of the psychological and cultural underpinnings of the service Couchsurfing International was to provide to interested users. If the venture was unable to bring all of this together through a well-designed and dependable tech platform, it didn't stand a chance to succeed.

Chapter Two: Birth of a Business

Fenton, Hoffer, and Le Tuan brought their own unique backgrounds, interests, and talents when they joined Fuxito Worldwide and ended up making important contributions to the venture. Though they worked on different aspects of the company, the three formed a close friendship based on a shared love for innovation, exploration, and serving those in need. They realized that their diverse specialties, together with a unified purpose and vision, could help them develop a website that would revolutionize the way people travel. Thus began The Couchsurfing Project.

THE PATH TO 501(C)(3) STATUS After expanding the launch lineup to include Bassani da Silveira, the team began to form their ideas into a concrete plan. They all agreed steadfastly on many aspects of their start-up concept, the most important of which was that it would be created as a nonprofit organization. In March 2003, the co-founders filed in New Hampshire to incorporate Couchsurfing as a 501(c)(3), but it was not added to the official list of registered charities in the state until November 14, 2007. (See Chapter 8 for more information about 501(c)(3) status.) Why the delay? By taking their time to register the organization as a nonprofit with the state attorney general (which is required by law in the state of New Hampshire), Couchsurfing sidestepped certain recordkeeping and reporting responsibilities. This move led the Department of Justice in New Hampshire to investigate the organization at the end of 2007. With the pressure to comply growing, the company eventually sent the required documents for 2003 to 2006 to the attorney general, and the organization was officially added to the registered charities list.

WEBSITE LAUNCH After filing for 501(c)(3) status in 2003, the co-founders finally launched a beta version of the website. Because he had been so involved with the development of the basic idea and the coding that was needed, Fenton naturally accepted the role of executive director. Hoffer had experience managing small start-up companies, so he gravitated toward strategic development-related responsibilities. LeTuan had a solid grasp of the connection between human experience and both technology and cultural acceptance, so he headed the development of the website's overall purpose and mission. This provided the budding venture with a vision that could support and sustain the dedication and commitment of its members. With Bassani da Silveira on board to help with the many technical challenges that were sure to come up along the way, the team had all critical bases covered. A year after its beta testing was initiated, the website went public, and the founders were confident that users would come to discover and appreciate the power of relationship-based, reduced-cost travel.

Chapter Three: Riding the Wave of a ".org"

The founders fully believed that their venture would touch the lives of millions of people, but in the year following the website's launch, only 6,000 members joined the community. The founders continued to follow the same strategy for the next year, which saw membership jump to nearly 50,000. And with the continued growth came other new opportunities—that is, until 2006 rolled around.

In June 2006, the venture hit a serious snag: As a result of numerous technical errors within Couchsurfing's databases, the profiles of all of its members were lost. Because so much information had vanished and the future of the venture seemed to be so in doubt, Fenton sent out an email to the masses, reporting, "It is with a heavy heart that I

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face the truth of this situation. Couchsurfing as we knew it doesn't exist anymore."

Immediately upon sending out this message, Fenton started receiving a great deal of criticism. But at the same time, many members were very supportive, which inspired the Couchsurfing team to design a new website (called CS2.0) within a couple of weeks after the technical failures. The team also created a new slogan for the venture, "Participate in Creating a Better World, One Couch at a Time." This perfectly fit the new culture of the rehabilitated enterprise. With the continued support of past and current members, in addition to the international media attention that the new website received, Couchsurfing's membership exploded from around 50,000 to over 3.5 million individuals by the beginning of 2012. During this period, nearly 5.5 million travel-related connections were formed using this one-of-a-kind community website.

Chapter Four: What to Do When Growing Too Fast

Up to this point, the only revenues that Couchsurfing had received were from donations and its identification verification service (highly recommended, but not required), which could be used to confirm that a member was who they claimed to be. Fenton and Hoffer were strongly committed to providing an online source of help to travelers looking for free places to stay and to offering that service without the advertisements and expenses that other travel websites featured. But with the explosion of growth Couchsurfing had experienced, the management team needed to decide if remaining a nonprofit was best for the future of the company. To complicate matters further, Couchsurfing applied to receive 501(c)(3) status in November of 2007, only to see its application be formally rejected by the IRS in early 2011. From this setback, Hoffer came to realize that the nonprofit structure can blunt organizational innovation and flexibility as a result of increased regulatory oversight and various auditing requirements stipulated by law.

In their search for guidance, they sought the advice of four people who were members of the venture's board of directors: Tony Espinoza, Matt Cohler, Jonathan Teo, and Todor Tashev. These seasoned executives brought a wealth of experience to discussions about the company and its future. Espinoza had worked at Apple and had served as vice president and general manager for MTV Networks, vice president and co-founder of When.com, vice president of AOL, and CEO of SuperSecret.com. Cohler was one of the founding members of LinkedIn, where he served as vice president and general manager. He was also one of the first five employees hired at Facebook and was a general partner at Benchmark, a venture capital firm. Teo was a member of the strategy team at Google and a principal at Benchmark, where he helped initiate the original investments in companies like Twitter and Instagram. Tashev had worked as a venture capital analyst for JP Morgan and later became a partner at investment firm Omidyar Network, where he directed consumer Internet and mobile initiatives.

These board members suggested converting the business to a new organizational form specifically designed to use the power of business to solve a social or environmental problem. As a B Corporation (or benefit corporation), performance and accountability standards are demanding, sustainability must be a primary thrust, and transparency is forced through B Impact Reports that have to be filed. But the team quickly realized that converting to this form would allow them to accept investments, and to be nimble and flexible while remaining true to their original and continuing social mission. Responding to this advice, the team decided to change its status officially to a B corporation in late 2011. As predicted, this allowed the business to raise a significant amount of new investment. A Series A round of $7.6 million was announced on August 24, 2011. This was followed by a Series B infusion of $15 million almost exactly one year later. It seemed that Couchsurfing might finally have found its rhythm.

Chapter Five: Transition to For-Profit Corporation

Unfortunately, the good times didn't last, and before long Couchsurfing found itself again in need of further outside investment. It was around this time that the move to become a B Corporation was dropped, and the company was converted to a private for-profit enterprise that was legally organized as a C corporation. This latest shift was initiated in 2015 when Couchsurfing welcomed Patrick Dugan, an avid sailor, traveler, and leader of boutique capital fund Dugan Katragadda, as a new investor. This move allowed the company to avoid having to make an appeal to existing investors for a Series C round, which was important because the company did not meet the necessary growth metrics. Dugan implemented nearly a dozen strategies to turn Couchsurfing into a more profitable business, but all of his efforts were met with little success. During the COVID-19 pandemic, the business was forced to begin charging a subscription fee. This increased revenue but dropped the overall number of bookings and angered long-term subscribers.

While the change in status at Couchsurfing opened the door to greater opportunity, it also presented its share of risk. Change can erode confidence and will almost always generate at least some resistance. It certainly created significant backlash for Couchsurfing. About 3,000 members of the company's online community actually formed a group under the title "We are against CS

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becoming a for-profit corporation." This group voiced their reactions, which were varied and included statements such as "The structure of CS belongs to the community," "Members are no longer part of a true community, they are customers/consumers of a service sold by Couchsurfing International Inc.," and "The worst part is that the assets of a non-profit should not be allowed to change into a for-profit." These reactions indicate that the struggles at Couchsurfing International, following its conversion from a nonprofit organization to a private for-profit entity, are probably far from over.

Chapter Six: Looking Forward

Couchsurfing International is a very different organization today. Indeed, it has come to be described in recent years as "cagey" by some observers. Reflecting this new turn, the company is loathe to provide specific information about details like the name of its current owner and CEO, and it won't state outright how many "surfers" it currently has as members (a point made all the more confusing by the company website, which claims 12 million in one place and 14 million in another). Adding to the suspicion of many former users, current employees are told not to speak to journalists. It seemed clear that the sense of community that was the cultural center of the venture at the time of its founding had all but evaporated, along with its ethos of openness, tolerance, and sacrificial giving that attracted early fans of the networking service. Predictably, this was upsetting to those who had built a strong sense of identity with the venture, and they made their feelings known. Many made very public statements on social media and elsewhere about their decision to abandon the platform. The only question that remains now is whether Couchsurfing International will ever be able to get them back. Time will tell.

Questions

1. How would you describe the members of the founding team at Couchsurfing International? Is it a balanced team? What does each member bring to the business? Can you see gaps in their skill sets and capabilities that should be adjusted for in some way?
2. What is the form of organization that the founders of Couchsurfing International first chose for their venture? Assess the advantages and disadvantages of the major organizational forms mentioned in Chapter 8. Which of these would have been best for the company when it was founded? Why?
3. Identify and describe the organizational form to which the team most recently transitioned the firm. Was it a good decision to make this change? In your opinion, how well was the transition handled? In what ways might it have been managed better?
4. Assess the fit of the board of directors with Couchsurfing based on the profiles of those members mentioned in the case (the company has additional directors). What are the strengths and weaknesses of these board members, including potential gaps in their knowledge? Do you see any ways in which their advice to the entrepreneurial team may not have been in the best interests of the company?

Sources: Bren, "Is This Finally the End of Couchsurfing? (And What Is Next?)," May 27, 2020, https://brenontheroad.com/the-end-of-couchsurfing, accessed May 3, 2022; Couchsurfing, *Crunchbase*, https://www.crunchbase.com/organization/couchsurfing-international, accessed May 2, 2022; www.opencouchsurfing.org/tag/legal, accessed May 3, 2022; Andrew Federov, "Paradise Lost: The Rise and Run of Couchsurfing.com," *Input Magazine*, September 15, 2021, https://www.inputmag.com/features/rise-and-ruin-of-couchsurfing, accessed May 2, 2022; Bobbie Johnson, "After Going For-Profit, Couchsurfing Faces Revolt," https://old.gigaom.com/2011/09/01/after-going-for-profit-couchsurfing-faces-user-revolt, accessed May 3, 2022; Leonardo Bassani da Silveira, *Crunchbase*, https://www.crunchbase.com/person/leonardo-silveira-2, accessed May 2, 2022; Leonardo da Silveria, LinkedIn, https://www.linkedin.com/in/leobassani, accessed May 2, 2022; Michael O'Regan, "B Corp Certification Won't Guarantee Companies Really Care for People, Plant, and Profit," *The Conversation*, October 7, 2019, https://theconversation.com/b-corp-certification-wont-guarantee-companies-really-care-for-people-planet-and-profit-124459, accessed May 3, 2022; Michael O'Regan and Jaeyeon Choe, (2019), "Managing a Non-Profit Hospitality Platform Conversion: The Case of Couchsurfing.com," *Tourism Management Perspectives* 30: 138–146; Nicole Perlroth, "Non-Profit Couchsurfing Raises Millions in Funding," *Forbes,* August 24, 2011, https://www.forbes.com/sites/nicoleperlroth/2011/08/24/non-profit-couchsurfing-raises-millions-in-funding/?sh=61f61ed03e3d, accessed May 3, 2022; and "Rankshaper Overview," *SignalHire*, https://www.signalhire.com/companies/rankshaper, accessed May 2, 2022.

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Case 9

Mr. Holmes Bakehouse

Transitioning from a Physical Operation to an Online Presence

It was April of 2020, and Aaron Cadell had to make a quick decision. He had been forced to close his retail and wholesale bakery operations and coffee houses in San Francisco and Los Angeles because of the COVID-19 pandemic and a mandate by Governor Gavin Newsome of California. The order declared a state of emergency and closed most of the state's businesses. Now Cadell had to decide what steps to take to keep his business going for the sake of his employees—a number of whom were single mothers and desperately needed the income. There were a few options that quickly came to his mind: (1) produce an online baking show from the bakery; (2) produce masks and/or hand sanitizer, both of which were urgently needed because of the pandemic; (3) operate as a grocery store and sell off the company's baking products; or (4) develop, produce, and sell baking kits online.

In 2012, when he was 19 years old, Cadell left his job as a barista in San Francisco after negotiating a profit-sharing agreement with a failing chocolate retailer. Shortly after the deal was consummated, he decided to turn the business into a craft bakery. He named the bakery Mr. Holmes Bakehouse after a friend's cat named Mr. Holmes.

Then, in 2013, Cadell opened another retail bakery and café in San Francisco. These efforts met with success, leading him to consider expanding to other locations elsewhere in California. His first venture outside of the Bay Area was a coffee shop in the Highland Park neighborhood of Los Angeles, which he opened in 2016. The Mr. Holmes Bakehouse concept was beginning to get real traction as it evolved into a thriving small business.

As is the case with any young venture, there were always challenges that needed to be overcome. One of the greatest of these for Cadell was obtaining pastries from the wholesale bakeries that served San Francisco. There were three such businesses in the area, but they were already operating at full capacity and still didn't seem to be able to provide all of the baked goods Cadell figured he could sell. To overcome the constraint, he decided to open his own wholesale bakeries in 2014, one in San Francisco and another in Los Angeles. Although he had a handle on running retail operations, Cadell realized that he now would have to learn the ropes of managing a wholesale venture, too. It wasn't long before he proved he could make it work.

By the spring of 2020, Cadell's bakeries and coffee shops were bringing in $2 million annually in retail business and another $3 million a year in revenues from wholesale operations. But when the COVID-19 pandemic hit in early 2020, it all came to a screeching halt. Cadell was forced to temporarily close all of his retail bakery and café operations on March 18 of that year. To make the best of a very bad situation, he opened the Los Angeles café the next day as a grocery store so he could keep his workers employed and sell all of the bakery products that he had on hand.

The COVID-19 virus had swept across the United States, but those states on the West Coast were among the earliest to be affected. The first confirmed case of COVID-19 infection in California was reported on January 26, but that set off a chain of events that had a devastating impact on businesses across the state.

At that time, economic advisers predicted the economy in California would probably not reopen until July at the earliest, so Cadell knew he had to make a decision quickly to keep his employees on board. He had already come to realize that he would have to radically re-create his business model if his enterprises were to survive the restrictions of the epidemic. Something had to give. To add to his headaches, within 72 hours after the state-mandated quarantine, all 60 of the company's wholesale customers called to say they were canceling their orders. As a result, Cadell had no choice but to close his bakery locations in both San Francisco and Los Angeles. Since the state government had already mandated that all restaurants had to be closed, he also was unable to serve his retail customers. It was clear that he would have to make major changes if he wanted to keep his ventures alive.

Mr. Holmes Bakehouse had a warehouse in San Francisco and another in Los Angeles that were used as facilities for dough production for the company's wholesale baking program. Each warehouse had over 40,000 square feet of space and a staff of skilled bakers, and the company had a favorable social media presence with more than 121,000 Instagram followers. These were substantial assets, and Cadell would need to turn to them to find a way out of the jam he was in. At the front of his mind were the people who worked for him. Before the pandemic swept through the state, he had 52 employees, and he wanted to keep as many employed as he could.

Cadell decided to do some quick research to see what he could learn that might help him figure out what to do. From his research, he learned that the baking industry had experienced little growth in revenue between 2005 and

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2020, with annual rates of increase ranging from a high of 4.41 percent to a low of –3.91 during this period.

This slow growth in revenues was primarily due to changes in health trends (in particular, gluten-free food choices and low-carbohydrate dieting plans), which resulted in adjustments in consumer tastes and buying preferences. And a handful of entry barriers to the industry tended to keep new competitors out, including the following: Consumers demanding healthy options in bread, such as less sugar, fat, and carbohydrates; declining demand for conventional breads; the increasing price of wheat on global markets; steadily declining per capita consumption of white loaf bread between 2010 and 2020; and acquisitions and mergers in the industry that had resulted in increased market concentration.

Recognizing that many people had changed their eating habits because of the pandemic, the International Food Information Council conducted a survey to identify more precisely the shifts that had occurred. The Council found the following:

Types of Changes	Percentage of Respondents
Adults changing eating or food preparation habits	85
Women reporting eating more than usual	24
Men reporting eating more than usual	17
Parents admitting snacking more	41

The survey also found that when COVID-19 hit and schools had to close, which was around the middle of March 2020, more people began cooking and eating at home. In addition, more people began working from home, so they tended to migrate to the kitchen and spend more time cooking and teaching their children to cook. However, the supply chain for most goods had slowed down during the pandemic, and it was difficult to get some ingredients.

It is important to point out that changes resulting from the pandemic were good for some businesses. For example, companies selling online found that their sales had increased significantly during this period. Consumers were buying everything from office supplies and jigsaw puzzles to dumbbells and hot tubs. At the beginning of the pandemic, people began to hoard paper products because they were in short supply. Shoppers also discovered that many of the staples they normally bought in stores were completely out of stock. Bread was one of the food items that tended to be snatched up as soon as it hit the shelves.

Taking all of this in, Cadell began to process his thoughts about the pandemic and the future of his business. He took note of three things in particular: (1) the inaccessibility of bread in grocery stores, (2) the trend toward cooking at home during the pandemic, and (3) the starter they used in Mr. Holmes Bakehouse bread was regenerative and lasted a long time.

The shift to a grocery store to sell the company's existing bread making supplies had been successful, but Cadell knew it could only be a stopgap measure. He would have to come up with a more developed plan if he wanted to survive the rest of the pandemic and eventually reopen his businesses. But his main concern for the moment was keeping his employees on the payroll.

By the middle of May 2020, he was down to 36 employees who were helping him with the grocery store operation. Many of those who could afford to drop out of the workforce had chosen to stay at home instead. But in Cadell's mind, his employees were like family, and he wanted to keep employing any who wanted to or needed to remain on the payroll.

Cadell had noticed when he opened the grocery store that one of the top sellers was bread starter, which is the mix of flour, water, and yeast that causes bread to rise and gives it its distinct flavor and texture. He had also observed that the other ingredients for breadmaking were difficult to find on store shelves. This led Cadell to the conclusion that offering a bread starter kit would allow people who were shut up in their homes a way to ease their boredom and make their own bread. The kit would include all necessary starter ingredients, along with detailed instructions on how to bake bread.

Mr. Holmes Bakehouse Kits were sold online, a business-to-consumer (B2C) operation that greatly increased the reach of the store. The team was able to leverage their existing assets in this new online venture. With these as a foundation, Cadell put together a website in only 24 hours and was delighted to see orders flowing in almost as soon as it was launched. As a check on operations, the team mailed the first kits to themselves to be certain that they could handle the process. Since no one in the company had experience with e-commerce, they scrambled to find and hire someone with that expertise, which didn't take long. Having trained briefly as an engineering student in college before going into business, Cadell had always found it natural to bring an efficiency mindset to his ventures. Leaning on this background, the team was able to increase their efficiency at packing goods for shipment by around 70 percent in a short time. Everything seemed to be coming together.

To make a long story short, the formula the team had dreamed up worked! Offering starter kits for $25 each, Mr. Holmes Bakehouse had orders to ship kits to 47 states in the first 10 days. The transition from a physical operation to an online operator had been achieved, and in a very short period of time. But as Cadell took time to

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contemplate all that he and his team had accomplished, a nagging question kept coming back to his mind. “We weathered the storm for now,” he reflected, “but will we be able to hold on long enough to survive the pandemic?” Time would surely tell.

Questions

1. Looking forward, do you think Mr. Holmes Bakehouse would have as much potential if Aaron Cadell were to continue operating the business as an e-commerce venture as it did when the company only did business through the physical facilities that it had before the pandemic?
2. In a post-pandemic scenario, do you think it would be best for Cadell to operate his business through both physical facilities and online? Or should he choose to stay with only one mode or the other? If he should choose just one mode, which option would you recommend?
3. What recommendations would you have for Cadell if he should opt to continue operating the new online side of his business? Do you think he should try to reposition the business in some way? For example, do you think he should sell different products, target different markets, or make some other adjustments?
4. Aaron Cadell launched his business initially in the two largest cities in California, San Francisco and Los Angeles. Consider the five key factors that are presented as important to selecting a good location for a business with physical facilities (refer to Exhibit 9.1 for a summary of these). In light of these factors, do you think Cadell’s initial location decisions were wise? Rate these locations on a scale of 1 to 10 (with 10 being highly favorable and 1 being highly unfavorable) across each of the five key factors. How did Cadell’s locations stack up? What did you use as your point of comparison?
5. Cadell’s business came under extreme pressure when the pandemic hit in 2020, forcing him to close down his physical facilities and transition to online-only operations. As you think about his situation, what would you say are the odds that his online business will survive these current conditions and continue operating in the future?

Sources: US Industry (NAICS) Report, April 2020, “Bread Production in the US,” https://my-ibisworld-com.ezproxy.baylor.edu/us/en/industry/31181/industry-performance, accessed May 16, 2022; International Food Information Council Foundation, 2020 Food and Health Survey, https://foodinsight.org/2020-food-and-health-survey, accessed May 16, 2022; Telephone interview with Aaron Cadell.

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Guinn Associates

Understanding a Firm's Financial Statements

Case 10

After completing college in 1989. Donna Guinn started her career in public accounting in Dallas, TX. Six years later, she decided not to continue in accounting and returned to college for an MBA. Following the MBA, she accepted a position with a private equity firm in Dallas, where she eventually became the chief financial officer. She enjoyed her work for 17 years, making investments in a variety of companies. But at a point, she decided that she wanted to be the entrepreneur at the table, seeking financing from investors for her own business.

In 2012, Donna started Texas Rehab, Inc., primarily selling what she called "complex rehab chairs" for handicapped individuals, mostly young people. Shortly thereafter, she adapted her business model to capture a second revenue stream by selling supplies to her wheelchair clients. But two years later, she sold the business to a national firm in the industry. Her decision to sell her company came out of her seeing what she believed was a greater opportunity in the medial supply industry.

In 2014, Donna, along with her two daughters, Krista and Kate, founded Guinn Associates. Based on her prior experience in the medical supply industry, Donna believed there was a significant unmet need to provide nutritional needs to patients that can only be met through feeding pumps. She also knew that once a patient became a customer, it would typically be for life, at least as long as the business was providing quality service.

It is now 2021 and the firm's sales are approaching $10 million. The company has diversified into a number of profitable markets, such as breast pumps. But while the firm has experienced significant growth, Donna has asked Krista and Kate to prepare an evaluation of the firm's overall financial performance during the last two years. She has specifically asked the following questions:

1. Compared to other similar businesses, how is Guinn Associates doing in terms of: (1) the company's liquidity, (2) the profitability on its assets invested, (3) the use of debt in the business, and (4) the return on the owners' equity?
2. What information can be learned from the firm's most recent statement of cash flows?
3. What recommendations would they make to Donna from their findings?

To begin, the daughters contacted their industry association and have been provided averages of a number of financial ratios for the firms in their industry. From that list, they selected the following data they thought would address their questions, these being:

Financial Ratios	Industry
Current ratio	2.20
Return on assets	14.6%
Gross profit margin	39.0%
Operating profit margin	7.3%
Total asset turnover	2.00
Debt ratio	40.0%
Return on common equity	13.0%

You are asked to provide your own answers to the questions, given the financial data below.

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Guinn Associates

Balance Sheets for Years Ending 2020 and 2021

				Percentage of Total Assets	
Assets	**2020**	**2021**	**Change**	**2020**	**2021**
Current assets:					
Cash	$ 15,500	$ 76,885	$ 61,385	0.4%	1.5%
Accounts receivable	1,236,590	1,310,120	73,530	28.9%	25.5%
Inventory	1,288,428	1,456,729	168,301	30.1%	28.3%
Prepaid expenses and deposits	42,935	44,640	1,705	1.0%	0.9%
Other current assets	32,705	52,000	19,295	0.8%	1.0%
Total current assets	$ 2,616,158	$ 2,940,374	$ 324,216	61.1%	57.2%
Fixed assets:					
Gross fixed assets	$ 3,007,560	$ 3,674,100	$ 666,540	70.2%	71.4%
Accumulated depreciation	(1,350,650)	(1,488,180)	(137,530)	–31.5%	–28.9%
Net fixed assets	$ 1,656,910	$ 2,185,920	529,010	38.7%	42.5%
Other assets	10,279	17,707	7,428	0.2%	0.3%
TOTAL ASSETS	$ 4,283,347	$ 5,144,001	$ 860,654	100.0%	100.0%
Debt (Liabilities) and Equity					
Current liabilities:					
Notes payable to bank	$ 500,756	$533,000	$ 32,244	11.7%	10.4%
Accounts payable	572,110	724,159	$ 152,049	13.4%	14.1%
Accrued expenses	285,355	274,040	($11,315)	6.7%	5.3%
Total current liabilities	$ 1,358,221	$ 1,531,199	$ 172,978	31.7%	29.8%
Long-term debt	$ 1,255,004	$ 1,565,000	$ 309,996	29.3%	30.4%
Total debt	$ 2,613,225	$ 3,096,199	$ 482,974	61.0%	60.2%
Stockholders' equity:					
Common stock	$ 325,000	$325,000	$0	7.6%	6.3%
Retained earnings	1,345,122	1,722,802	377,680	31.4%	33.5%
Total stockholders' equity	$ 1,670,122	$ 2,047,802	377,680	39.0%	39.8%
TOTAL DEBT AND EQUITY	$ 4,283,347	$ 5,144,001	$ 860,654	100.0%	100.0%

Income Statements for Years Ending 2020 and 2021

			Percentage of Sales	
	2020	**2021**	**2020**	**2021**
Net sales	$ 8,632,554	$ 9,547,600	100.0%	100.0%
Cost of goods sold	(5,464,112)	(5,919,512)	–63.0%	–62.0%
Gross profits	$ 3,168,442	$ 3,628,088	36.7%	38.0%
Operating expenses:				
Selling and general & admin expenses	$ (2,483,993)	$ (2,625,870)		
Depreciation expense	(98,000)	(137,530)		
Total operating expenses	$ (2,581,993)	$ (2,763,400)	–29.9%	-28.9%
Operating profits	$586,449	$ 864,688	6.8%	9.1%
Interest expense	(64,817)	(67,420)	–0.8%	–0.7%

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Guinn Associates (continued)

Interest income	1,600	1,450	0.0%	0.0%	
Profits before tax	$ 523,232	$ 798,718	6.1%	8.4%	
Income taxes	(261,509)	(221,038)	−3.0%	−2.3%	
Net profits	$ 261,723	$ 577,680	3.0%	6.1%	
Statement of Retained Earnings For Years Ending 2020 and 2021					
	2020	**2021**			
Beginning retained earnings	$ 1,210,399	$ 1,345,122			
Net profits	261,723	577,680			
Dividends	(127,000)	(200,000)			
Ending retained earnings	$ 1,345,122	$ 1,722,802			
Statement of Cash Flows for 2021					
Cash flows from operations:					
Net profits		$ 577,680			
Depreciation expense		137,530			
Profits before depreciation		$ 715,210			
Increase in accounts receivable		(73,530)			
Payments for inventories:					
Increase in inventories	$ (168,301)				
Increase in accounts payable	152,049				
Net cash payments for inventories		$ (16,252)			
Increase in prepaid expenses		(1,705)			
Increase in other current assets		(19,295)			
Decrease in accrued expenses		(11,315)			
Cash flow from operations		$ 593,113			
Cash flows from investing activities:					
Increase in gross fixed assets	($666,540)				
Increase in other assets	(7,428)				
Cash flows from investing activities		($673,968)			
Cash flows from financing activities					
Increase in notes payable	$ 32,244				
Increase in long-term debt	309,996				
Issued common stock	0				
Cash dividends paid	(200,000)				
Cash flows from financing activities		$ 142,240			
Net change in cash		$ 61,385			
Beginning cash		15,500			
Ending cash		$ 76,885			

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Case
11

Ashley Palmer Clothing, Inc.

Financial Forecasting

Ashley Palmer Clothing, Inc., produces dresses for women. The firm was launched in June 2015 by Ashley Jantz and Amanda Palmer, both graduates of Boston College. Ashley Palmer designs apparel for the modern woman's shape rather than using the traditional standard sizing.

History of Sizing Clothing

In 1939, the National Bureau of Home Economics of the U.S. Department of Agriculture was charged with standardizing sizing for women's clothing. Over a two-year period, some 15,000 women were given full-body measurements. This system created the sizing system that is still in use today.

Studies have found that the average body proportions of American women when the sizing charts were created are different from the body proportions of today's women. Specifically, American women in 1939 were markedly more slender and shorter. The result is that it is difficult for some women to find clothing that fits well. In the September 2015 issue of *Fashionista Magazine*, Jantz, who stands six feet tall, said,

> *We were tired of not finding the clothes that were the right fit so we decided it would be a good venture to create products for today's women based on bust measurement, cup size and torso length.*

The Opportunity

For Jantz and Palmer, this problem represented an opportunity. After considerable research, they decided to start a business that produced fitted clothing for today's young women. They recruited a young up-and-coming fashion designer, Joy Lee, who had experience in apparel design for several major women's clothing brands. Seven months after starting the business, they offered their first dresses for sale online.

Then, in early 2010, the firm began supplying clothes both to Neiman Marcus and to Saks Fifth Avenue. Within a year after becoming a supplier to these exclusive retail outlets, the company's production orders had more than doubled. In order to keep up, the firm added five more team members in October 2010.

Sales continued to increase over the next three years, reaching $4.7 million in 2019. During this same time, the number of employees grew from 7 to 16. The company also moved into a 4,000-square-foot facility and added additional sewing equipment and presses.

Planning for Growth

In August 2019, Ashley Palmer ventured into creating professional attire for young women. The products received rave reviews. Within three months, the retail outlets had sold over 90 percent of their inventories, quickly placing orders for more products.

The founders, while excited about the prospect of sales growth, began to worry. Based on their estimates, the company would most probably experience a 50 percent growth rate, compared to the 25 percent they had experienced over the past two years. They knew that if they wished to avoid cash flow problems from the anticipated growth, they needed to anticipate the asset requirements and additional financing that would be required to sustain their business.

The owners believed they would need to purchase state-of-the-art industrial sewing machines, cutting tables, and pressing machines at a cost of $280,000. The new equipment would be depreciated over 14 years, using straight-line depreciation. Jantz also thought that the following assumptions were appropriate:

1. Cash, accounts receivable, and inventory would follow their same relationships to sales as in the past two years; that is, each asset would maintain the average asset-to-sales percentages experienced in 2018 and 2019.
2. Both cost of goods sold and marketing expenses are variable and would approximate the average percentage of sales as in 2018 and 2019.
3. General and administrative costs are fixed in nature but should increase to $130,000 in the next year.
4. The interest rates on the already outstanding debt would be renegotiated, which would reduce the interest on this debt to $45,000.
5. The firm's tax rate should be about 40 percent.

To meet the firm's financing needs, Palmer has negotiated a line of credit with Amway Bank for up to $100,000. The bank has also agreed to lend the firm $150,000 for

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purchasing new equipment; this is to be repaid over five years. The principal is to be repaid in $30,000 annual payments, with interest payments being made on the remaining balance of the note. Both notes will carry a 5 percent interest rate. The short-term notes payable and long-term debt owed in 2013 will be reduced by $50,000 and $30,000, respectively. Accounts payable and other current liabilities should increase proportionally with sales increases.

Finally, if additional money is needed, Jantz and Palmer are willing to provide more of their own money in the form of equity. They will also lower the amount of dividends they have been paying themselves (about 40 percent of earnings over the past two years). They both have decided to limit their dividends individually to $15,000, or a total of $30,000.

Ashley Palmer Clothing, Inc.
Income Statements for the Years Ending December 31, 2017, 2018, and 2019

	2017		2018		2019	
Sales	$ 3,000,000	100.0%	$ 3,760,000	100.0%	$ 4,700,000	100.0%
Cost of goods sold	(2,400,000)	80.0%	(3,045,600)	81.0%	(3,877,500)	82.5%
Gross profits	$ 600,000	20.0%	$ 714,400	19.0%	$ 822,500	17.5%
Marketing expenses	(215,000)	7.2%	(250,000)	6.6%	(275,000)	5.9%
General & administrative expenses	(90,000)	3.0%	(100,000)	2.7%	(110,000)	2.3%
Depreciation expense	(25,000)	0.8%	(25,000)	0.7%	(25,000)	0.5%
Operating profits	$ 270,000	9.0%	$ 339,400	9.0%	$ 412,500	8.8%
Interest expense	(66,000)	2.2%	(66,000)	1.8%	(66,000)	1.4%
Profits before taxes	$ 204,000	6.8%	$ 273,400	7.3%	$ 346,500	7.4%
Taxes @ 40%	(81,600)	2.7%	(109,360)	2.9%	(138,600)	2.9%
Net profits	$ 122,400	4.1%	$ 164,040	4.4%	$ 207,900	4.4%
Dividends paid	$ (48,960)		$ (65,616)		$ (83,160)	
Addition to retained earnings	$73,440		$98,424		$ 124,740	

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Ashley Palmer Clothing, Inc.
Balance Sheets for the Years Ending December 31, 2017, 2018, and 2019

Assets	**2017**	**2018**	**2019**
Cash	$ 48,000	$ 95,424	$ 60,000
Accounts receivable	150,000	175,000	246,816
Inventory	335,000	390,000	511,500
Total current assets	$ 533,000	$ 660,424	$ 818,316
Plant & equipment	560,000	560,000	560,000
Accumulated depreciation	(125,000)	(150,000)	(175,000)
Net plant & equipment	$ 435,000	$ 410,000	$ 385,000
TOTAL ASSETS	$ 968,000	$ 1,070,424	$ 1,203,316
Debt (Liabilities) and Equity			
Accounts payable	$ 128,000	$ 153,000	$ 135,000
Short-term notes payable	250,000	275,000	275,000
Other current liabilities	46,000	50,000	51,152
Total current liabilities	$ 424,000	$ 478,000	$ 461,152
Long-term debt	300,000	250,000	275,000
Total debt	$ 724,000	$ 728,000	$ 736,152
Owner's capital	155,560	155,560	155,560
Retained earnings	88,440	186,864	311,604
Total equity	$ 244,000	$ 342,424	$ 467,164
TOTAL DEBT AND EQUITY	$ 968,000	$ 1,070,424	$ 1,203,316

Questions

1. Given the assumptions that Jantz and Palmer have made, prepare a pro forma income statement and balance sheet for 2020. Assume that the line of credit provided by the bank will be needed for the full year.
2. Using the financial ratios presented in Chapter 10, compare Ashley Palmer's ratios over time, including the pro forma ratios for 2020. If the bank requires a current ratio of at least 1.5 and a debt ratio not to exceed 55 percent, can the owners expect to be able to honor these covenants?
3. Prepare a statement of cash flows for 2019 and the 2020 projections. What did you learn from these statements?

Source: Thomas Totoe, April 2019.

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Rose Properties, LLC

Negotiating a Bank Loan: Understanding the Banker's and Entrepreneur's Mindset?

Case 12

John T. Rose has been a small real estate developer in the Nashville area for the past six years. He both builds commercial properties and purchases existing buildings that he believes can be redesigned to attract new renters.

Rose is in the process of purchasing an existing building for $750,000, currently leased by a franchisee of Mr. Transmission. The franchisee occupies about two-thirds of the rentable space in the building. Rose believes the remaining space could be remodeled and leased to similar businesses to Mr. Transmission.

Rose is prepared to finance $250,000 of the purchase price with equity, but would need $500,000 in bank financing. Thus, he has submitted a loan request to US Bank, where he has banked for the past 12 years. His request is shown in Exhibit C12.1.

Exhibit C12.1 Rose Loan Request

January 31, 2021

Mike Jones
US Bank
2 West Jackson Street
Nashville, TN 38501

Re: Loan Proposal

Dear Mike,

We are taking loan proposals to finance an existing facility located at 758 South Willow Avenue in Nashville. The building and property has been appraised for $850,000. The building has been leased to a franchised Mr. Transmission tenant, who has been in business for over five years. During this time, the facility has had an annual lease income net of all operating expenses of approximately $92,000. We are seeking the following terms for our financing:

Loan amount	$500,000
Interest rate	3.85% Fixed rate
Note term	20 years
Coverage ratio	1.2
Loan to value	60%
No points	
No prepayment penalty	
No personal indemnity	

My wife and I will sign for the note. Thank you for your consideration of our request.

Sincerely,

John T. Rose
CEO
Rose Properties, LLC

The bank subsequently responded to his request, sending the basic terms that would be required by the bank to make the loan. The bank's terms are shown in Exhibit C12.2.

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Exhibit C12.2 US Bank Response to Rose Loan Request

US BANK
CONFIDENTIAL
Proposal Letter

February 13, 2021

John T. Rose
Rose Properties, LLC
1843 Foreman Drive
Nashville, TN 37203

Dear John,

US Bank is pleased to provide the following terms for financing the purchase of the facility located at 758 South Willow Avenue here in Nashville.

The contents of this proposal are CONFIDENTIAL and shall not be disclosed to any third party (other than legal counsel representing Client and Bank) without prior written consent of Bank.

Upon receipt of your acceptance of this proposal, US Bank will seek full board approval.

TERMS:	
CLIENT:	Rose Properties, LLC
GUARANTORS:	100% guaranteed by John T. Rose and Sandra Rose. Joint and Several
AMOUNT OF LOAN:	\$500,000
PURPOSE:	Commercial
COLLATERAL:	1st deed of trust, assignments of rents and leases and certain UCC-1 filings held in the names of Rose Properties, LLC located at 851 S Willow Ave, Nashville, TN, on attached schedule
ORIGINATION FEE:	\$5,000 (to be included in loan)
REPAYMENT TERMS:	120 monthly payments of principal and interest with balance due at maturity based on 25-year amortization.
MATURITY:	The loan will mature 120 months from the closing date.
INTEREST RATE:	4.25% fixed for 84 months After 84 months, interest rate will be based on the 30-day LIBOR rate, as published in the *Wall Street Journal,* plus 350 basis points or 3.5% with a minimum floor rate of 4.25%.
OTHER:	Loan-to-Value (LTV) covenant is 75% Annual Debt Service Coverage Ratio (DSCR) 1.20:1.0
CLOSING COSTS:	Client agrees to pay all costs associated with this transaction, even in the event the loan does not close.
EARLY EXIT FEE:	• 3% of the principal balance for months 1–12 • 2% of the principal balance for months 13–24 • 1% of the principal balance for months 25–60 • Fee does not apply if principal balance is reduced with subject collateral sale proceeds.
DEPOSIT ACCOUNTS:	Client will maintain their primary operating accounts with US Bank.
PRE-CLOSING CONDITIONS:	Prior to closing, the Bank will need: • Appraisals (prior appraisals used in evaluation are to be acceptable to Bank) • Title insurance

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US Bank is pleased to be of service to you. If you have any questions or need clarification of any of the above, please call me at (615) 528-1122.

Respectfully yours,

US BANK
Mike Jones
VP Retail

The undersigned hereby accepts the foregoing commitment and the terms and the requirements therein set forth, and agree to be bound thereby the ____ day of ________, 2021.

Date______________

John T. Rose

Questions

This case is based on an actual loan request, where only the names and dates have been changed.

The purpose of the case is to help you get into the heads of entrepreneurs and bankers when they come into the process of negotiating a loan. You will need to go beyond what is presented in Chapter 12 regarding the terms explained in negotiating a bank loan. But you will be challenged to learn the process all the better. So, consider the following questions:

1. Who benefits, directly and indirectly, when bank loans are made?
2. What are the different types of loans a borrower can acquire from a bank, and what is the purpose for each type? What kind of loan is Rose requesting?
3. When negotiating a loan, what is important to the borrower? To the banker?
4. Briefly describe each of the bank's loan covenants and why the bank is including them.
5. Which terms do you think would bother Rose the most?
6. Why might the bank be willing to negotiate on the terms it is suggesting?

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Case 13

Medlink Inc.

Finishing Strong: When Is the Right Time to Exit?

At the end of 2018, Bill Nelson, CEO of Medlink, Inc., a medical IT consulting firm, was thinking about selling the firm. But, he was also determined to find an acquirer who would pay his "non-negotiable" sales price of $50 million. Having been in the industry for most of his career, Nelson knew which companies would be the most likely candidates to acquire the business. He eventually decided that IBM most likely would be the only company that could and would meet his terms.

When he approached IBM about a possible acquisition, IBM responded that the company might have an interest, but Nelson would need to continue as CEO for Medlink for at least three years after the merger.

Brief History

Resource Management Group (RMG) was founded in 2006 with $250,000 in capital, followed by another raise of $500,000 a year later. Within a few years, the company was cash-flow positive in terms of operating profits and by using a line of credit from its bank. But that ended in 2014 when RMG acquired another firm in the health care IT space, Medlink.

The acquisition was a noncash transaction (stock swap). The purpose of the merger was to achieve company growth by expanding service lines (add implementation capability) and geographic penetration into the southeastern and southern United States.

After the two companies merged, Nelson owned 30 percent of the combined business, along with two other early investors (a business angel and a venture fund investor) owning a combined 20 percent of the new stock. The remaining 50 percent was owned by RMG investors.

The emerging company retained the name "Medlink" and by 2018 had revenues of $20 million, with an expected growth trajectory of 300 percent over the ensuing five years from 2019 to 2024. By combining the two firms, Medlink would gain substantial market share in the United States. The combination would also allow the business to move into the federal health care IT space, and possibly even into global markets.

The federal strategy was based on new subcontract relationships Nelson had developed with new federal contractors. The global focus would begin in England, where a new federal initiative was underway to develop new automation in managing the country's medical records, and then use that base to leapfrog into Europe. They also saw some new opportunities in Malaysia and Australia.

Why Sell?

So, given Medlink's potential opportunities going forward, we have to wonder why Nelson was interested in selling. Nelson gave several reasons for selling:

1. IBM was willing to pay his asking price of $50 million, but did require him to continue as CEO for at least three more years, albeit as an IBM employee.
2. He needed to cash out the business angel who had remained with Medlink for 12 years, as well as the venture firm whose own investment fund had run its course. (Venture capital funds terminate at the end of 10 years.)
3. Nelson believed that sales for the next year (2019) could grow by 80 percent rate, but would most likely decline significantly in the coming years.

The Acquisition Process: Making It Happen

The process of finalizing a company sale is sometimes long and hard, as briefly described below for Medlink.

In December 2018, Medlink's CFO, Roger Houston, met with IBM to explore how serious IBM was about acquiring Medlink.

In preparing for the meeting, Medlink put together a small team of six to eight people to oversee the process. A detailed 44-page due diligence list was provided by IBM to prepare for their review. Medlink filled 50 or more large notebooks with copied materials and prepared several detailed presentations. On January 31, 2019, they met for a week in Charlotte, NC, with IBM's due diligence team consisting of at least 25 people. Between January and April 2019, the parties worked intensely on terms and conditions.

Questions

1. Before RMG acquired Medlink, the firm was cash-flow positive. Why do you think that changed with the acquisition of Medlink?

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2. Do you think Nelson should sell Medlink? Why or why not?
3. When selling a business, agreeing on a price for the company by both buyer and seller is of course a significant issue. You do not have the information to know if Nelson's asking price of $50 million is a "fair price." But assume for our purposes that IBM has accepted Nelson's asking price. What other terms would you recommend that Nelson request in negotiating the sale? Explain.
4. Based on your reading of "Developing an Effective Harvest Plan" presented in Chapter 13, what would you want to ask Nelson about his approach to selling the business?
5. What is the risk from going through such an arduous process for entrepreneurs and their firms, as was the case for Medlink?
6. What advice would you give Mr. Nelson?

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Case
14

Numi Organic Tea

Building a Business by Focusing on Customers

Numi Organic Tea was started in 1999 by brother and sister team Ahmed and Reem Rahim, who have formed the venture around a clear sense of identify and an emphasis on relationships. Every member of the Tea'm, as they call it, is committed to the company's core values of sustainability, creativity, and quality organics. This extends to their corporate customers and their producers, as well. And like their teas, every relationship is carefully cultivated and maintained.

In recent years, demand for organic and ethically produced products has exploded. At the same time, economic influences have driven affluent and natural foods consumers to large discounters, grocery chains, warehouse clubs, and online shops. Numi has had to take these trends into account to ensure the long-term success of its business. "In the positioning of our brand, we wanted to target a certain type of customer base, from natural health food stores to fine dining and hotels to universities and coffee shops," says Ahmed, Numi's co-founder, previous CEO, and current chief visionary officer. "But what I've been most surprised about in our growth is the mass market consumer." In an effort to make necessary adjustments while emphasizing that it would remain true to its core identity, Numi Organic Tea converted to a certified B Corporation in 2016. This provided a clear signal that the firm would continue to adhere to an unwavering sense of purpose—that is, to creating benefits for shareholders, employees, their communities, and the environment.

From research conducted by the company, Numi was surprised to learn that its most typical consumer was older, college-educated, female, bought two to three boxes of tea per month (usually green tea), and had a strong preference for organic products. Up to that time, Numi had assumed its customers fit the same profile as its young staff, but that turned out not to be the case. This meant that significant adjustments would be needed. The findings indicated that the company would be better served by focusing greater energy on reaching older customers and moms, while holding on to the younger college market that had been its primary target.

To reach younger consumers, Numi took planned measures to boost product awareness on college campuses, where interest in issues of sustainability, fair trade, and organics tends to run very high. However, the big hurdle to reaching these potential customers was the expense involved. Numi teas are a premium product and therefore have a higher price point than conventionally produced teas. Because college students have limited financial resources, Numi figured out that it could access these customers best by getting university food service departments to serve tea as part of prepaid meal plans. The strategy was a success. Not only did these food service contracts represent huge accounts for Numi, but they also encouraged students to give the product a try. When it came to attracting new users, sampling was Numi's most successful marketing activity, and this strategy allowed students to give Numi teas a try, essentially for free.

For many buyers of organics, the most compelling reason for drinking Numi Tea was its health benefits. But Numi Organic Tea's appeal to this group was even stronger for unrelated reasons—namely, the fact that it is a privately owned, triple-bottom-line social enterprise that is committed to educating consumers about the company's products and sustainable practices. In support of this broader mission, the company's in-house PR team worked with editors of women's magazines to make consumers aware of the health benefits of tea. The team also organized tea-samplings at Whole Foods stores and at events targeted to environmentally conscious customers. The website provides an in-depth look at the company's most emphasized priorities, including its climate action plan, fair trade certification emphasis, development of compostable packaging, and the Numi Foundation's initiatives that support COVID-19 food relief and clean water projects in the United States and around the world.

Numi has benefited from being the tea of choice in many high-end restaurants, hotel chains, and cruise lines. In fact, sales to the food service industry made up about 40 percent of its business. But this premium reputation came with greater pressure to deliver on price, quality, and customer service. While the company was already a recognized product-quality leader, it is difficult for any small business to compete with giant food service companies when it comes to price.

An important feature of Numi Organic Tea is its story. To tell that story, the management team forged very hands-on, personal relationships with restaurant food and beverage managers, which gave them a natural competitive advantage. A regular teabag may be cheaper, but there's not much else to say about it. Numi promoters have been able to conduct private cuppings (tea tastings) for kitchen staffs and talk about all the different exotic teas

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it has to offer, as well as commenting on the farms and farmers all over the world that have been involved in growing the tea and the company's unwavering commitment to sustainability. This multifaceted message makes for a very compelling pitch. Because turnover has always been notoriously high in the food service industry, there has always been the risk that a new chef or buyer would choose a different tea supplier. Fortunately for Numi, this usually was not the way circumstances would unfold. Due in part to excellent customer relationships, it was more common for the company to keep the old client *and* follow the chef or buyer to their new restaurant.

Numi's success in the food service industry has been a primary driver of its retail business. While the company reports countless testimonials of customers who experienced Numi tea for the first time at a friend's house, a surprising number of Numi converts were initially introduced to the product while dining at a restaurant. As requests from consumers wanting to know where to get Numi in their local area rolled in, the company expanded its efforts to reach retail customers. Once available only at natural food stores and cafes, some large grocery store chains and a number of warehouse clubs have since started to carry Numi products. This certainly is convenient for users, but it poses a potential threat to the Rahims' carefully maintained relationships with fine-dining customers. So far, offering the products through these parallel and very different channels has not been a problem. But if it becomes widely recognized that the same premium tea served at high-end restaurants is also available at the local Target, for example, the brand image of the company and its products could be jeopardized.

In January 2022, shared-workspace provider WeWork announced a partnership with Numi Organic Tea. Under this agreement, the company stocked its products in more than 1,000 WeWork pantries in Canada and the United States. It offers its six top-selling teas in these locations. In addition to these promotional efforts, Numi has become an official sponsor of Earth Day. This is consistent with the company's decision to promote Climate Neutral Certification and to work with partners to fight climate change and reduce plastic waste. As one example of these efforts, Numi announced its new Carbon Footprint Label in March of 2022, which reports a breakdown of its emissions as these relate to four facets of the firm's operations: ingredients, preparation, packaging, and transport. The goal of this initiative has been to make it easy for consumers to understand the environmental impact resulting from their tea purchases. "Consumers are looking for a way to take actions against climate change, and we want to empower them with the information they need to do that," says Reem Hassani, chief brand officer and co-founder of Numi.

Plenty of challenges lie ahead for Numi Organic Tea. For example, as the company continues to expand its business around the globe, one of the greatest tests to Numi's marketing model will be to see if it can hold on to the "family feel" it has established in the minds of consumers. The company has taken several measures to maintain this impression. For one, the marketing team has customized email communications to newsletter subscribers to inform them about local events. These connections have been further promoted through Facebook, Twitter, Pinterest, Instagram, and LinkedIn. The sites are monitored by a staffer to address any questions or concerns about Numi products. Most importantly, no matter how busy they may get, founders Ahmed and Reem have always done what they can to provide a special touch through their art, personal stories, and related experiences. While the marketing and PR teams promote the company's tea products—through in-store sampling, planned environmental events, arranged partnerships with like-minded companies, and other actions—they have always kept a close eye on the demographic and psychographic profiles of their customers so they could use these insights to build even closer relationships with them. Numi Organic Tea believes this will be the key to their current and future success.

Questions

1. Spend a few minutes on Numi Organic Tea's website (www.numitea.com). Based on what you have read in the case and learned from looking at the company website, what is the message that you believe Numi is attempting to convey? What do you find on the home page that leads you to your conclusions?
2. Looking at the colors, images, and style of its website, who do you conclude to be the firm's target customer? Does this match the conclusions from the research Numi has conducted (mentioned in the case)? Explain your reasoning.
3. Compare the feel of the website to that of the company's presence on social media. Which platform do you think is best for collecting customer information, and why? Which one seems to connect best with Numi's target market? Be sure to explain why you think this is true.

Sources: *BOONE/KURTZ, Contemporary Marketing, 15e.* 2012 (Updated 2022), Cengage Learning; Alissa Marripodi, "Numi Organic Tea Creates Carbon Footprint Label for Its Tea Boxes," Nutritional Outlook, April 4, 2022, https://www.nutritionaloutlook.com/view/numi-organic-tea-creates-carbon-footprint-label-for-its-tea-boxes, accessed May 5, 2022; Numi Organic Tea, "Numi: Activating Purpose," https://numitea.com/about-us, accessed May 5, 2022; Ahmed Rahim, LinkedIn, https://www.linkedin.com/in/ahmed-rahim-6938773, accessed on May 5, 2022; WeWork Inc., "Numi Organic Tea Selected as Exclusive Tea Partner of WeWork," Seeking Alpha, January 11, 2022, https://seekingalpha.com/pr/18626212-numi-organic-tea-selected-exclusive-tea-partner-of-wework, accessed May 5, 2022.

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Case 15

Cocofloss

Cocofloss was founded in 2015 by two sisters with the purpose of encouraging flossing and to make it more fun. Chrystle Cu, a dentist, enlisted the help of her sister, Catherine Cu, to design and create a product that would generate some excitement around the practice of flossing.

As a dentist, Chrystle constantly witnessed the adverse consequences of poor dental hygiene. Countless patients were forced to undergo preventable dental procedures, like fillings and restorations, while others faced more invasive and painful treatments, including root canals and even tooth extractions—all because they failed to floss on a regular basis. Dr. Cu struggled to understand how her Californian patients could be so dedicated to health and wellness and not carry that attitude over to their teeth. So, she and her sister conducted a study to better understand habits and feelings surrounding flossing. They carried this out through what they called a 21-Day Flossing Challenge, which they completed with their friends. From this exercise the sisters came to two important conclusions: flossing is boring, and people can't see or feel any immediate results afterward.

This research complemented what Dr. Cu had found through her work in the dental field. She discovered that most flossing options available on the market were typically made of nylon or Teflon, and neither of these materials were that effective for flossing. She also learned that most people never stopped to consider what their floss was made of; instead, they considered it a mundane and unnecessary accessory that served mostly to add to the clutter in their bathroom drawer.

Dr. Cu concluded that the design of the floss could address both the issues identified in her clinical research and in the 21-Day Flossing Challenge. With the help of her sister, Dr. Cu developed a prototype with materials that would not only do a better job at removing plaque, but also featured interesting tastes and smells. Cocofloss is made with specially woven, expanding filaments that can reach much tighter spaces and remove much more plaque than traditional floss. Cocofloss is also manufactured in a brilliant blue, allowing for customers to easily and immediately see the effects of their work, with the successfully removed plaque contrasting against the bright string.

The Cu sisters finalized their new product in 2014 and sent samples to hundreds of friends and family members in an attempt to test for quality before their official launch. By encouraging those who received the samples to participate in their 21-Day Flossing Challenge, the two were able to test their hypothesis that this product's effectiveness and intentional fun-factor could get people to commit to flossing daily.

One of the primary goals of the company was to keep the brand from feeling too clinical or dull. To accomplish this, the company projects a casual, fun brand image with intentional language accompanied by whimsical product packaging. The variety of floss scents, including mint, coconut, orange, and strawberry, align with their associated bright, tropically themed packaging. The sisters hoped that the creative flavor options would not only increase how often people floss, but also make flossing a more enjoyable experience overall. The sisters see their product as similar in some ways to an exfoliating face wash: a satisfying self-care practice that people look forward to.

After their initial friends and family quality test, Cocofloss was promoted to dental offices, hoping that it would spark interest with dental practitioners and patients. This proved to be an effective strategy, and the brand developed some of its biggest advocates and brand ambassadors. Today, dentists remain a primary source of the company's positive reviews on many social media platforms, and thus have come to be an important part of the company's overall marketing efforts.

After developing this direct-to-dentist model, the company then extended its reach to wellness influencers to grow via word-of-mouth. In the latter half of 2016, the company developed relationships with popular stores not previously known for selling oral care items, including Urban Outfitters, Goop, Anthropologie, Sephora, Free People, and others. Between 2016 and 2017 alone, Cocofloss went from being available in 10 stores to more than 100, and the company has only continued to grow. "From the day we started the company," recalls Catherine Cu, "we were thinking about this idea of getting people excited about floss." Customer response has definitely matched, if not exceeded, the founders' enthusiasm. Some even now claim that because of Cocofloss, flossing is now a fun activity that they look forward to each night. It could be said that the product has become far more than just a hygiene tool; it's also a "stylish" dental product that may even be suitable for gifting.

Another factor that sets their product apart from those of competitors is its pricing. Cocofloss is almost double the

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price of all other flosses on the market. Although many contend that this price point could drive down the brand's chances for success, the sisters believe it galvanizes their unique brand image by helping buyers to recognize that they're paying for something that's extraordinary. In the end, though, the Cu sisters' emphasis on innovation, careful product development, and intentional brand planning will help them reach their main goal for the company: to help people to have stronger teeth and achieve better overall health.

Questions

1. It is reasonable to say that the Cu sisters were thinking innovatively when they created Cocofloss. It certainly is different from other floss products on the market. Chapter 15 offers a few "rules of thumb" that help to reduce the risk of failure when trying to gain a competitive advantage over rivals through innovation. (Details can be found in the "Gaining a Competitive Advantage" section in the chapter.) Based on the "rules of thumb" presented, assess the approach the Cu sisters have taken in coming up with their innovative product. Then, rate their start-up's odds of long-term competitive success on a scale of 1 (extremely low odds) to 10 (extremely high odds). Be sure to explain your reasoning for the assessment you assign.
2. Using the information found in the case, conduct your own business analysis of Cocofloss. (Refer to the "Business Analysis" section in the chapter for a list and brief explanation of the four factors that are typically considered for this kind of analysis.) How does the company hold up under such an analysis?
3. The founders of Cocofloss sent hundreds of samples to family and friends to test their product. What were they hoping to learn from this? Do you think they missed opportunities to learn about other important facets of the product and market reactions to it? Do you think the quality of the product was adequately tested? What potential problems could emerge later if the quality of the product proves to be inadequate?
4. What do you think of the branding strategy at Cocofloss? Consider the information in the case as well as what you can find on the company website (www.cocofloss.com) as you size up the Cu sisters' approach. What grade would you assign (from A+ to failing) to these efforts? Explain why you are assigning the grade you are giving the company.

Sources: "Cocofloss: Our Story," https://cocofloss.com/pages/our-story, accessed May 6, 2022; Cocofloss: Blog, https://cocofloss.com/blogs/cocofloss-life/founder-spotlight-cat-cu-talks-family-friends-and-food, accessed May 6, 2022; Lesa Hannah, "The Two Sisters Who Are Changing the Notion of Flossing," *Fashion*, April 10, 2018, https://fashionmagazine.com/beauty-grooming/cocofloss-sisters-dentist-designed, accessed May 6, 2022; Rina Raphael, "How This Unique Tooth Floss Turned a Dull Ritual into a Luxury Treat," *Fast Company*. October 23, 2017, https://www.fastcompany.com/40477295/how-this-unique-tooth-floss-turned-a-dull-habit-into-a-luxury-treat, accessed May 6, 2022; and Jamie Weissman, "Dr. Chrystle and Catherine Cu Created Dental Floss Meant to Make You Smile," *Martha Stewart*, January 20, 2021, https://www.marthastewart.com/8048415/chrystle-and-catherine-cu-cocofloss, accessed May 6, 2022.

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Case

16

Ōura Ring

Pricing

Ōura Health Ltd. is a wellness technology company, best known for its signature product, the Ōura Ring, a smart ring that tracks activity and sleep. The wedding-band-like device collects data using optical heart-rate monitoring. Made of titanium and offered in four finishes, the Ōura Ring fits comfortably on most fingers, but the company recommends wearing it on the index finger to optimize results.

The company was founded in 2013 by Petteri Lahtela, Kari Kivelä, and Markku Koskela. Harpreet Singh Rai was the CEO from 2018 until 2021, when Michael Chapp was appointed to the role on an interim basis. The company is headquartered in Oulu, Finland, with additional locations in Helsinki, Finland, and San Francisco, California.

Ōura gained its initial round of funding in 2015 via a Kickstarter campaign, which it used to develop its first-generation ring. The second iteration debuted in 2018, with a subsequent funding round attributed to Forerunner Ventures, Square, MSD Capital, Marc Benioff, Lifeline Ventures, Metaplanet Holdings and Next Ventures. The third version became available in the fall of 2021, with new features including 24/7 heart rate monitoring, blood oxygen monitoring, and menstrual cycle prediction.

The company uses advanced sensor technology and an app to deliver precise and personalized information to its users; Ōura's sensors "capture the wearer's biometric data at significantly higher frequencies than wearable products from competitors such as Apple and Fitbit" (Chen and Redmen, 2021).

The ring accomplishes this via two sensors that measure skin temperature while simultaneously shining infrared light beams through the skin, capturing changes in the reflected light beams to track respiratory rate, heart rate, and heart rate variability. The Ōura Ring uses these biomarkers to detect movement and track the quality of the user's sleep, posting the results to a branded app.

The app leverages this information to develop and deliver three scores: Sleep, Activity, and Readiness:

- Ōura's Sleep score is very similar to the scores customers can see in other sleep apps, such as Slumber, Calm, and Better Sleep. Like the scores found in those apps, the Ōura result is clear: The more total sleep the wearer gets per night, particularly REM sleep, the higher the score will be. The Sleep score also contributes to factors including sleep efficiency (total time lying down in bed divided by the total amount of sleep recorded) and how aligned the user's sleep is with the sunrise and sunset.
- The Activity score is also predictable: The more the user moves around during the day, the higher the score.
- The Readiness score answers the question, "How ready are you for the day?" Ōura defines Readiness as the "overall picture of the user's health." The score reflects recent activity, sleep patterns and direct biomarkers that can signal that the body is experiencing stress.

As a young company, Ōura has been recognized for its innovation in the field of wearable tech. Their smart ring was included as one of the TIME 100 Best Inventions of 2020 after gaining media attention stemming from its use by NBA players. In 2020, Ōura Health Ltd. received the 'Best Consumer Wellness Company' award from the UCSF Digital Health Awards, and in May of 2021 Ōura announced Series C funding of $100 million from The Chernin Group, Elysian Park, Temasek, JAZZ Venture Partners and Eisai.

The Ōura Ring Gen3 costs between $300 and $400 (depending on the finish); but unlike the earlier models, the new ring requires a $6-a-month subscription. Without the subscription, users have access only to a basic daily Readiness score, with all of the other information being stored behind a paywall in the app. The Ōura Ring lacks the common smart wake-up alarms that other apps offer; those alarms sound when they detect the user is waking during a specified window of time. The launch of this membership model received much criticism from Ōura users who expressed concern over the cost of the membership in addition to the premium price of the ring.

From a pricing perspective, the Ōura Ring is more expensive than many of the top-rated sleep devices and tracking apps. The Go2sleep ring by SleepOn sells for $99 with no additional subscription fees. The Whoop 4 Band and corresponding subscription service is $30 a month with a required one-year commitment. There is the Tempur Pedic Sleep Trackr, an under-mattress tracking device, priced at $349 with no additional fees. Another player in the device market is Biostrap with a minimum price of

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$319 as well as optional subscription services. Looking at the phone application sector, there is the premium version of SleepScore costing $50 per year and the premium version of Sleep Cycle only running $30 annually.

Subscription fees are trending in the wearable fitness tech space, with monthly add-ons becoming the norm rather than the exception (as evidenced by Amazon's Halo subscription band, Fitbit's Premium service, and Apple Fitness Plus). Ōura's subscription fee, according to former CEO Singh Rai, will help fund new health research and app content; and current Ōura Ring owners will be able to buy new rings and use them subscription-free, a move the company recognizes as a bonus for early adopters.

Questions

1. The Ōura Ring is a premium product that offers unique features and is priced higher than the competition. Identify the pricing strategy the company is using. Explain this strategy and discuss why premium products use this strategy so frequently.
2. Former Ōura CEO Harpreet Singh Rai has said that current Ōura Ring owners will be able to buy new rings and use them subscription-free, as a reward for early adoption. Identify the type of pricing strategy he is employing here and explain what it is. Give an example (other than to reward early adopters) of when this strategy might be used.
3. With the Ōura Ring Generation 3, users can get the Readiness score without the monthly fee, but if they upgrade to the subscription, they gain full access to all of the data and health insights the new ring offers. What is this strategy called? In addition to break-even analysis, pricing strategies such as this one incorporate what kind of considerations?

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Case 17

HubSpot, Inc.

Transforming the Marketing Model

Brian Halligan and Dharmesh Shah, the founders of HubSpot®, met at MIT in 2004. The company is based in Cambridge, Massachusetts, directly across from the campus where it was first envisioned. Both Halligan and Shah were interested in the transformative impact of the internet on small businesses and were early students of Web 2.0 concepts. After two years of discussions and early work, in June of 2006 the company was officially founded and funded.

The most interesting aspect of the internet's impact on business from HubSpot's perspective is how it has changed the nature of shopping and subsequently the shape of every vendor's sales funnel. Ten years ago, if a company was interested in buying a new product or service, it started by attending trade shows, reading industry journals, and going to seminars to learn more. Early in the process, it would engage directly with key vendors' salespeople, who would provide product information.

Today, that same process looks very different. The potential customer starts by googling relevant keywords. The prospect spends time on each vendor's site, searching Yelp or Google for reviews, perhaps joining an industry discussion group on Facebook or Reddit, and so on. At some point in the decision cycle, the prospect engages the vendor's salespeople directly through email or by text. That first vendor conversation today is much different from the one two decades ago because the prospect often knows as much about the vendor's product as the sales rep does and the prospect is already much more "qualified."

The internet has tended to make every marketplace more efficient. Just as DePop makes the niche market for Off-White suspenders and Balenciaga fanny packs more efficient, the internet is making niche markets for intellectual property law, system dynamics consulting, and food brokerage more efficient. It used to be that the size of a firm's sales force was the key to finding the new customers, but that is not necessarily the case today. The good news for small businesses is that on the internet, it's easier to hide if your business is a sole proprietorship or a large consultancy.

The internet disproportionately favors small businesses, since it enables them to position their niche products so that they are available to everyone who is shopping for them, regardless of the prospective customer's location. HubSpot Inbound Marketing Software helps over 4,000 customers to generate traffic and leads through their websites, and to convert more of those leads into customers. Its vision has been to provide a killer marketing application and provide great advice to small businesses, enabling those companies to leverage the disruptive effects of the internet and "get found" by more prospects.

HubSpot transforms potentially static websites into modern marketing machines that produce the right leads and helps convert a higher percentage of them into qualified opportunities. HubSpot focuses on tools to help the small business owner create, optimize, and promote content; capture, manage, and nurture leads to win more customers; and learn to make smart marketing investments that get results. Some of the tools it provides include social media, blogging, search engine optimization, and content management.

Questions

1. How has the salesperson's role changed because of internet marketing? Consider differences in prospecting and presentation.
2. Do you agree with HubSpot that a prospect is more "qualified" to make purchasing decisions when it uses information found on the internet?
3. How might the salesperson's compensation be different or the same with internet sales versus traditional sales methods?
4. Should a new small business rely solely on internet promotion? What other methods should it use?

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Budgy Smuggler

Case
18

Budgy Smuggler is a family-owned swimwear company that started in Manly, Australia. Manly is a small beach town just north of Sydney. Founded in 2003 by Adam Linforth and several of his friends, the idea for the company began as a joke when some friends scribbled "Budgy Smuggler" on the back of a Speedo-style swimsuit at a backyard barbeque. According to the company's website, enough people found the idea funny to inspire the friends to establish a small website and see if there might be a real market for the quirky suits.

The term *budgie smuggler* refers to a style of swimsuit that is popular in Australia and Europe. Linforth admits that the misspelling in their company name (Budgy vs. Budgie) was unintentional, but the accident wasn't realized until it was too late. Their original product line consisted of various Speedo-style swimsuits with fun, wacky patterns and their signature "Budgy Smuggler" written across the back. Although the company members originally developed the design ideas themselves, their patterns are now mostly crowdsourced by artists, fans, and customers who want to get in on the fun. And while the designs are distinctly whimsical, the key element that differentiates Budgy Smuggler's products from those offered by its competitors is its market positioning. Linforth states, "While other brands were focusing on people with perfect physiques, we made it our mission to focus on ordinary people of all shapes and sizes." The company really aims to serve the "regular person," and that can be seen in all aspects of the brand's image.

It has been a priority for Budgy Smuggler to include and support Aboriginal, or Indigenous, People in Australia; and as an extension of that commitment, the company has intentionally invited emerging Australian Aboriginal artists to develop designs. These artists retain ownership of their work, and they earn a royalty on the sale of each suit featuring their pattern. The company also serves as a co-host for the event, Strut the Streets, and through that has raised more than $250,000 for the Australian Indigenous Mentoring Experience (AIME). In addition to its work with Australia's Aboriginal People, Budgy Smuggler is involved with charities that promote both mental health and men's health issues.

Beginning in 2009, Budgy Smuggler introduced a woman's line dubbed "Smugglettes." Originally, this line included only a basic bikini and racing one-piece; however, since then, the company has grown this market and developed additional options for its female customers.

The company offers a product line for children, too, that features boys' and girls' swimsuits and long-sleeved swim shirts. Accessories comprise everything from dog rashies, to face masks, underwear, T-shirts, bucket hats, towels, and socks. Beyond Budgy Smuggler's standard options, customers can create their own product by inputting their design on the website. As with the men's line, the company has continued to focus on inclusivity and has worked to create designs for all shapes, sizes, activities, and ages.

In Budgy Smuggler's early days, Linforth had the ambition of "taking over the world" with his business—and as soon as possible. But after speaking with mentor Andrew Rich, he decided to focus on and prioritize building local demand and a brand with a reputation for high quality. Only after accomplishing both did Budgy Smuggler expand internationally. While continuing to manufacture 100 percent of its products in Australia, in 2016 the company established a London-based operations center to allow for overnight shipping for its European customers. By continuing to manufacture its products exclusively in Sydney, Linforth believes that the company is both investing in its commitment to quality and ensuring that its suits remain a true symbol of Australia. In an interview, Linforth stated that "making the products in Australia is a core part of the brand," and he believes that, as the country's national swim costume, Budgy Smuggler suits are quite literally a "piece of Australia."

Before its international expansion, the brand's largest export markets were in Europe. But that is changing as Budgy Smuggler now ships worldwide every day to markets that include the United States, South Africa, Hong Kong, Canada, and New Zealand. And although it competes head to head with larger brands, such as Zara and TopShop, Linforth believes Budgy Smugglers' "uniquely Australian value proposition" will continue to differentiate the company as it pursues the goal of "having a Budgy Smuggler suit on every beach in the world."

Questions

1. Recall that Budgy Smugglers' products are 100 percent made in Sydney, Australia, despite options to

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reduce costs by manufacturing elsewhere. Knowing this, which basic force (or forces) do you believe best represent(s) the company's motives for global expansion? Why?

2. As a company grows and demand for its products expands, the increased product volume allows for greater efficiency and sometimes cost cutting. Identify what this benefit is called, explain what it is, and discuss how it relates to international expansion.
3. Adam Linforth and his co-workers learned many lessons when starting Budgy Smuggler that later allowed them to improve and continue to grow. For example, Linforth came to believe that before expanding internationally and "taking over the world," he needed to build a strong local presence and generate demand closer to home first. This strategy laid the foundation for the company's international expansion plan, but perhaps it was not optimal for the company. Was this a wise strategy, or do you believe it slowed down the eventual expansion of the business? Build a case for both strategies and determine which option is most compelling.

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Andrew Mason and Groupon

Case 19

> *After four and a half intense and wonderful years as CEO of Groupon, I've decided that I'd like to spend more time with my family. Just kidding—I was fired today.*

With these words, predictably flippant in their tone, Andrew Mason stepped down from his position at the helm of Groupon, the deal-of-the-day company that sells coupons for deeply discounted goods and services to customers who must get others to buy them, too, before they all can use them. Mason will always enjoy the distinction of having founded what became the "Fastest Growing Company Ever," to quote *Forbes* magazine. But Isaac Newton could have directed his words as aptly to Groupon as he did to gravity: What goes up apparently must come down.

So how did things go so horribly wrong? It may have been Mason's playful behavior that established the culture at the company that seemed to serve it so well for so long. He clearly had a reputation for being something of a goofball, often coming off more like a big kid than the leader of a major new firm with a multi-billion-dollar market value. These antics might have been seen as cheap entertainment while the company was growing, but when sales began to decline and the firm's stock price retreated, Mason's offbeat style and the company's fun-focused atmosphere suddenly became less than amusing.

It also didn't help that Mason had no significant business experience prior to starting Groupon. The music-major-turned-software-developer stumbled onto the idea for the company and became its CEO almost by default. And it showed. With his often-rumpled appearance and strong leaning toward all things wacky, he seemed more intent on promoting the company's comical vibe than on actually making the business work. Mason fashioned Groupon into a lively place to work, where the dress code and vacation policy were loose, and comedians wrote ad copy and served in customer support roles. But this was just the tip of the iceberg. Making the fun last at Groupon was very serious business.

And then there were the problems with the company's business model. Consumers didn't like the forward planning required to take advantage of its offers—that is, the need to buy a deal in advance, print it out, redeem it in time, and so on. Participating vendors also had complaints. If a deal ended up being a smash hit with subscribers, the merchant could very well be flooded with more customer demand than it could handle. And because the deals featured steep discounts in order to get new customers to bite, they could be expensive to offer. Many vendors quickly noticed that they were getting a lot of bargain hunters coming through their doors but few continuing customers, so as a result, they started to cool to the idea of signing up for more offers.

The extraordinary pace of change at the company was also creating serious headaches for Mason. The tempo of innovation was so fast and so furious that management struggled to keep up, which generated its share of conflict. One observer described the situation this way: "The size and complexity of Groupon grew so quickly that it outpaced the rate of maturity of the organizational culture—much like a gangly, pimply teenager [who] grows to 6 feet tall."

Finally, there were concerns about Mason's struggle to relate to some of the employees. Many respected his grasp of Web technology and keen product development prowess but recognized that he wasn't much of a people person and often failed to appreciate employees in roles that were vital to the company and its success, most notably sales. For example, there were at least five layers of bureaucracy between Mason and the company's sales staff, causing a disconnect between the two and leading some to believe that he probably would have preferred to have had fewer salespeople and the headaches that naturally go along with them.

Despite the problems, the firm did have something going for it; at least Google thought so. The online-search giant reportedly made an offer to buy the business for approximately $6 billion in December 2010. The two sides negotiated for weeks, but Mason, figuring the deal wasn't sweet enough, decided to walk away. It was at this point that observers seriously began to question his business judgment and his ability to lead such a large enterprise. But Mason stood by his decision:

> *Life is not about money. . . . The reason that we made a decision to be an independent company is we quite simply wanted control of our destiny. We wanted the ability to make big bets and take smart risks and go after what we saw as a big opportunity.*

The shortsightedness of Mason's decision is now very apparent, but life offers very few "do-overs."

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Mason's rejection of Google's offer was only the beginning of his slide at Groupon. The chorus of questions about his ability to lead such a large and growing business was about to grow much louder. In June 2011, Groupon filed for an IPO (an initial public offering, allowing shares of the company to be sold to the general public) and raised $700 million in the process. But this focused an intense spotlight on the firm and how it was being managed. Suddenly Mason's "incessant jokiness" was no laughing matter for government regulators and investors. His college-kid-like demeanor raised doubts about his suitability to lead a publicly traded firm. One business writer recounts an episode that occurred during a series of presentations given to raise interest in the IPO that certainly lifted more than a few eyebrows:

> *Between meetings with bankers, Mason, a self-professed video game junkie, played a game called Whale Trail on his iPhone. In the game, the player navigates a cheerful flying whale named Willow through a psychedelic sky while trying to gobble rainbow-colored bubbles and avoid black clouds that do the bidding of the evil Baron Von Barry.*

Mason explained his behavior by saying that the game was great "for just tuning out," adding with a laugh that iTunes had just listed it as "one of the best games for four- to six-year-olds." That's not exactly what investors want to see in the CEO who is running their business.

In the wake of the IPO, Groupon's financial difficulties escalated. After the company posted a net loss of $67 million, the firm's stock took a tumble, from a peak of around $31 to a low of $2.63 in November 2012. It eventually settled at $5 per share, but by that point, the company had lost around 75 percent of its IPO value. And as a telling sign of investor sentiment, the price bounced up by nearly 12 percent when news of Mason's firing was finally announced.

Before being forced out as CEO, Mason was already moving the company away from the daily-deal business and toward the creation of what he was calling an "operating system for local commerce." This software platform would allow customers to turn to Groupon as a source of information to guide their search for products, services, and the lowest prices for both. Merchants could use the system to advertise their offerings, as well as use it as a touchpoint for the sales they made and as a hook for pulling customers back for more business. It was an ambitious project, leading some investors to further question Mason's wisdom and business acumen—even *after* his departure from the firm. They came to think of Groupon as a public company that was in desperate search of a business that just might pull it out of its sticky situation. Also, there was a concern that existing competitors would challenge the company on its planned path for recovery. These included powerhouses like OpenTable (which dominates online restaurant reservations), customer loyalty program providers (such as American Express, Visa, Citibank, and Amazon), Google and PayPal (with recently expanded offerings for local merchants), and Square (with its suite of software that reduces the transaction costs and hassles for small businesses). Finding a competitive opening in such a crowded marketplace would not be easy.

While the Groupon story did not have a happy ending for Mason, it provides important lessons about entrepreneurial leadership. As one writer put it:

> *Andrew Mason has his own kind of panache. Not the epic, Steve Jobs panache. Or the eclectic, Barry Diller panache. Or even the oafish, Steve Ballmer panache. But as CEO of one of the fastest-growing startups in history, he had the small-scale, misfit quirkiness of an indie movie. Panache-ette.*

Without a doubt, the story is unique. But to be fair, Mason's distinctive leadership style and the company culture that it engendered may have been both Groupon's greatest advantage and the very anchor that eventually pulled it nearly under.

It bears mentioning that Mason's fitness for entrepreneurial endeavors has been lived out in post-Groupon start-up exploits, including the launch of a mobile app business that supports location-aware audio walks called Detour.com, as well as his accepting a leadership role in 2017 as CEO of Descript.com, an all-in-one audio- and video-editing venture. However, there is no getting around the fact that the playful and giddy style that Mason personified during Groupon's meteoric rise to greatness did not endear it to the Wall Street players who laid a heavy hand to the rudder of the publicly traded company. That's the way the game is played as ventures grow and develop, and some entrepreneurs are simply not suited to be a part of that world. Perhaps Andrew Mason is one of them.

Questions

1. How would you describe the leadership skills of Andrew Mason? How would you rate his leadership style? In what ways does he fit the profile of the typical business founder? In what ways is he different?
2. Assess the organizational culture at Groupon. What are its strengths and its weaknesses? What changes would you make to the culture to improve the performance of the company?

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3. Do you think that it was because of Mason that Groupon was unable to transition smoothly through its growth and development stages, or can you identify other possible causes?
4. What kind of leader do you think would be best suited to run Groupon? Create a profile of its ideal leader. Then create a profile of the ideal leader of a technology start-up, and compare the two. What would you recommend as a plan for developing leaders of start-ups into leaders who are well equipped to manage large but still-entrepreneurial firms?
5. In your opinion, what are some of the other problems at Groupon?

Sources: Alex Blumberg, "The Super-Quick Rise and Even Faster Fall of Groupon," *New York Magazine*, October 10, 2018, https://nymag.com/intelligencer/2018/10/andrew-mason-on-groupon.html, accessed May 10, 2022; "Hey Groupon, Can You Spare Some Culture Change?" *Chicago Brander*, August 24, 2012, https://chicagobrander.com/tag/groupon-culture, accessed May 10, 2022; Eric Jackson, "Source of Groupon Problems: Managing People," *Forbes*, August 14, 2012, https://www.forbes.com/sites/ericjackson/2012/08/14/source-of-groupon-problems-managing-people/?sh=69ffc5fe7371, accessed May 10, 2022; Noah Kirsch and Michela Tindera, "Groupon Made Eric Lefkowsky a Billionaire – His Cancer-Fighting Startup Is Worth Far More," *Forbes*, July 31, 2019, https://www.forbes.com/sites/noahkirsch/2019/07/31/eric-lefkofsky-cancer-tempus/?sh=7e48123f31b7, accessed May 10, 2022; Joan Lappin, "Don't Cry for Groupon's Andrew Mason," *Forbes*, March 5, 2013, https://www.forbes.com/sites/joanlappin/2013/03/05/dont-cry-for-groupons-andrew-mason/?sh=12067ca151b2, accessed May 10, 2022; "Andrew Mason," LinkedIn, https://www.linkedin.com/in/andrewmason, accessed May 10, 2022; Laura Montini, "Groupon Ex-CEO Andrew Mason: Why Perfection Gets You Nowhere," *Inc.*, March 3, 2015, https://www.inc.com/rebecca-deczynski/small-business-administration-small-business-person-of-the-year-bright-futures-jill-scarbro.html, accessed May 10, 2022; Brad Plumer, "Groupon's CEO Writes the Best Resignation Letter Ever," *The Washington Post*, March 1, 2013, https://www.washingtonpost.com/news/wonk/wp/2013/03/01/groupons-ceo-writes-the-best-resignation-letter-ever, accessed May 10, 2022; Mary Ellen Podmolik, "10 Years Ago, Groupon Turned Down Google's $6B Offer. Here's What's Happened Since," *Chicago Tribune*, December 3, 2020, https://www.chicagotribune.com/business/ct-biz-groupon-google-anniversary-20201203-i7euppwfnnfytkozr4dyp43qlq-story.html, accessed May 10, 2022; and David Streitfeld, "Groupon Dismisses Chief After a Dismal Quarter," *The New York Times*, March 1, 2013, p. B1.

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Case 20

Jason Fried and HR Practices at Basecamp

Intentional Selection and Managing for Results

It takes excellent people to build a great company.

Since launching the Chicago-based applications company in 1999 that today is known as Basecamp, Jason Fried, its co-founder and president, has developed a careful and deliberate approach to finding and managing people for his company. Why is he so intentional in his hiring? “Hiring people is like making friends,” asserts Fried. “Pick good ones, and they’ll enrich your life. Make bad choices, and they’ll bring you down.” This view makes sense. As Fried argues, the people you work with are actually more important in some ways than your friends, since you will spend much more time with your workmates.

The company has a deliberately small staff of 34, and it works hard to keep them happy. After 23 years in business, the rate of employee turnover has been very low—especially considering the dynamic industry in which Basecamp must operate. Competition for the limited pool of technical staff is fierce, which makes job-hoping the norm.

To be sure, the company has hit a few bumps on the road to figuring out how best to manage its human talent. Perhaps the most public of these was in 2021 when Fried and his partner in the business announced a new policy that banned political discussions at the office. They found such talk to be a workplace distraction that cut into employee productivity. Some of Basecamp’s staff strongly disapproved of the decision, so Fried allowed any employees who disagreed with the new policy to leave with six months of severance pay. Some one-third of Basecamp’s staff did exactly that—or at least declared that they would. But despite this notable HR hiccup, the company continues to be a very popular employer.

Fried’s hiring method has served Basecamp well, but some of his methods clearly lean toward the unorthodox. For example, he hires late (only “after it hurts”) and never before a new employee is needed. He won’t even hire “the perfect catch” if he doesn’t have “the perfect job” open for that person. Invent a position to keep a talented person from getting away? Never! And Fried won’t hire for a job he has never performed himself. In his mind, there is no way to find the right person for a job if you don’t understand the position on a deep level.

Fried’s approach to evaluating job candidates is also a little out of the ordinary. Résumés are ignored most of the time. “They’re full of exaggerations, half-truths, embellishments—even outright lies.” Cover letters are given extra weight, because they reveal who wants the specific job being offered, and not just any job, and they also show who can write well. “When in doubt, always hire the better writer,” Fried suggests. He bases this on experience: “Every time we’ve been hesitant about someone, their skills have been great but they weren’t good writers, it turned out that we probably shouldn’t have hired them.” And during interviews, Fried listens carefully for signs of self-initiative. He reasons that candidates who ask, “How do I do that?” or “How can I find out this or that?” often are not used to figuring things out for themselves and thus would be a drain on others. On the other hand, Fried likes it when a candidate asks, “Why?” He interprets this as “a sign of deep interest in a subject” and “a healthy dose of curiosity.” Details can make a huge difference.

Even if all indications are positive, Fried still chooses to go slow. “We . . . try to test-drive people before hiring them full time. We give designers a one- to two-week design project to see how they approach the problem,” paying them a competitive stipend for their time. Fried sometimes extends the project into a month-long contract “to see how we feel about the person and how the person feels about us.” The point is to avoid hiring mistakes that would be bad for the company and unfair to the candidate.

Looking forward, many small businesses are realizing that it is becoming increasingly difficult to find the workers they need—especially if they prefer to hire very carefully, like Fried. Many are figuring out how to get by with fewer workers, perhaps because they have no choice. Some are turning to flexible management practices, like cross-training employees, hiring temporary workers on an as-needed basis, or forming outsourcing partnerships to adjust to fluctuations in market demand. And because of modern economic realities, these challenges continue to escalate. As one sign of the times, Fried explains that working with remote staff is here to stay: “At some point, if you want to find great talent, you’re going to have to look outside the walls of your city [because] there are great people everywhere, all over the world. Amazing people.”

What business doesn’t want to hire “amazing people”? So, one way or another, the small business show must go on, and that means having the right people on board when you need them. In the future, that may be far easier said than done.

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Questions

1. Do you think Fried's hiring methods are reasonable? Will they lead to good hires for his growing company? What are the best features of his approach (if you believe there are any)?
2. Do you think it is a good idea for Fried to take a pass on "perfect" candidates because he doesn't have an attractive job open for them at the moment? Is it smart for Fried to let talented candidates get away by refusing to create more suitable positions to keep them?
3. If Fried were to use the behavioral interview format described in Chapter 20, what kinds of questions might be especially helpful, given what you know of the types of people he prefers to hire?
4. Do you agree with the view that working with remote staff will be necessary for small businesses that want to hire highly capable employees? On what do you base your view?
5. What recommendations would you have for Fried regarding his human resource management practices in general?

Sources: Jason Fried, "The Importance of Hiring Late," BigThink.com, https://bigthink.com/videos/the-importance-of-hiring-late, accessed May 11, 2022; Jason Fried, "Never Read Another Resume," *Inc.,* https://www.inc.com/magazine/20100601/never-read-another-resume.html, accessed May 11, 2022; Jason Fried and David Heinemeier Hansson, *Rework* (New York: Crown Publishing, 2010); Jason Fried, David Heinemeier, Andrea LaRowe, Kristin Aardsma, and Jeremy Daer, "Hire When It Hurts," *The Rework Podcast*, June 16, 2019, https://www.rework.fm/hire-when-it-hurts, accessed May 10, 2022; Sarah Kessler, "A Third of Basecamp's Workers Resign after a Ban on Talking Politics," *The New York Times*, April 30, 2021, https://www.nytimes.com/2021/04/30/technology/basecamp-politics-ban-resignations.html, accessed May 11, 2022; Matt Mullenweg and Jason Fried, "Jason Fried on Treating Workers Like Adults," *Distributed*, January 9, 2020, https://distributed.blog/2020/01/09/episode-18-jason-fried-on-treating-workers-like-adults. accessed May 10, 2022; Matthew Turner, "6 mistakes smart people make when hiting a virtual assistant," *Entrepreneur*, September 13, 2017, https://www.entrepreneur.com/article/300151, accessed May 10, 2022; and "We are Basecamp!" https://basecamp.com/about, accessed May 11, 2022.

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Case

21

Schoneman Jewelers

Managing Operations for Customization and Efficiency

"Welcome to Schoneman Jewelers," came the greeting as the young couple stepped into the Castle Rock, Colorado, jewelry store. "May I help you?"

"Well, actually, I'm just here to browse some with my fiancée," was the response—and a somewhat uncomfortable one at that.

"Oh! So, you two are getting married. Congratulations! That's wonderful! My name is William Schoneman. My wife Sarah and I own the store. Can I ask your name?" he continued as he extended his arm to shake hands.

"Hello, William. My name is Kristen, and this is my husband-to-be, Ben."

"A pleasure to meet you both," Mr. Schoneman said, and then added, "We always like to have visitors, so please feel free to look around and let me know if I can help you with anything."

At that point he walked behind the counter so as not to hover, but then added, "Can I get either of you something to drink while you browse?"

"No, thank you," responded Ben as he took notice of a beverage center and comfortable leather chairs in the back corner of the store. Kristen and Ben continued checking out the displays of engagement rings as William gave them space.

After about 10 minutes had gone by, Ben approached Mr. Schoneman and said, "Hey, I noticed your big, high-definition screen showing that rotating wedding ring. Wish I had something like that for a television at my house. What is that about anyway?"

"It's for a 3D software system that allows clients to co-design their own ring," Mr. Schoneman explained. You can pick out your choice of diamonds or other jewel stones and then mount them on any ring you want. Once the entire ring design is finalized, our manufacturer can then produce it. Our clients can have their own unique piece of jewelry that way. It makes quite a statement, actually."

"That sounds great! Can you show us how it works?" an eavesdropping Kristen asked Mr. Schoneman.

"It would be my pleasure," he responded. "Please have a seat and I will give you both a quick demonstration." At that, the three of them began to design a prototype ring with Mr. Schoneman asking a lot of questions and getting the couple's input. It was clear that he was beginning to establish a more friendly connection with Kristen. Ben was quite a bit slower to warm up to him, but it seemed he might be coming around, too.

"All of the ring designs can be stored on the computer for future reference," added Mr. Schoneman. "That's important because your ideas about what would look best can take time to come together."

Mr. Schoneman went on to explain how diamonds became a symbol of social status and wealth in India about 3,000 years ago. De Beers, a diamond mining and production company, began to market diamonds in the 1900s with slogans like, "A diamond is a girl's best friend," and, "A diamond is forever." One modern De Beers' ad stated, "She already knows you love her. Now everyone else will, too." A century of advertising and branding had shaped public thinking to the point to where the diamond has come to be seen as a symbol of "eternal love."

While Mr. Schoneman and Kristen exchanged ideas about alternative ring designs, Ben interrupted momentarily to ask what time it was. "It's almost 3 p.m.," Mr. Schoneman reported. "About what I figured. Whew, I need a break," Ben responded as he stood up from his chair. Everyone chuckled at his comment. "OK, I'll hurry—I promise," Kristen said as she glanced over at Ben for a moment. Her fiancé walked around the store for a few minutes and then sat back down to reenter the "design your own ring" conversation. He actually found it difficult to stay out of the discussion because the process was turning out to be very interesting.

But by 4 p.m., everyone was starting to feel exhausted. The group had already worked through a number of ring-design questions, answers, and what-ifs. However, by that time Mr. Schoneman and Ben had gotten a much better idea of what Kristen wanted in an engagement ring. Two ring designs had already been worked up and stored on the computer, so good progress had clearly been made.

"I'll have my daughter Rachel work on these designs a little more," Mr. Schoneman said. "I am good with the software, but she's the true CAD expert. And she will call our diamond and ring dealers in New York and make sure what we have designed can be manufactured at your target price," he continued. "Well, I wouldn't say I'm an expert, actually," chimed in Rachel, who was standing nearby and overheard the conversation. "But I will be more than happy to help in whatever way I can. I love working with customers on a custom design because what we come up with in the end will forever be a part of them."

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"Thank you, Rachel," responded Kristen, who turned quickly back to Mr. Schoneman and interjected, "Before we go, can you tell me what you mean by 'CAD'?"

"That will take some time, and Ben is probably about worn out for the day," Mr. Schoneman said with a chuckle as he glanced over at the waiting fiancé. Ben grinned back and indicated that hanging around a little longer would be worth it if they could learn more. Apparently he had the same question.

"OK, let me give you the short version," began Mr. Schoneman. "CAD is shorthand for computer-aided design." He went on from there to explain that since the 1970s, CAD and other related digital tools, like computer-aided-engineering and computer-aided manufacturing, have been enabling corporations to design and manufacture a wide variety of items, such as industrial parts, buildings, furniture, landscapes, and kitchens. Today, many firms have achieved complete integration of their design and production functions into what we now call computer-integrated systems. Technicians can conceive, analyze, test, and simulate product design options before they are physically created, and then actually go on to manufacture them as tangible products—even very sophisticated ones like Boeing's 777 Dreamliner jet aircraft. To make these systems even more useful, 3D CAD and 3D printing are expanding the frontiers of designing plastic parts, such as gears, toys, and heart values, so they can be immediately put to use.

After this very brief introduction to CAD applications, Mr. Schoneman promptly transitioned to a description of what these new technologies mean for clients who are interested in the kinds of products that are offered at Schoneman Jewelers. He explained that CAD technology had made its way into the design of custom jewelry in recent years, both online and in stores. The customer and CAD specialist can go through a step-by-step, computer-led method to co-design rings and other jewelry, just as he had been doing with Kristen and Ben. Of course, Mr. Schoneman had already been discussing with the couple that the process they were following to create a wedding ring for Kristen had factored in decisions about the size, clarity, color, cut, price, and shape of the diamond to be figured into the design. Included in their earlier conversation had been other questions about the setting, such as whether to work from a single gold band of a certain thickness or something more complicated, as well as thinking about the matching prongs needed to hold the diamond securely in place.

The couple had already seen for themselves that once a CAD-designed ring is assembled on screen, it can be rotated visually to see how it would look from any angle—even presented on a virtual male or female hand. Because various design options are stored in the computer, they can be compared side-by-side on the high-definition screen. And, of course, alternative ring designs can be emailed to friends and family worldwide to get their input.

"Thank you for taking the time to explain all of this to us," responded Kristen. "I love jewelry, but I had no idea that the business of creating and selling rings would be so advanced and interesting. But because I love this guy so much," she turned and smiled at Ben, "I guess we really should be going."

"Of course," responded Mr. Schoneman. "All things in their time. And I'm sure we will have plenty of opportunity to discuss other aspects of what we do here when you come back to see the more-polished results that Rachel works up for you. She really has a gift when it comes to using technology."

With that, they all stood up and prepared to part ways.

"Mr. Schoneman," Ben asked as he started to walk toward the door, "Why is your inventory so much lower in price? Is it because of this custom design capability?"

Mr. Schoneman replied with a positive nod, "Yes… definitely. Stocking lots of diamonds and jewelry at a store can be a risky venture. By using the 3D/CAD system, I think we do a better job of matching our physical inventory to customer needs and jewelry trends. This means that we have quite a bit less security, loan, and insurance risk by using CAD. And as a bonus, customers seem to really enjoy designing their own unique jewelry."

As Kristen and Ben were about to leave the store, they thanked Mr. Schoneman and Rachel for their help. By a quirk of timing, Mr. Schoneman's wife, Sarah, arrived at just that moment and was preparing to enter the store, so they were all introduced. There was no missing the fact that Schoneman Jewelers was a true, one-store family business.

Kristen and Ben walked across the street to a restaurant and discussed their first computer-aided engagement ring design experience. Kristen was excited about the prospect of having a one-of-a-kind ring—so much so that she couldn't quit talking about it. Ben listened quietly as he sipped a Coke and started into his burger and fries, which he considered a fitting reward for his patience that day.

It took three more visits to Schoneman Jewelers before the final ring design was ready for the grand unveiling. It met with everyone's delight! Rachel and Mr. Schoneman carefully went over every aspect of the design to make a few final tweaks. For example, the CAD system allowed Kristen and Ben to see several prong options, in gold and platinum, that could be selected to hold a yellow diamond. After this, once Kristen and Ben were confident that everything about the ring was as they wanted it to be, they made the necessary payment with their credit card, and the final ring design was sent electronically to the jewelry manufacturer in New York.

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One month later, Schoneman Jewelers called Kristen and Ben to let them know that the engagement ring they helped to design was finished and ready for pick up. Within minutes, the couple was in the car and on their way to catch their first look at the final product. When they had arrived and entered the store, all three Schonemans were there and greeted Kristen and Ben by name.

"Are you ready to see your ring?" Rachel asked in an excited voice.

"Are you kidding?" gushed Kristen, "I feel like I am ready to burst!"

Mr. Schoneman motioned for Ben to come to the back room where special jewelry items were kept secure. He unlocked the safe and passed the ring to Ben. "Can we put it in something to make it look really special?" the groom-to-be inquired. "You bet," replied Mr. Schoneman, as he handed him a him a beautiful black velveteen keepsake box. Ben placed the ring neatly in the box, closed it, and then walked into the storefront. When he got to where Kristen was, he gave her a kiss on the cheek, and handed her the box. She opened it at once to see the ring, which danced with brilliance in the store's crisp lighting. "I love you, sweetheart," whispered Ben. "Oh! It is so perfect," gushed Kristen as she hugged Ben tightly. Everyone present was moved by the moment. Any other response simply would not have been fitting.

Mr. Schoneman then said caringly, "We have some other presents for you." At that, he gave Ben a bottle of champagne and handed Kristen a small picture album that summarized how the ring was designed and manufactured, step by step. It showed a 3D line drawing of the ring, a wax model of the ring that was used in production, the raw casting with platinum and gold prongs without the diamonds, and finally the complete ring from several viewpoints. The couple thanked everyone, spent a few moments in excited conversation, and then left the store. They drove across town to their favorite restaurant to celebrate their memorable experience. Kristen almost didn't get around to eating; she was too busy staring at the ring and taking in the way it stood out on her finger. "I mean it, Ben," she gushed. "It couldn't be any more perfect! It's so beautiful!"

Questions

1. Chapter 21 mentions that small businesses can use operations management to compete effectively against their rivals. In your opinion, is Schoneman Jewelers using its operations effectively to contend with competitors and expand its business? What suggestions would you have for the Schonemans to sharpen their operations and be even more competitive?
2. How would you describe the inventory management practices that the Schonemans are following? The case focuses on the co-design process that Kristen and Ben chose to use, but you are probably at least somewhat familiar with the typical inventory needs of jewelry retailers, and you can assume Schoneman Jewelers has to operate a significant part of their business in the same way. What do you think the company could do to meet the basic objectives of inventory management, as outlined in the chapter, and perhaps control inventory costs even better?
3. If "retail is detail," how well is Schoneman Jewelers doing in serving its customers? What kinds of measurements would be helpful to ensure the successful operation of the business? How easy would it be to gather appropriate measures to assess the quality of its operations?
4. Lean production principles can be used by businesses of any size to squeeze out waste from operations. What possible sources of waste might Schoneman Jewelers be overlooking in its operations? What would you recommend that the family do to address these forms of waste?

Sources: This case is based on industry research and provides an accurate representation of practices followed by jewelry retailers as they employ new technologies to serve their clients. However, though it is a realistic composite of true business experiences, it does not depict those of any specific company.

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Martin Distribution, Inc.

Managing a Firm's Working Capital

Case
22

Brothers David and Jess Martin are the owners of Martin Distribution, Inc., with locations both in Dallas and Austin, Texas. The firm sells high-tech lighting systems to commercial customers and services the systems. Although the business has operated successfully since the Martins founded their company, it continues to experience working-capital problems.

Martin's Financial Performance

The firm has been profitable since its founding. In fact, profits for 2021 were the highest for any year to date. Exhibit C22.1 shows the income statement for the year ending December 31, 2021.

The balance sheet as of December 31, 2021, is presented in Exhibit C22.2. Note that the firm's total debt now exceeds the owners' equity. However, $10,737 of the firm's liabilities was a long-term note payable to David and Jess. This note was issued at the time the company was founded, with payments going to the Martins.

Martin's Cash Balance

Martin currently has a cash balance in excess of $28,000. The owners have a policy of maintaining a minimum cash balance of $15,000, which allows them to "sleep well at night." Recently, Jess has thought that they would still be able to "breathe comfortably" as long as they kept a minimum balance of $10,000.

Martin's Accounts Receivable

The accounts receivable at the end of 2021 were $56,753, but at times during the year, receivables could be twice this amount. These accounts receivable were not aged, so the firm had no specific knowledge of the number of overdue accounts. However, the firm had never experienced any significant loss from bad debts. The accounts receivable were thought, therefore, to be good accounts of a relatively recent nature.

Customers were given 30 days from the date of the invoice to pay the net amount. No cash discounts were offered. If payment was not received during the first 30 days, a second statement was mailed to the customer and monthly carrying charges of 1/10 of 1 percent were added.

On small jobs, the Martins tried to collect from customers when the work was completed. When service representatives finished repairing a system, for example, they presented a bill to the customer and attempted to obtain payment at that time. However, this was not always possible. On major items, such as unit changeouts – which often ran as high as $2,500 – billing was almost always necessary.

On new construction projects, the firm sometimes received partial payments prior to completion, which helped to minimize the amount tied up in receivables.

Martin's Inventory

Inventory accounted for a substantial portion of the firm's working capital. It consisted of the various units, parts, and supplies used in the business.

The Martins had no guidelines or industry standards to use in evaluating their overall inventory levels. They believed that there *might* be some excessive inventory, but, in the absence of a standard, this was basically an opinion. When pressed to estimate the amount that might be eliminated by careful control, David pegged it at 15 percent.

The firm used an annual physical inventory that coincided with the end of its fiscal year. Since the inventory level was known for only one time in the year, the income statement could be prepared only on an annual basis. There was no way of knowing how much of the inventory had been used at other points and, thus, no way to calculate profits. As a result, the Martins lacked quarterly or monthly income statements to assist them in managing the business.

Jess and David had been considering changing from a physical inventory to a perpetual inventory system, which would enable them to know the inventory levels of all items at all times. An inventory total could easily be computed for use in preparing statements. Shifting to a perpetual inventory system would require that they purchase new computer software. However, the cost of such a system would not constitute a major barrier. A greater expense would be involved in the maintenance of the system – entering all incoming materials and all withdrawals. The Martins estimated that this task would necessitate the work of one person on a half-time or three-fourths-time basis.

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Martin's Note Payable to the Bank

Bank borrowing was the most costly form of credit. The firm paid the going rate, slightly above prime, and owed $17,600 on a 90-day renewable note. Usually, some of the principal was paid when the note was renewed. The total borrowing could probably be increased if necessary. There was no obvious pressure from the bank to reduce borrowing to zero. The amount borrowed during the year typically ranged from $10,000 to $25,000.

The Martins had never explored the limits the bank might impose on borrowing, and there was no clearly specified line of credit. When additional funds were required, David simply dropped by the bank, spoke with a bank officer (who also happened to be a friend), and signed a note for the appropriate amount.

Martin's Accounts Payable

A significant amount of Martin's working capital came from its trade accounts payable. Although accounts payable at the end of 2021 were $38,585, payables varied over time and might be double this amount at another point in the year. Martin obtained from various dealers such supplies as copper tubing, sheet metal, electrical wire, and electrical conduit. Some suppliers offered a discount for cash (2/10, net 30), but the Martins felt that establishing credit was more important than saving a few dollars by taking a cash discount. By giving up the cash discount, the firm obtained the use of the money for 30 days. Although the Martins could stretch the payment dates to 45 or even 60 days before being "put on C.O.D.," they found it unpleasant to delay payment more than 45 days because suppliers would begin calling and applying pressure for payment.

The firm's major suppliers used different terms of payment. Some large products could be obtained on an arrangement known as "floor planning," meaning that the manufacturer would ship the products without requiring immediate payment. The Martins made payment only when the product was sold. If still unsold after 90 days, the product had to be returned or paid for. On items that were not floor-planned but were purchased from suppliers, Martin paid the net amount by the 10th of the month or was charged 18 percent interest on late payments.

Shipments from one major supplier required payment at the bank soon after receipt of the products. If cash was not available at the time, further borrowing from the bank became necessary.

Another supplier required net payment without discount within 30 days. However, if payment was not made within 30 days, interest at 18 percent per annum was added.

Can Good Profits Become Better?

Although Martin had earned a good profit in 2021, the Martins wondered whether they were realizing the *greatest possible* profit. The slowdown in the construction industry during 2021 was currently affecting their business. They wanted to be sure they were meeting the challenging times as prudently as possible.

Questions

1. Evaluate the overall financial performance and structure of Martin.
2. What are the strengths and weaknesses in this firm's management of accounts receivable and inventory?
3. Should the firm reduce or expand the amount of its bank borrowing?
4. Evaluate Martin's management of accounts payable.
5. Calculate Martin's cash conversion period. Interpret your computation.
6. How could Martin improve its working-capital situation?

Exhibit C22-1 Martin Distribution, Inc.

Income Statement for the Year Ending December 31, 2021	
Sales revenue	$ 757,679
Cost of goods sold	466,562
Gross profit	$ 291,117
Selling, general and administrative expenses (including officers' salaries)	189,031
Earnings before taxes	$ 102,086
Income tax	17,546
Net income	$ 84,540

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Exhibit C22-1 Martin Distribution, Inc.

Balance Sheet
December 31, 2021

Assets	
Current assets:	
Cash	$ 28,789
Accounts receivable	56,753
Inventory	89,562
Prepaid expenses	6,415
Total current assets	$181,519
Loans to owners	41,832
Autos, trucks, and equipment, at cost, less accumulated depreciation of $36,841	24,985
Other assets	18,500
TOTAL ASSETS	$266,836
Debt (Liabilities) and Equity	
Current debt:	
Current maturities of long-term notes payable*	$ 26,403
Accounts payable	38,585
Accrued payroll taxes	4,173
Income tax payable	13,818
Other accrued expenses	4,001
Total current debt	$ 86,980
Long-term notes payable*	51,231
Total stockholders' equity	128,625
TOTAL DEBT AND EQUITY	$266,836

*Current and long-term portions of notes payable:	**Current**	**Long-Term**	**Total**
• 10% note payable, secured by pickup, due in monthly installments of $200, including interest	$ 1,827	$ 1,367	$ 3,194
• 10% note payable, secured by equipment, due in monthly installments of $180, including interest	584	0	584
• 6% note payable, secured by inventory and equipment, due in monthly installments of $678, including interest	6,392	39,127	45,519
• 9% note payable to stockholder	0	10,737	10,737
• 12% note payable to bank in 30 days	17,600	0	17,600
	$26,403	$51,231	$77,634

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Case

23

ALOHA Collection

The ALOHA Collection was founded by Heather Aiu and Rachael Leina'ala in 2013. A former banker and flight attendant, respectively, the two women claim that their meeting and eventual partnership were pure fate. Both native Hawaiians, they first met in 2009 over a vacant room listing on Craigslist and were later reunited in 2013.

At the next meeting, they discovered both felt unfulfilled with their current day jobs. They decided to start a small business they dubbed the ALOHA Collection. Their brand's mission is "To encourage travel, adventure, healthy and active lifestyles, and to Share the ALOHA." Their company focuses on making water-resistant, lightweight bags, designed specifically for travel or the beach. Their products come in a variety of shapes, sizes, and patterns and have been spotted around the world.

As a flight attendant, Rachael describes having to frequently deal with a wet bikini after long layovers. Her solution was to wrap it in a sarong before her departing flight. Because flight attendants must pack all of their things in a carryon bag, Rachael knew she needed something lightweight and leak-proof to serve as a better solution for her damp bathing suits. Similarly, Heather, a hot yoga enthusiast, needed a solution for storing her damp workout clothes after plastic bags were banned in several of the locations where she attended classes.

As fuel for their business idea, Heather and Rachael agreed to contribute $2,000 each. However, after designing and registering their logo and a trademark, plus developing several prototypes, their initial capital was practically gone. After considering other options for more capital, they decided to launch a Kickstarter campaign.

Kickstarter is a fundraising platform designed to introduce new ideas to communities that will support fledgling ventures. Over 21 million people have funded a Kickstarter campaign, with over 200,000 successfully funded initiatives. Kickstarter is passionate about the fact that there are no corporate strings attached. Entrepreneurs are free to follow their own creativity, and donors feel vested in the success of the project.

Through their efforts on Kickstarter, along with support from friends and family, the two women raised another $6,000, which was enough to fund the production of their first run of bags.

Their Hawaiian heritage is the foundation of their mission and corporate culture, so the ALOHA Collection contributes 5 percent of their annual profits to Hawaiian-based conservation projects. Their primary objective in giving back is to help preserve the cultural heritage and natural beauty of their home. Recipients of the company's charitable giving include the Conservation Council for Hawai'i, Livable Hawai'i Kai Hui, and Kua'aina Ulu Auamo. As a company founded by two women, they are also driven to support service opportunities that empower women all over the globe, as evidenced by their partnership with the YWCA in Kaua'i, where they designed and contributed signature bags in celebration for the YWCA's 100-year anniversary.

Having succeeded in the first step, the founders began evaluating the next phase of growth. For example, expansion plans include a strategic collaboration with the Free People brand. The team also determined that establishing a flagship retail presence in a strategic and symbolic location was an important next step, so they began evaluating the risks associated with leasing a space versus purchasing it. With limited experience in real estate, they decided to lease, and their retail storefront in the popular Moana Surfrider Resort on the busy and touristy Kalakua Avenue in Waikiki opened in 2021.

The ALOHA Collection's original two bags were based on the founders' initial need: storing wet bikinis and hot yoga clothes. They started with just two different pouches; today, they have hundreds of products, 40 employees, and a constantly growing international business. This growth represents an exciting future for the ALOHA Collection, but it also means there are new considerations and decisions to be made about how to protect the business, its employees, and its customers. The founders have said, "It is never going to be perfect. And it's not going to be easy. If someone says no, figure out how to find a yes. Just start and keep moving forward. You will learn from your mistakes."

And while their growth mindset and entrepreneurial approach has served them well as they have gone from a star-tup to an established small business, successfully managing the evolving risks that emerge through the different phases of the company's life cycle will undoubtedly become an increasingly important part of their path to long-term success.

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Questions

1. Was the creation of the ALOHA Collection an example of market risk or pure risk? Why?
2. Understanding that the ALOHA Collection decided to lease their retail store in Waikiki and their warehouse space, are they managing real property, personal property, or a mix of the two? What kind of risks are associated with this kind of property that company leaders will need to consider?
3. The founders of the business have been critical to the brand's launch, growth, and success. Understanding how fundamentally tied they are to the company and how difficult they would be to replace, what kind of insurance might be important for the company consider? Why? Who purchases the insurance and who is the beneficiary of it?

Sources: Kait Hanson, "How a Flight Attendant and Banker Met on Craigslist and Created a Million-Dollar Brand," *Today*, September 9, 2021, https://www.today.com/tmrw/how-flight-attendant-banker-met-craigslist-created-million-dollar-brand-t229037; Brian McInnis, "Aloha Collection Opens First Brick-and-Mortar Store," *Pacific Business News*, August 5, 2021, https://www.bizjournals.com/pacific/news/2021/08/04/aloha-collection-moana-surfrider.html; "About Us," https://aloha-collection.com/pages/about-us; Brie Thalmann, "Free People Tapped Aloha Collection to Create These Sporty Chic Beach Bags," *Honolulu* magazine, March 18, 2019, https://www.honolulumagazine.com/free-people-tapped-aloha-collection-to-create-these-sporty-chic-beach-bags/

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